AFU08605

ADVANCED FINANCIAL REPORTING II

AFU08605: ADVANCED FINANCIAL REPORTING 2

- 1.2.1 Use IAS 19 to record transactions relating to employees' benefits
- 1.2.3 Apply IAS 29 to adjust accounts and reflect changes in price levels in hyper inflationary economies
- 1.2.4 Apply IFRS 9 and IFRS 7 to account for Financial Instrument
- 1.2.2 Apply IFRS 15 to account revenue from contracts with customers
- 1.2.5 Apply IAS 24 to account related party disclosure
- 1.2.6 Apply IAS 41 to account for agriculture
- 1.2.7 Apply IFRS for SMEs to record business information

Course Assessment

- Test 20%
- Assignment(s) 16%
- Quiz/tutorials/ Lectures 4%
- Final Exam 60%

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Topic 1: IAS 19 EMPLOYEE BENEFITS

1.2.1 Use IAS 19 to record transactions relating to employees' benefits

17.1 INTRODUCTION

- While accounting for wages, salaries and other short-term benefits is relatively straightforward, post-employment benefits can be more troublesome
- All benefits provided to employees, both ST and LT, should be accounted for to ensure that an entity's financial statements reflect a liability when employees have worked in exchange for future benefits
- The objective of IAS 19 *Employee Benefits* is to specify the accounting and disclosure requirements for employee benefits
- IAS 19 applies to an employer in accounting for employee benefits (except those for which IFRS 2 *Share-based Payment* applies and employee benefit plans under IAS 26 *Accounting and Reporting by Retirement Benefit Plans*) (*See Chapter 34*)

INTRODUCTION

- Employees receive a variety of benefits in return for providing services to their employer. Some benefits are received from the employer almost immediately the services are performed eg wages and salaries. Some, such as an annual bonus, are determined and paid after the year-end. Others, such as pensions, are not paid until many years in the future when the employee retires.
- One thing these benefits have in common is that they are a cost to the employer and this cost should be recognised as the benefits are earned or accumulated by the employee.

OBJECTIVES

- On completing this module you should be able to:
- apply the provisions of IAS 19 in accounting for short-term employee benefits;
- identify the key features of defined contribution and defined benefit pension plans;
- apply the provisions of IAS 19 in accounting for defined contribution and defined benefit plans;
- describe the principal disclosure requirements relating to post-employment benefit plans;
- describe and apply the requirements of IFRS 2.

IAS 19 *EMPLOYEE BENEFITS*

IAS 19 addresses:

1. Short-term employee benefits
2. Post-employment benefits (defined contribution and defined benefit)
3. Other long-term employee benefits
4. Termination benefits

Fundamental principle

- Recognise:
  - A liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
  - An expense when the economic benefits arising from service provided in exchange for employee benefits are consumed

Short-term employee benefits

- All forms of consideration in exchange for services rendered by employees that are payable within 12 months of the service being rendered (other than termination benefits)
- Examples include wages, salaries, paid holidays, sick leave and bonuses payable within 12 months of the service being rendered
- Should be recognised as service is rendered

Short-term employee benefits

Includes:

- **wages, salaries and social security contributions;**
- **short-term compensated absences eg annual paid leave;**
- **profit sharing and bonuses payable within 12 months of the period end of giving the related services; and**
- **non-monetary benefits (benefits in kind).**

Accounting treatment-Short-term employee benefits

When an employee has given service during a period the employer should recognise the benefits expected to be paid:

- as a liability to the extent they have not been paid at the year-end;
- as an expense (unless it is treated as part of the cost of a fixed asset, stock or construction contract etc).

Profit sharing and bonus plans

Almost all short-term benefits are paid as the services are provided or shortly afterwards eg most employees are paid at the end of each month. Profit share and bonuses may not be known until some time after the year-end and this raises questions about when they should be recognised and how much should be accrued.

Amounts for these should be recognised only when:

a) **the company has a present legal or constructive obligation to make such payments as a result of past events; and**

b) **a reliable estimate can be made of the amount.**

- A **present obligation** exists when, and only when, the enterprise has no realistic alternative but to make the payments. When the right to a bonus is in a contract of employment this will give a legal obligation assuming other conditions (eg relating to performance or profitability) are met.

Example 1

Nairn plc includes a bonus system in its contracts of employment of all staff. Key terms are:

i. if profits increase by more than 10% in any one year a bonus equivalent to 2% of gross wages and salaries (excluding employers NI) is payable to staff;

ii. the bonus is payable at the end of month 6 of the following year to all employees who worked in the year and are still employed by the company on the date the bonus is payable.

In the year to 31 December 2018 gross wages and salaries totalled TZS 1,400m and employers NSSF was TZS150m. PAYE and employees NSSF average 32% of payroll. Payments to the Revenue (eg TRA) are paid one month in arrears. Profits in 2017 and 2018 equalled TZS630m and TZS710m respectively.

Staff details are as follows:

Date	**Number**
At 31.12.18	610
Of which left between 1.1.19 and 30.6.19	12

The accounts for the year to 31 December 2018 are being completed in July 2019.

Employers NSSF is 12.8%.

Required:

a) assuming those that left earned the average wage, calculate the total short-term employment cost for Nairn plc for the year to 31 December 2018; and

b) Calculate the liability relating to employee benefits as at 31 December 2018

Solution

a) Total short-term employment cost

	TZS000
Wages and salaries	1,400,000
Employers NSSF on wages and salaries	150,000
Annual bonus	30,963
	1,580,963

Annual bonus

There is a legal obligation to pay a bonus if the conditions are met.

% increase in profits = 12.7%, therefore bonus will be paid.

Number of staff eligible	= 610 – 12	
	= 598	
Bonus = 2% x 598/610 x TZS1,400m	=	TZS27,449,180
NSSF on bonus (12.8%)	=	3,513,495
		TZS 30,962,675

b) Liability at 31 December 2018

Annual bonus	30,962,675
PAYE and NI (32% x TZS1400m/12 + TZS150M/12)	
(= TZS37,333,333 + TZS12,500,000)	<u>49,833,333</u>
	<u>80,796,008</u>

Accounting treatment-Short-term employee benefits

- Recognise undiscounted amount of benefit earned by an employee in return for service provided as an expense in SPLOCI – P/L
- An asset or liability in the SFP arises if there is a prepayment or accrual
- For accumulating paid absence (e.g. holiday entitlements), recognise an expense when employee renders service that increases the entitlement to absence
- For non-accumulating paid absence (e.g. sick day), recognise the expense when the absence occurs

Example.2: Paid annual leave entitlement

Belfast Limited has 1,000 employees and each employee is entitled to 30 days' paid annual leave each year. The holiday year commences 1 July each year and, at the company's financial year end of 31 December 2017, employees had on average each taken 10 days leave in the six months to 31 December 2017.

Requirement

Assuming an annual salary of €30,000 and a working year of 250 days, calculate the provision to be made in the financial statements at 31 December 2017.

Example .2: Paid annual leave entitlement

Solution:

As employees are entitled to holiday leave of 15 days each at 31 December 2017 (6/12 months x 30 days), it is necessary for an additional 5 days (15 days – 10 days).

1,000 employees x 5 days x €120 per day = €600,000 (before any associated employer related taxes).

Example .3: Profit-sharing plan

Derry Limited, a company that prepares its financial statements to 31 December each year, agreed a profit sharing plan with its employees on 1 January 2018. Under the terms of the plan, the company agreed to pay 10% of its profits after tax on a pro rata basis to staff who had been employed throughout the whole year. While on 1 January 2018 Derry had 500 employees, only 300 of these employees were still employed by the company on 31 December 2018. Derry Limited's profit after tax for the year ended 31 December 2018 was TZS1,000,000,000.

Requirement

How should Derry Limited recognise the profit sharing plan as at 31 December 2018.

Example.3: Profit-sharing plan

Solution:

Derry Limited should recognise a liability and an expense of TZS60,000,000 (that is 10% x 60% employees remaining x TZS1,000,000,000)

Post-employment benefits plans

These include:

a) Pensions; and

b) Other post-retirement benefits (eg medical care).

- Includes retirement benefits, such as pensions, and other post-employment benefits, such as post-employment medical care that are payable after the completion of employment
- Most common are ***defined contribution*** and ***defined benefit*** pension plans
- Accounting treatment depends on type of plan
- **Defined contribution plan**
  - Contributions are paid into a separate fund
  - Entity has no further legal or constructive obligation to the fund
  - The risk of fund deficit lies with the employee
- **Defined benefit plan**
  - A post-employment benefit plan other than a defined contribution plan

As pensions are by far the most common type of post-retirement benefits we will concentrate on these. Pensions often are part of the remuneration package offered by companies to their employees. While the pension will not be paid until an employee retires, normally contributions are made towards the cost of providing the future pension throughout the working life of the employee.

Pension schemes can be either contributory (both the employee and the employer contribute to the pension) or non-contributory (the employee makes no contribution).

The employee's contribution is a deduction from gross salary and is accounted for in the same way as other deductions eg PAYE and NHIF.

- **The main accounting problem is with the employer’s contribution – which is a cost to the company in addition to the gross salary of the employee.**

Types of plans

There are two types of pension plan: defined contribution and defined benefit

1. **Defined contribution plans** (or money purchase schemes) require the company to make an agreed level of contributions to the scheme. The pensioners will enjoy the full benefits of all returns generated from the subsequent investments, although they also run the risk of a poor pension if the scheme's investments are unsuccessful. The principal risks lie with the employee as, once the employer has paid its contribution, it has no further obligation. These plans are increasingly popular with employers.

2. **Defined benefit plans** (or final salary schemes) require the plan to pay an agreed pension on retirement for the remainder of the pensioner's life. The amount of the pension will usually be based on a formula taking account of length of service and salary at the time of retirement. The actual amount to be paid as a pension will not be known until retirement. Employees pay a fixed contribution to the plan. Employers are required to pay contributions to the scheme to meet the projected pension liability. This is obviously less risky for the employees, but it leaves the risk with the employer. These plans are becoming less common

- Defined benefit schemes create **pension liabilities** which are related to a variety of unknown factors: salaries at time of retirement, length of retirement, probability of death in service, etc. This makes the liability extremely difficult to measure. **Pension assets** are usually accumulated to meet these liabilities.

Example 4

An employee joins a non-contributory scheme on his 50th birthday. It is assumed he will retire in ten years when he will receive a pension based on 1/50 of salary for each year worked. He earns £30,000 pa. It is estimated that the employee will live for 15 years after retirement. The pension will not increase during retirement. Assume inflation and salary increases are zero and return on investments is 12% and contributions are made at the end of each year.

The actuarial problem is to build up a fund by age 60 sufficient to fund an annuity of £30,000 x 10/50 = £6,000 per annum. The obligation to fund the pension is a pension liability

What fund of assets is required at retirement?

The assets at retirement must be able to fund payments of £6,000 per annum for 15 years ie an annuity of £6,000 for 15 years. Using PV tables assuming a 12% discount rate (return on investments) gives:

£6,000 x 6.8109 = £40,865

For each year's service £4,086 (£40,865/10) requires to be available to fund the pension when the employee retires.

What annual contributions are required to build up the fund?

For each year of pension entitlement £4,086 must be accumulated by the time of retirement. The PV of £4,086 in ten year's time is:

£4,086/(1.12)10 = £1,316

What percentage of salary should the employer contribute in the first year?

£1,316/£30,000 = 4.39%

On the above assumptions this would be the total contribution rate

If the scheme was contributory the employer would contribute the balance to give a total contribution of 4.39% eg if the employee contributes 2%, the company's share would be 2.39% or £717.

This should ensure that the pension assets (contributions paid in to the fund) keep pace with the liabilities (the obligation to pay pensions).

- Consider some of the simplifications that have been made in this example:
- inflation zero
- salary increases zero ie no annual increases or promotion
- known life of pensioner
- investment returns constant at 12%
- no increase in pension over the 15 years (by law pensions must be increased by the lower of 5% and Retail Price Index (RPI))
- No dependants' pension rights
- Worker does not die in service or seek early retirement.

It is not surprising that calculating a contribution rate is difficult and that past estimates will require to be reviewed and changed in the future.

ACCOUNTING FOR DEFINED CONTRIBUTION PLANS

- Accounting for defined contribution plans is straightforward as the company's obligation is determined by the amounts to be contributed for the period. Once the company pays this there is no further liability. The main points are
- any **contribution by the employee** is deducted from their salary as part of the salaries system and is paid over to the pension scheme. Any amount deducted but not paid over to the pension scheme at the year end is a liability of the company.
- any unpaid or pre-paid part of the **company's contribution** is an accrual or prepayment.
- the company charges its share of the contribution to the pension scheme to the profit and loss account (unless it is to be included in the cost of fixed assets, stock etc.).

Pitcher plc operates a defined contribution plan under which employees pay 5% of gross salary and the employer 13%. Payments are made to the pension scheme and the Revenue 14 days after the end of each month.

Gross salaries for November 2018 were £500,000. PAYE and NSSF deductions were £100,000. Employer's NSSF equalled £56,000 for the month.

Required:

(a) calculate the total employment cost for November 2018;

(b) prepare journal entries to record the relevant transactions

Solution

(a) Employment cost

	£	£
Gross salary		500,000
Employer's NI		56,000
Employer's pension contribution (13% x £500,000)		65,000
		621,000

Journal entries

30 November 2018

Dr	Wages and salaries		621,000	
	Cr	Inland Revenue		156,000
		Pension liability		90,000
		Bank		375,000

Being payroll for November 2018

14 December 2018

Dr	Inland Revenue		156,000	
	Pension liability		90,000	
	Cr	Bank		246,000

being payment of deductions

Defined contribution pension plan

- Recognise the contribution payable to a defined contribution plan in exchange for services rendered by an employee in an accounting period
- Recognise amount as an expense in SPLOCI – P/L unless another standard permits its inclusion in the cost of an asset
- An asset or liability arises in the SFP if there is a prepayment or accrual

Example 17.3: Defined contribution pension plans

Bryson Limited operates a defined contribution pension plan for its employees. The company's contribution rate to the pension fund is 5% of gross salaries. During the year ended 31 December 2012, gross salaries amounted to €6 million. For convenience, a regular amount of €20,000 was transferred monthly into the pension fund by the company, with the balance being paid by the company in January 2013.

Requirement

Calculate the amounts to be included in the SPLOCI of Bryson Limited for the year ended 31 December 2012 and the SFP as at that date.

Example 17.3: Defined contribution pension plans

Solution:

The SPLOCI – P/L expense for 2012 is based on 5% of gross salary cost of €6 million = €300,000*.

As payments of €240,000 were made during 2012 (€20,000 x 12 months), an accrual of €60,000 is required in the 2012 SFP .

While this is due to be paid in January 2013, if it was not due to be paid within 12 months of the end of the reporting period, the outstanding contributions should be discounted to their present values.

* The expense may be capitalised as part of the cost of an asset where required or permitted by another accounting standard (for example IAS 2 or IAS 16).

Defined benefit pension plans

- Post-employment plans other than defined contribution plans
- Plan obligations may be financed by contributions to a separate fund set up to meet employee benefit payment when they are due
- As the employer effectively agrees to pay a promised level of benefits, this exposes the enterprise to actuarial and investment risks
- If the assets exceeds the obligation, the plan is in surplus. If the obligation exceeds the asset, the plan is in deficit

Defined benefit pension plans

With respect to the accounting treatment, the key elements are:

- SFP
- Current service cost
- Past service cost
- Remeasurements
- SPLOCI

Each of these is now addressed in turn.

Statement of financial position

The SFP figure, which could be a net asset or liability, will arise as follows:

1. **Opening SFP** – i.e. a net defined benefit pension asset or obligation
2. **Current and past service costs** – these increase the liability, with the corresponding expense being recognised in SPLOCI – P/L. Past service costs are recognised in the period of the plan amendment (See **Past Service Costs** later)
3. **Net interest expense/income** – a discount rate based upon market yields at the end of the reporting period on high quality corporate bonds is applied to the defined benefit pension obligation at the beginning of the reporting period. The same interest rate is also applied to the carrying value of the defined benefit pension plan assets at the beginning of the reporting period to identify an amount of interest income (if any). The net interest expense or income is recognised in SPLOCI – P/L.
4. **Remeasurement** – the net difference between the actual return on the defined benefit pension plan assets and obligations and the expected (see (iii) above). It is recognised through other comprehensive income (OCI).
5. **Closing SFP** – this will show either a net defined benefit pension asset or obligation depending upon each of the above.

(Items 2, 3 and 4 are addressed in more detail later.)

Statement of financial position

- Pension plan assets are measured at fair value (market value)
- An actuarial valuation method known as the *Projected Unit Credit Method* must be used to measure defined benefit liability / obligation and the current and past service costs

Current and past service costs

Current service costs

Current service costs increase the present value of the obligation resulting from employee service in the current period.

Past service costs

Past service costs change the present value of the obligation for employee service in prior periods. They arise from amendments to the terms and conditions of a defined benefit plan or a curtailment. Additional costs arise where new benefits are introduced or existing benefits are improved. Costs are reduced where existing benefits are reduced. Past service costs should be recognised in the period of the plan amendment (***they are no longer spread over future periods***).

Example 17..4: Past service costs

Cork Limited, a company that prepares its financial statements to 31 December each year, operates a defined benefit pension plan that provides company employees with a pension of 3% of their final salary for each year of service with the company. The benefit becomes vested after 5 years of service. On 1 January 2012 Cork Limited improved the terms to 4% of final salary for each year of service starting from 1 January 2009. At the date of improvement (1 January 2012) the present value of the additional benefits for service was:

Employees with less than 5 years of service on 1 January 2012, with the average period until vesting being 3 years: €300,000
Employees with more than 5 years service on 1 January 2012: €500,000

Based upon the information provided, the change in terms would result in a charge (expense) in the 2012 SPLOCI – P/L of Cork Limited of €800,000.

IAS 19 *Employee Benefits*

Termination Benefits:

- Are to be recognised as a liability and expense when the enterprise is demonstrably committed to either:

a) Terminate the employment of employees before the normal retirement date

b) Provide termination benefits as a result of an offer made to encourage voluntary redundancy

Termination benefits

- Employee benefits provided in exchange for termination of employment as a result of either:
  - Termination of employment before normal retirement date; or
  - Employee decision to accept offer of benefits in exchange for termination
- Termination benefits are a separate category of employee benefits because the event that gives rise to the obligation is the termination rather than employee service
- Examples include (i) redundancy payments, (ii) salary until end of a period if the employee renders no further service
- Liability for termination benefits can only be recognised if the enterprise is demonstrably committed to a termination (IAS 37)
- Liability must be measured at PV if the benefits fall due more than 12 months after reporting date
- For a voluntary redundancy offer, termination benefits must be measured based on the number of employees expected to accept the offer