Grant Thornton

Technical Accounting Alert

Compensated absences

Introduction

This alert highlights the requirements of AASB 119 and identifies the factors to be considered in properly classifying compensated absences and so determining the appropriate recognition and measurement requirements.

Compensated absences
Employee benefits related to compensated absences include payments for annual leave, sick leave, maternity/paternity leave, jury service, military service, long-term disability absence, sabbatical leave and paid leave granted for other agreed reasons. There are practical difficulties in applying the requirements of AASB 119 to these compensated absences.

The terms and conditions of the leave entitlement need to be analysed carefully to identify whether the compensated absence is a long or short-term, accumulating or non-accumulating, vested or non-vested benefit in order to determine the appropriate accounting policy under AASB 119.

The primary objective of AASB 119 is to 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 entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Entitlements to compensated absences should be analysed into:

- accumulating - entitlements that can be carried forward and used in future periods; and
- non-accumulating - entitlements that expire at the end of the period.

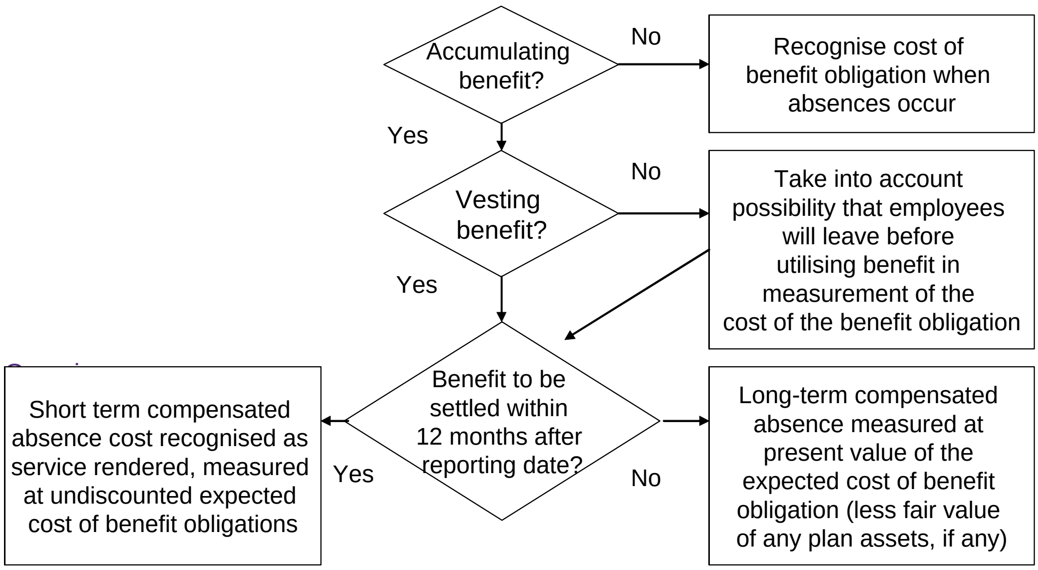
The cost of **accumulating** compensating absences is recognised as employees render the service that increases their entitlement to future compensated absences. The cost of **non-accumulating** compensated absences is recognised when the absences occur.

The timing of recognition of the cost of the benefit is equally applicable to both short-term and long-term accumulated benefits (see discussion section below), although the method used to measure the liability recognised is different:

- short-term: measure at the undiscounted amount of the obligation
- long-term: measure at the present value of the obligation.

Where the payment of the accumulated benefit is contingent on a future event, such as completion of future service or the employee becoming sick (ie it is a non-vesting benefit), the probability of the future event occurring affects the measurement of the obligation but does not determine whether that obligation exists. If the employees will be paid for any unused entitlement on leaving employment, then the benefit is vesting. The measurement will take into account the timing of payment.

The diagram below summarises this information:



Detailed discussion

The underlying objective of AASB 119 is the recognition of a liability when the entity receives services in exchange for future employee benefits and recognition of an expense when the entity consumes the benefit of employee services.

Therefore, for compensated absences, AASB 119 requires that a liability is recorded if:

- the benefit entitlement may be carried forward to be paid in the future (ie the benefit is accumulating); and
- the benefit entitlement is increased as a result of services rendered (ie the benefit relates to the employer's "consumption" of employee services).

To apply the second requirement it is essential to identify the relationship between the services rendered by the employees and the benefits to which they become entitled through that service.

The other factor that affects the accounting is whether the benefit is classified as short-term or long-term (see below).

Together, these factors determine:

- if a liability should be recorded for future benefits based on employee services received; and
- if so, how that liability should be measured.

Accumulating and non-accumulating absences

Employees' entitlement to compensated absences fall into two categories - accumulating and non-accumulating.

Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full.

Accumulating benefits are clearly linked to some extent to the services rendered. To satisfy the objective of AASB 119, the cost of providing these benefits is accrued over the period that the service contributes to the level of benefit entitlement.

Non-accumulating absences do not carry forward. If the employee does not take the relevant compensated absence in the current period then the entitlement lapses. The entitlement to non-accumulating absences is not directly related to services rendered and is usually available to all employees or to all employees within certain categories. Sick leave and maternity leave usually fall into this category.

This distinction between accumulating and non-accumulating is referred to explicitly in AASB 119 for short-term compensated absences. For long-term compensated absences, the link between accumulating and non-accumulating absences is not so clearly stated. However, it is clear that the recognition of a liability for long-term benefits accrues as the employees render the services that entitle them to future benefits. This applies the same principle and recognition treatment to long-term accumulating benefits as is expressly required by AASB 119.11(a) for accumulating short-term benefits. Therefore, the timing of recognition of the cost of the benefit is the same for both short-term and long-term accumulating benefits.

This is demonstrated by the treatment of long-term disability benefit. This type of benefit may be accumulating or non-accumulating, depending on the specific terms of the employment contract. If the level of benefit depends on service rendered (ie is accumulating), an obligation arises when the service is rendered and so a liability for the cost of providing that benefit is accrued as the service is rendered. However, if the level of benefit is the same for any disabled employee regardless of the level or amount of service rendered (ie is non-accumulating), the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

Recognition of the cost of accumulating absences

The employer entity recognises the cost of non-accumulating compensated absences when the absences occur because the employee service rendered does not increase the amount of the benefit.

The employer entity recognises the cost of accumulating compensated absences as employees render services that increases their entitlement to future compensated absences, to reflect the accruing obligation.

Accumulating compensated absences may be either vesting (in other words, employees are entitled to a cash payment for unused entitlement on leaving the entity) or non-vesting (when employees are not entitled to a cash payment for unused entitlement on leaving).

For a non-vesting benefit, future payment may be contingent on the occurrence of a future event (eg the employee completing future service or becoming sick). The possibility that the employee will leave before they utilise an accumulated non-vesting benefit affects the measurement of the obligation, but does not determine whether the obligation exists.

Common types of compensated absences

Annual leave

Annual leave is most commonly expressed as an annual number of days paid holiday. Some arrangements permit employees to carry forward some or all of any unused entitlement. If an employee is entitled to 24 days paid annual leave per annum, this is characterised as 2 days per month. If an employee joins or leave part-way through a year, the entitlement is usually time-apportioned. The benefit is therefore related to service. A liability is recorded to the extent of any accrued unused entitlement that may be carried forward.

Sick leave

Sick pay entitlements enable the employee to continue to be paid on days when they are not well enough to work. Paid sick leave might be capped at a certain number of days and payments might be limited to a proportion of normal salary. Typically, this cap is not related to service and the employee cannot carry forward unused days. In this fact pattern, an expense for sick pay is recognised only as the sickness absences occur. However, some other arrangements do require a liability to be recognised - see Examples section below.

Maternity / paternity leave

Maternity or paternity pay entitlements are usually set at a certain number of days and payments might be limited to a proportion of normal salary. Typically, this entitlement is not related to service and the employee cannot carry forward unused days. Consequently, an expense for maternity/paternity pay is recognised only as the relevant absences occur.

Sabbatical leave

Some arrangements entitle employees to be released form their normal employment duties for a period of compensated sabbatical leave to do research or study or to travel or participate in charitable or other vocational activities or sometimes just to rest. The entitlement is usually based on service and so is usually an accumulating benefit. A liability is recorded to the extent of any accrued unused entitlement that may be carried forward.

Long-term disability benefit

Long-term disability benefit entitlement might be capped at a certain number of days (though this may be several years) and is usually limited to a proportion of normal salary. If the level of benefit depends on service, an obligation arises when the service is rendered and a liability is recorded to the extent of any accrued unused entitlement that may be carried forward. Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

Measurement of the cost of accumulating absences

Compensated absences can be either short-term or long-term employee benefits. AASB 119 defines short-term benefits as "employee benefits (other than termination benefits) that are due to be settled within twelve months after the end of the period in which the employees render the related service". Long-term benefits are those that are not due to be settled within this twelve month period.

As explained, this distinction does not affect the timing of recognition of a liability but does have an impact on the method used for measuring the liability. When an employee has rendered service to an entity during a period, the entity shall recognise a liability measured as follows:

- **Short-term** accumulating compensated absences: the **undiscounted** expected cost of the benefits that have accrued to the reporting date in exchange for services received.
- **Long-term** compensated absences: the **present value** of the expected cost of the benefit obligation at the reporting date (minus the fair value of plan assets (if any) out of which the obligations are to be settled directly).

In either case, the expected cost is recognised to the extent that future payments for individual employees exceed the future payments that would have been expected in the absence of the accumulation feature. (Again, this is stated explicitly in the context of short-term compensated absences but in our view, the same principle should be applied to long-term compensated absences.) This method is demonstrated in the following examples.

Examples

Accumulating paid sick leave
An entity has 100 employees, who are each entitled to five working days of paid sick leave for each year. Unused sick leave may be carried forward for one calendar year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X1, the average unused entitlement is two days per employee. The entity expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of paid sick leave in 20X2 and that the remaining eight employees will take an average of six and a half days each.

The entity expects that it will pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X1 (one and a half days each, for eight employees). Therefore, the entity recognises a liability equal to the undiscounted cost of 12 days of sick pay.

In this example the benefit is short-term, non-vesting and accumulating.

Accumulating paid sick leave with non-accumulating base-level
An entity has 100 employees, who are each entitled to a minimum of five working days of paid sick leave for each year. Any unused sick leave from this basic entitlement may not be carried forward. In addition, employees are entitled to one additional day of paid sick leave for each year of service completed. These additional days can be carried forward until the employee leaves, at which time the entitlement lapses. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X1, the average unused accumulating entitlement is seven days per employee. The entity expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of paid sick leave in 20X2 and each year thereafter and that the remaining eight employees will take an average of seven days each.

In this case, the basic entitlement of five days is non-accumulating and so no liability is recognised in this respect at the reporting date.

The benefit of the additional days is accumulating but non-vesting. As the benefit of the accumulating extra days is expected to be settled over a number of years. This is a long-term* benefit (see below) and so the entity will recognise a liability for the present value of the obligation to provide the additional days that have accumulated to date. The measurement of this liability will reflect the expected pattern of absences and the expected number of entitlement lapses due to employees leaving without taking their full entitlement.

Short-term vs long-term classification

As noted earlier, the definitions of short-term and long-term benefits were amended in the Improvements to IFRS published in May 2008. The equivalent standard was issued in Australia to amend AASB 119.

This has led to uncertainty as to what is meant by "due to be settled".

This should be based on the timing of **expected** settlement. This seems to be the IASB's intention, as noted in the Basis for Conclusions to the amendment: "Noting respondents' comments on the exposure draft of Improvements to IFRSs published in 2007, the IASB concluded that **the critical factor in distinguishing between long-term and short-term benefits is the timing of the expected settlement**. Therefore, the IASB clarified that other long-term benefits are those that are not due to be settled within twelve months after the end of the period in which the employees rendered the service." (Improvements to IFRSs IAS 19.BC4B - emphasis added.)

This interpretation is also consistent with the old version of AASB 119 in which AASB 119.8(b) stated that short-term employee benefits include compensated absences where the absences **are expected to occur** within twelve months after the end of the period in which the employees render the related employee service" (emphasis added).

Alternatively, "due to be settled" may be interpreted as the earliest date that employees can require settlement, to be consistent with the use of the same wording in AASB 101.69 when determining the classification of liabilities as current or non-current. This may be supported by the following: "The IASB noted that this distinction between short-term and long-term benefits is consistent with the current/non-current liability distinction in IAS 1 Presentation of Financial Statements. However, the fact that for presentation purposes a long-term benefit may be split into current and non-current portions does not change how the entire long-term benefit would be measured." (Improvements to IFRSs IAS 19.BC4C.) This interpretation would result in the benefit obligation being measured at an undiscounted amount.

However, the second sentence of BC4C above may be used to argue that, as AASB 101 only addresses presentation, an employee benefit liability may be measured as a long-term benefit if it is expected to be settled over the longer term, even though it might be presented as current because the employer has no unconditional right to defer settlement for more than twelve months if the employees become sick and are absent from work.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au