ASSURANCE & ADVISORY
BUSINESS SERVICES

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AS 15 (Revised) - Employee Benefits

A Guide to Accounting Standard 15 (Revised)

Executive Summary

The complexity in employee compensation structures have increased quite considerably in recent times. The manner in which today's employee gets remunerated has been significantly innovated, and very often accounting is complex and challenging. The revised AS-15 - 'Employee Benefits', generally deals with all forms of employee benefits (other than stock compensation for which a separate guidance note is promulgated), many of which were not dealt with by pre-revised AS 15.

The standard has a significant impact on the financial statements of an enterprise, broadly arising due to:

a) Specificity on actuarial assumptions and actuarial method to be applied

b) Definition of employee under revised AS 15, includes part time, casual and temporary employees. In the absence of this definition in the pre-revised AS 15, provisions may not have been made by some enterprises

c) Coverage of all forms of employee compensation, for example, post retirement medical expenses, jubilee award, loyalty programs, etc

d) Treatment of provident fund as defined benefit rather than defined contribution

e) Treatment of gratuity scheme funded with LIC as defined benefit rather than defined contribution

f) Deferral of past service cost, which was not permitted by pre-revised AS 15

g) Accentuation of constructive obligation for recognition purposes

h) Application of the transitional provisions

i) Tax effect of the above items

Though the standard pertains to employee benefits, strangely, the term employee is not defined in the standard. As per the scoping paragraph of the revised standard “an employee may provide services to an enterprise on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this statement, employees include whole-time directors and other managerial personnel”. From this scoping paragraph it may be possible to conclude that employee includes an employee hired on a casual or temporary basis. But that may not mean that all casual labour or temps working for the company are employees of the company!

In this dossier, we have discussed the above issues and provide perspective in a simple manner including on the transitional adjustment. In a few instances, in the absence of any specific guidance from The Institute of Chartered Accountants of India, interpretations may differ, e.g. whether a particular adjustment is a transitional adjustment or a prior period item or a person rendering services to the company will satisfy the meaning of the term “Employee” for the purpose of revised AS 15. In such instances we have tried to explain both the views. We believe that on many of these issues, consensus would develop over time.

There is a very interesting folklore that accentuates the importance of this standard. Many believe that accounting under German GAAP tends to be very conservative. Despite that, in 1993, under German GAAP Daimler-Benz reported a profit of 168 million Deutsche Marks but under US GAAP for the same period, the company reported a loss of almost a billion Deutsche Marks, largely caused by pension blues. Other than being a solid case for global convergence of accounting standards, it also highlighted problems related to pension accounting and funding. Though in India, pension payments are quite insignificant in comparison to global enterprises, as Indian companies become global, this will become a critical issue. Not to forget, pension accounting in the Government sector (other than a corporate entity), is on a cash basis, and it is to state the obvious, that the actuarial liability would be humongous.

The Standard applies from April 1, 2006 in its entirety for all Level 1 enterprises. Certain exemptions are given to other than Level 1 enterprises, depending upon whether they employ 50 or more employees. Listed companies that have to report quarterly as per SEBI requirements, will have to deal with all the issues in their first quarter of April-June 2006. This dossier is developed predominantly for Level 1 enterprises, and does not consider exemptions available to other than Level 1 enterprises.

AS 15 (Revised) - Employee Benefits

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1. Synopsis of Revised AS 15 Requirements

1. The Standard deals with all forms of employee compensation other than employee stock option. It also covers casual and temporary employees. Therefore all contract employee obligations would also get covered.

2. Liability is recognised not only for legal obligation or formal plans but also for constructive obligation, such as those arising out of informal practices, where the cost is unavoidable.

3. Short term employee benefits fall due within one year, and include, wages, leave, bonus, etc. They are accounted for on an undiscounted basis. Non accumulating leave do not carry forward and hence are recorded as they occur. Accumulating leave is utilised or encashed in future years and hence provision for the same is required.

4. Post employment plans, could be defined contribution plans or defined benefit plans. Accounting for defined contribution is fairly straightforward, and contributions are recognised to income statement as and when they become due.

5. Accounting for defined benefit plan requires actuarial computation. The Standard does not allow flexibility in terms of the actuarial method to be used and requires the Projected Unit Credit method to be applied invariably. Similarly, the requirements relating to actuarial assumptions are more specific. The assets held under the defined benefit plan are also required to be fair valued. Actuarial gains and losses are required to be recognised immediately. Past service costs are required to be deferred over the vesting period. To the extent the benefits are vested, past service cost should be charged immediately to the income statement.

6. Long term employee benefits include long term loyalty and jubilee awards, bonus, etc which fall due beyond one year and are accounted for in a similar fashion as defined benefit plans, except that past service cost are not deferred and are recognised immediately.

7. Termination benefits like voluntary retirement cost are recognised based on when the liability crystallizes rather than when the enterprise becomes demonstrably committed to a voluntary retirement scheme. To this extent there is a dilution of the general principle of recognising liability based on constructive obligation.

8. There is a sunset provision to the option of deferring termination benefit. No amount can be carried forward beyond accounting periods commencing on or after 1 April, 2010.

9. Transitional provisions require incremental provisions due to revised AS 15 to be adjusted to revenue reserves net of the tax effect.

2. Meaning of the term 'Employee'

As already discussed earlier the term employee is not defined under the standard. Here we look at some perspective on who could be included as an employee for the purposes of revised AS 15. It may be noted that it is important to know who is an employee, since what is paid to an employee is employee cost, whereas what is paid to other than employee is other operating costs. Also the obligation relating to an employee would be measured as per revised AS 15, whereas it is arguable if obligation relating to a non-employee should be measured using revised AS 15 or AS 29.

Query

Is a contract of employment either necessary or sufficient to establish an employee relationship?

Response

AS 15 does not define who is an 'employee', but states in paragraph 6 that: "An employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel." This suggests that the intention was for the term 'employee' to apply more widely than simply to persons with a contract of employment as 'casual' and 'temporary' staff may frequently not have such contracts. Further, as directors are explicitly included, this indicates that a contract of employment is not necessary in order to consider an individual to be an employee since directors can frequently have letters of appointment that fall short of a formal employment contract.

The existence of an employee relationship is a judgement to be made in the light of all the facts and circumstances in order to reflect the substance of the arrangement. In particular, whilst a contract of employment may suggest such a relationship, in-substance employee relationships can exist without employment contracts. The following indicators suggest an employee relationship may be more likely to exist, and may help in making individual judgements (this is not intended to be exhaustive nor a 'check list' of requirements):

- A contract of employment exists;
- Individuals are considered employees for legal / tax / social security purposes;
- Services must be performed by a particular individual who has no discretion to arrange for someone else to perform them;
- Services must be performed at a location specified by the employer;
- There is a large amount of oversight and direction by the employer;
- Necessary tools, equipment and materials are provided by the employer;
- Individuals receive benefits of a nature typical for employees (e.g. paid holidays, paid sick leave, post-retirement benefits, death and disability benefits);
- Services provided through an entity are in substance services provided by a specific individual, indications of which could be that the entity:
  - Has no other clients;
  - Has served the employer for a long period;
  - Faces little or no financial risk;
  - Requires the explicit permission of the employer to concurrently undertake additional employment elsewhere.

3. Defined Contribution v Defined Benefits

Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further contributions. Defined benefit plans are post-employment benefit plans other than defined contribution plans. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. In defined benefit plans, the actuarial and investment risk fall on the employer.

The distinction between defined contribution and defined benefit is important, since accounting is significantly different for the two plans. In defined contribution plans the contribution is charged to income statement, whereas in defined benefit plans, a detailed actuarial calculation is performed to determine the charge.

Query

Jigdoot Ltd offers employees a gratuity plan where retired employees are paid an amount equal to 15 days of their final salary for each year that the employee worked for the company, subject to a ceiling of Rs 5 lakhs. Jigdoot Ltd makes annual contributions to LIC that promises to make the payments to employees after retirement. LIC cannot request that the company make additional contributions to cover plan shortfalls. LIC does, however, reserve the right to increase the company's future required contribution rate. Is this gratuity scheme a defined contribution or defined benefit scheme?

Response

An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have an obligation to either: (a) pay the employee benefits directly when they fall due; or (b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods. If the enterprise retains such an obligation, the enterprise should treat the plan as a defined benefit plan. Further, paragraph 26 of revised AS 15 sets out examples of cases where an enterprise's obligation is not limited to the amount that it agrees to contribute. This includes a plan benefit formula that is not linked solely to the amount of contributions.

Thus in the given case, based on the above reasoning, the gratuity scheme funded with the LIC is a defined benefit scheme. In a defined benefit scheme, there will be a defined benefit obligation and plan assets if the obligation is funded. In the give case, the obligation will be determined based on the PUC method and as per revised AS 15 principles, and not as per LIC valuation.

On the asset side, a question arises as to whether the funds under the scheme as certified by LIC would be treated as plan assets or reimbursement rights. The distinction is important (though both are measured on fair valuation basis) because plan assets are reduced from the defined benefit obligation and the net amount is disclosed in the balance sheet, whereas, in the case of reimbursement rights, the defined benefit obligation and the reimbursement rights are shown separately as liability and asset on the balance sheet. This would have the impact of making the balance sheet heavy both on the asset side as well as the liability side.

As per revised AS 15, plan assets include a qualifying insurance policy. A qualifying insurance policy is one which is for exclusive benefit of the employee and where the creditors have no access to it in a bankruptcy situation and neither is it available to the reporting entity except to pay the employee or receive surplus balance in the fund. Therefore funds with LIC under group gratuity scheme would constitute a qualifying insurance policy and consequently would be treated as a plan asset and not a reimbursement right.

Query

A group has two companies, in one company, the PF is managed by the group through a trust specifically created for this purpose. In the other company, the PF is contributed to the government. Are these two schemes defined contribution or defined benefit?.

Response

Paragraph 26 of revised AS 15 sets out examples of cases where an enterprise's obligation is not limited to the amount that it agrees to contribute. This includes a guarantee, either indirectly through a plan or directly, of a specified return on contributions. Such schemes would be defined benefit schemes. As regards the PF scheme where the group manages the trust, prima-facie it seems that it would be a defined benefit scheme, since the trust will have to pay interest on contribution at rates specified by the government which may be more or less than the interest earned by the trust. Since the arrangement is prima-facie a defined benefit scheme, the computation as well as the disclosure will have to be made in accordance with the revised AS 15, which could be quite onerous. However, ICAI needs to give guidance to clarify this issue.

The implications of treating the PF scheme as defined benefit scheme are as follows:

1) apply PUC method to determine the total defined benefit obligation and current service cost of the PF scheme

2) determine the fair value of the assets of the PF fund

3) recognise fully the excess of the obligation as determined in (1) above over the fair value of the assets as determined in (2) above

4) if the fair value of the assets as determined in (2) above is greater than the obligation as determined in (1) above, the excess should be accounted for in accordance with paragraph 59 of AS 15.

As regards the PF scheme with the government, the group has no obligation beyond its contribution and therefore such schemes would be defined contribution.

4. Actuarial Assumptions

Actuarial assumptions comprising demographic assumptions and financial assumptions should be unbiased and mutually compatible. Financial assumptions should be based on market expectations, at the balance sheet date, for the period over which the obligations are to be settled. Therefore assumption relating to inflation, salary growth rates, labour turnover, etc have to be based on long term indications, which could be materially different from current or short term statistics. For example, current salary growth rates may be very high, but over a very long term it is inconceivable to expect that trend to be sustained.

The rate used to discount post-employment benefit obligations (both funded and unfunded) should be determined by reference to market yields at the balance sheet date on government bonds. The currency and term of the government bonds should be consistent with the currency and estimated term of the post-employment benefit obligations. Therefore the discount rate for determining actuarial liability in the case of a company in India, cannot be based for example on US treasury bill rates. The discount rate should be long term government bond rates applicable in India.

Query

For the purposes of determining gratuity provision a software company considers salary growth rate of 8% when five years past experience suggest that it has been @ 20%. Would this be a tenable assumption?

Response

Actuarial assumptions have to be supportable and for this purpose detail facts and circumstances should be considered. The salary growth rates that are factored in actuarial computation are very long term, and in a long period it would be hard to imagine a consistent salary growth rate based on limited past experience. Empirical evidence suggests that in the very long term consistent high salary growth rate is not possible. A lot of software companies pay compensation using stock options and sweat equity, which are not to be included for the purposes of determining salary growth rates as gratuity is computed based on last drawn basic wages.

Query

SobT Ltd has calculated the net present value of the defined gratuity obligation on the assumption that: (a) Salary cost will increase in line with general price inflation at 7% a year (this is based on SobT's past experience) (b) The rate of return on plan assets is 8% (c) The discount rate, calculated by reference to the yield on high-quality fixed-rate government bonds, is 7.5% (d) Inflation index published by Government is 4.6%.

Response

Actuarial assumptions are mutually compatible if they reflect the economic relationships between factors such as inflation rates, interest rates and discount rates. The rate of return on plan assets is usually greater than the discount rate, reflecting the difference between the risk and time profile of plan assets and the risk on high-quality government bonds. SobT Ltd should demonstrate that the difference between the discount rate and the return on plan assets assumptions is justified based on the mix of plan assets. However, SobT Ltd assumptions about salary inflation and the inflation index appear to be incompatible.

5. Actuarial gains and losses and the Corridor Approach

In determining actuarial liability for post employment benefit schemes, significant assumptions are made in respect of interest rate, expected return on plan assets, salary growth rate, attrition rate, etc. Actuarial gains and losses are experience adjustments to the assumptions used and effect of changes in actuarial assumptions. Under IAS 19 as well as US GAAP, actuarial gains and losses can be carried forward and charged to future periods under the corridor approach. Revised AS 15 does not permit options and requires that actuarial gains and losses should be recognised immediately in the statement of profit and loss.

The ICAI has taken a puritanically correct approach based on fair value considerations. Immediate recognition of actuarial gains and losses represents faithfully the enterprise's financial position. An enterprise will report an asset only when a plan is in surplus and a liability only when a plan has a deficit. Paragraph 94 of the Framework for the Preparation and Presentation of Financial Statements notes that the application of the matching concept does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities. Deferred actuarial losses do not represent future benefits and hence do not meet the Framework's definition of an asset, even if offset against a related liability. Similarly, deferred actuarial gains do not meet the Framework's definition of a liability.

Whilst the requirement for full recognition of actuarial gains and losses based on the framework seems puritanical, it puts Indian companies to a disadvantage against its western counterparts who are allowed the deferral policy as an option. Therefore Indian companies under Indian GAAP are not on the same level playing field as their western counterparts adopting IFRS or US GAAP.

Under IFRS and US GAAP, the primary argument for the 'corridor approach' is that in the long term, actuarial gains and losses may offset one another. Defined benefit schemes tend to be extremely long term and hence this approach may be necessary.

6. Past Service Cost and Backwardation

Sometimes post employment benefit schemes may be modified. This would have a positive or negative impact not only in respect of future service to be rendered but also for service that has already been rendered. The impact to the extent the service has already been rendered is known as the past service cost. An enterprise should recognise past service cost as an expense on a straight-line basis over the average period until the benefits become vested. There is no option to charge unvested past service cost immediately to the profit and loss account. To the extent that the benefits are already vested immediately following the introduction of, or changes to, a defined benefit plan, an enterprise should recognise past service cost immediately. In the pre-revised AS 15, past service cost was required to be recognized immediately and deferral was not permitted.

Example

RamRaj Ltd operates a gratuity plan for certain employees to whom the Payment of Gratuity Act is not applicable. As per the scheme, the benefit vests after completion of 15 years of service. RamRaj Ltd increases the benefit from 15 days for each completed year of service to 20 days. Assume on an average employee has completed 10 years of service.

If on average employees have completed 10 years of service, the benefit of 50 days (5x10), should be amortised over the following 5 years.

Backwardation of Benefits

If an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity should attribute benefit on a straight-line basis from (a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service); until (b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

Query

Jassani Ltd operates a pension plan that pays a pension of 200 for each of the first 3 years of service; 400 for each of the years of service from years four to six; and 1,200 for each of the years of service from years seven to nine. An employee will therefore be entitled to a pension of 5,400 (200 x 3 + 400 x 3 + 1200 x 3) after 9 years of service. Further service after 9 years does not give rise to additional pension. How should the cost be allocated to various years?

Response

Jassani's employees' services in later years will lead to a materially higher level of benefit than in earlier years. It should therefore attribute benefit to years of service on a straight-line basis from the date when service by the employee first leads to benefits under the plan until the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases. Jassani Ltd should therefore attribute 600 to each year of service (5400 / 9 years) rather than following the attribution formula in the plan.

7. Leave Benefit

The pre-revised AS 15, was applicable to leave benefit only to the extent encashable on retirement, since it covered only retirement benefits. Nevertheless, the Expert Advisory Committee had opined that all leave cost computation was to be based on actuarial techniques. If a provision for leave encashable on retirement was not made, it would be a violation of pre-revised AS 15 as well as true and fair. If leave (other than encashable on retirement) provision was not made, this would not be in violation of pre-revised AS 15 since it did not cover such leave, but would be a violation of accrual basis of accounting and consequently financial statements would not be true and fair. It may be noted that the revised AS 15 covers all forms of leave benefit.

Entitlement to compensated absences falls 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 compensated absences may be either encashed or used for future leave only. An enterprise recognises the expected cost of short-term employee benefits in the form of compensated absences in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences; and in the case of non-accumulating compensated absences, when the absences occur.

Query

An enterprise has 10 employees, each of whom have 100 days leave credit to their balance. As per the employment policy, the leave can be fully utilized in any of the following years without limit. If the employee wishes to encash the leave, he/she can do so, only on retirement/resignation subject to a ceiling of 90 days. As per the scheme of the company, the leave is encashable at the basic wage prevailing at the time of encashment. The enterprise experience is that all the employees will utilize 10 days of leave in the near future and each of them will encash 90 days on retirement/resignation. How will the leave liability be measured?

Response

Short-term employee benefits are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service. Therefore though the benefit may actually be availed after one year, since it falls due within one year, it would be treated as short term. Provision is required to be made at the expected liability amount on an undiscounted basis. To the extent that the leave will be encashed, the provision is made at the estimated basic wage that would apply at the time of encashment. To the extent leave will be utilized, the provision is made based on the cost to the company.

It may also be noted that PF is required to be paid on encashed leave other than that encashed at the time of superannuation. Therefore in determining the actuarial liability, PF should be added to the provision made for leave expected to be encashed other than at time of superannuation.

Query

How is an event driven leave such as paternity or maternity leave accounted for?

Response

Non-accumulating compensated absences do not carry forward; they lapse if the current period's entitlement is not used in full and do not entitle employees to a cash payment for unused entitlement. This is commonly the case for maternity or paternity leave. An enterprise recognises no liability or expense until the time of the absence, because employee service does not increase the amount of the benefit. This liability is discharged automatically as salary payments.

8. Profit-Sharing and Bonus Plans

An enterprise should recognise the expected cost of profit-sharing and bonus payments when, and only when: (a) the enterprise has a present obligation to make such payments as a result of past events; and (b) a reliable estimate of the obligation can be made. A present obligation exists when, and only when, the enterprise has no realistic alternative but to make the payments. An enterprise can make a reliable estimate of its obligation under a profit-sharing or bonus plan when, and only when: (a) the formal terms of the plan contain a formula for determining the amount of the benefit; or (b) the enterprise determines the amounts to be paid before the financial statements are approved; or (c) past practice gives clear evidence of the amount of the enterprise's obligation.

Query

There are 11 employees, each of whom will receive a bonus of Rs 15,000 for their service in calendar year 2005, provided they continue to be on the payroll of the entity upto June 2006. Assuming 1 employee will leave by June 2006, how is the liability measured? The company feels that the charge for 2005 is Rs 100,000, determined for 10 employees, assuming the cost of Rs 15,000 is for one and a half-year.

Response

Under some profit-sharing plans, employees receive a share of the profit only if they remain with the enterprise for a specified period. The measurement of such obligations reflects the possibility that some employees may leave without receiving profit-sharing payments. The liability is Rs 150,000 (Rs 15,000 x 10) for the year 2005. The company's assumption that the cost should be spread over one and a half-year is not correct, since the bonus is for one year of service and hence the cost should be fully absorbed in that year.

Query

When employees participate in profit-sharing plans, whether the profit-share should be treated as an appropriation or charge to the profit and loss account?

Response

An obligation under profit-sharing and bonus plans results from employee service and not from a transaction with the enterprise's owners. Therefore, an enterprise recognises the cost of profit-sharing and bonus plans not as a distribution of net profit but as an expense.

Query

Whimsical Employer Ltd (WEL) grants annual bonus to its employees on discretionary basis. WEL has a March 2006 year end and finalises accounts by April 2006, but bonus is announced and paid in late May 2006. Is a provision required to be made for bonus at March 2006 year end?

Response

Since in the given case, there is no formula, nor is the amount finalized before the financial statements are approved, nor is there a reliable past practice, provision for bonus is not made in March 2006 accounts.

Query

Can public statements about benefits improvements create a constructive obligation for a company?

Response

Yes, public statements can create a constructive obligation. However, a public statement in itself may not be sufficient to create a constructive obligation and an entity should consider all of the facts and circumstances relevant to each case. For example, it is important to note who in the company has made those public statements and the authority attached to such public statements or what is the acceptability of these statements by the trade unions, etc.

9. Death-in-Service Benefits

A death-in-service (or disability) benefit may be provided in many ways. A lump sum and/or pension may be paid to survivors based on a specific formula, e.g. a lump sum of 4x salary plus a pension of say 1/3 x salary to the surviving spouse. This benefit can be provided through a post-employment benefit plan (defined benefit or defined contribution plan), or it can be provided on a stand-alone basis. Sponsors often insure these benefits with third party insurance companies. AS-15 does not provide any guidance on how to account for such benefits.

The death-in-service benefits may be accounted as follows:

Other than defined benefit post employment plan

1. In the case of benefits insured with third parties, in the period in respect of which the related insurance premiums are payable; the premiums should be charged to the income statement, since this would be a defined contribution scheme

2. In the case of benefits not insured, account for the liability to the extent that deaths have occurred before the balance sheet date. In other words, accounting is done when the event occurs.

Defined benefit through post employment plan

3 In the case of death-in-service benefits provided through a post-employment benefit plan, an enterprise should recognise the cost of those benefits by including their present value in the post-employment benefit obligation.

Query

Sethlon Ltd pays a lump-sum of 10,000 to an employee who becomes disabled as a result of an accident. This payment is the same regardless of the length of service. Bansal Ltd pays, a lump-sum of 10,000 to an employee who becomes disabled as a result of an accident within the first 5 years of employment and 20,000 if the employee becomes disabled after 5 years of employment. How is the accounting done in the two cases?

Response

The future cash outflow of Sethlon Ltd does not depend on past employee service. The obligating event is the occurrence of an accident that causes the disability of an employee. Sethlon has no present obligation to make the payment until an accident occurs. No accruals should be made by Sethlon until such event. The level of benefits of Bansal's employees depends on the length of employee service. An obligation arises when service is rendered. Bansal's obligation should be measured using the Projected Unit Credit Method. It should reflect the probability that payments will be required and the length of service for which payments are expected to be made.

10. Termination Benefits

IAS 19 provides that an enterprise should recognise termination benefits as a liability and an expense when, and only when, the enterprise is demonstrably committed to either (a) terminate the employment of an employee or group of employees before the normal retirement date; or (b) provide termination benefits as a result of an offer made in order to encourage voluntary redundancy. It further provides that an enterprise is demonstrably committed to a termination when, and only when, the enterprise has a detailed formal plan for the termination and is without realistic possibility of withdrawal.

When drafting AS 15 (revised), the standard setters felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystalised at this stage. Accordingly, the revised AS 15 (2005) requires more certainty for recognition of termination cost, for example, if the employee has sign up for the termination scheme.

As per the transitional provision of revised AS 15, as regards VRS paid upto 31 March, 2009, there is a choice to defer it over pay-back period, subject to prohibition on carry forward to periods commencing on or after 1 April, 2010.

Query

The relevant facts of the early retirement scheme include the following:

- early retirement at the age of 55(instead of legal age of 58)
- employees are free to accept the offer
- employer committed to pay a monthly benefit until the employee is 58
- the scheme is ongoing and will be renewed every 5 years

Should the plan identified above be accounted for as a termination benefit or as a post employment benefit? What amount should be provided for?

Response

The scheme is a post employment benefit plan rather than a termination benefit. The amount provided is based on an actuarial estimate made on all employees after considering the most probable retirement age. This evaluation should reflect the expected success of the plan. Differences between what was expected and reality are treated as actuarial gains and losses.

The objective of termination benefits is to terminate the employment of one class aged employees and to modify the population pyramid of the entity. Termination benefits are often closely linked with curtailments and settlements and with restructuring provisions. In the fact pattern, the entity is not in a phase of restructuring. Its early retirement plans tend to be renewed. Given the fact that these plans are renewed every five years, in this entity, the "normal" retirement age seems to be earlier than 58 (legal retirement age) because a constructive obligation has risen from past renewals of such schemes. Consequently, such benefits should be considered as post-employment benefits and actuarial provisions should be made on an ongoing basis.

Query

Borkar Ltd has a practice of providing a termination benefit based on a specific number of months of salary varying with years of service when employment is terminated. The payment is made in case of a) normal retirement, b) voluntary termination of the employment by the employee and c) involuntary termination of employment by the entity. How should Borkar Ltd account for the termination benefit?

Response

The termination gratuities provided are post-employment benefits. Only additional payments made as a result of either (a) an entity's decision to terminate an employee's employment before the normal retirement date; or (b) an employee's decision to accept voluntary redundancy in exchange for those benefits can be considered termination benefits. A liability should be recognised at the present value of the defined benefit obligation determined using the Projected Unit Credit Method. The event which gives rise to the obligation is the ongoing service rendered by the employees rather than the termination of employment.

11. Transitional Provisions and Impact Assessment

As per revised AS 15, on its first time adoption, the incremental adjustments are taken to revenue reserves net of the tax effect. The critical judgement here often would be is whether the incremental adjustments are those that arise out of first time implementation of revised AS 15, or in reality are a prior period item. In other words, is the incremental provision arising purely due to revised AS 15 and that it was never contemplated earlier under Indian GAAP.

The other issue is the one relating to tax effect that is taken to the revenue reserves. What happens when the tax effect reverses subsequently? Whether the effect should be taken to reserves account or should it be taken to the profit and loss account? In this context, the EAC has already given its opinion on a similar issue involving impairment of assets. The EAC has opined that subsequent reversal of the tax effect should be taken to the profit and loss account.

Query

As a result of revised AS 15, the company is examining its accounting for various compensation costs. The company wants to know how exactly the following matters at 1.4.2006 will be accounted for under the transitional provisions of revised AS 15.

a) The company has not made any provision for post retirement medical benefit scheme in the past

b) The company has a gratuity fund with LIC and funding is done on the basis of actuarial valuation method which is not the PUC method. Had PUC method been applied the liability funding at the opening date would have been higher

c) The company has a gratuity fund with LIC and funding is done on the basis of assumption that discount rate is 10%, though long term government bonds yield is 6% pa

d) The company does not have any fund for gratuity. It makes a gratuity provision based on actuarial valuation. This valuation is made only for those employees that have completed 5 years of service with the company

e) The company has not made any provision for a jubilee award scheme where on completion of 25 years of service, the employee is paid Rs 1 lakhs

f) The company needs to give its PF trust atleast Rs 100 lakhs so that future interest earnings by the fund would be commensurate to the minimum guaranteed interest payments and as per actuarial valuation under revised AS15

g) The company did a detail study of its contract employees, and realized that there is an unprovided actuarial gratuity liability of Rs 200 lakhs. Presently as and when the contractor pays the gratuity to the employees concerned the same is recovered from the company

h) For a financial year, the company pays a customary bonus in the forthcoming September. For the past 10 years, the company has consistently paid 20% bonus on basic wages, though this is not a statutory or legal liability. The company accounts for the bonus in September, when the amounts are finally determined and paid

i) Tax effect of the above items

Response

a) The actuarially determined liability as per revised AS-15 should be taken to the profit and loss account as a prior period item. This is because though pre-revised AS-15 did not deal with such benefit, EAC had given opinion that required actuarial liability to be provided for in such cases

b) No actuarial method was prescribed in the pre-revised AS 15. Therefore any increase or decrease in actuarial liability due to change in the method should be taken to the opening reserves as per the transitional provision

c) Though pre-revised AS 15 did not contain any guidance on actuarial assumptions, the use of a very high discount rate in the previous year should be treated as prior period item in the profit and loss account rather than as a transitional adjustment

d) Actuarial valuation should include even those employees who have not completed 5 years of service, after considering probable departures. This is not a new requirement and its interpretation should have been possible even in the pre-revised AS 15. Therefore increase in the provision amount due to this factor should be treated as a prior period item and adjusted to the profit and loss account

e) Since a provision for jubilee awards was not required by pre-revised AS 15 or EAC opinions or other Indian accounting promulgation, the cumulative provision could be adjusted to revenue reserves as a transitional adjustment arising out of first time implementation of revised AS 15

f) Since there was no express requirement to account for such deficits, the amount could be adjusted to revenue reserves as a transitional adjustment arising out of first time implementation of revised AS 15

g) Since there was no express requirement to account for such contract obligations, the amount could be adjusted to revenue reserves as a transitional adjustment arising out of first time implementation of revised AS 15

h) Pre-revised AS 15 did not apply to bonus since it is not a retirement benefit. Therefore the GAAP that was applicable to bonus was AS 29 which required provision for bonus based on constructive obligation. Therefore this adjustment should be reflected as a prior period item rather then a transitional adjustment.

i) Tax effect should be taken to the same head as the principal item. Therefore tax effect of prior period item should go to prior period item, whereas tax effect of adjustments made to revenue reserves should go to the revenue reserve account

12. Disclosure Requirements

Illustrative Accounting Policy

Employee benefits

i. Provident Fund is a defined contribution scheme and the contributions are charged to the Profit & Loss Account of the year when the contributions to the government funds are due.

ii. Gratuity liability and Pension liability are defined benefit obligations and are provided for on the basis of an actuarial valuation made at the end of each financial year.

iii. Short term compensated absences are provided for based on estimates. Long term compensated absences are provided for based on actuarial valuation.

iv. Actuarial gains/losses are immediately taken to the profit and loss account and are not deferred.

v. Payments made under the Voluntary Retirement Scheme are charged to the Profit & Loss account over a five year period.

Illustrative Disclosures

Provident fund, short-term compensated absences and other short-term benefits

Related party disclosures

(Amount in Rs. '000)

	2007	*2006*
Employee benefits expense for key management personnel	*516*	*434*

Details of individual parties with transactions of 10% or more of aggregate value in respect of key management personnel:

	2007	*2006*
Mr. X	*212*	*182*
Mr. Y	*182*	*174*

Schedule VI disclosures in the balance sheet

	2007	*2006*
Provisions		
Gratuity	*15*	*48*
Post-employment medical benefits	*254*	*165*

AS 15 and Schedule VI disclosures in the Profit and Loss Account

	2007	2006
Salaries, wages and bonus	4,256	3,527
Contributions to provident fund	634	563

Managerial remuneration:

	2007	2006
Salary	353	253
Contribution to provident fund	35	25

Note: Managerial remuneration excludes provisions for / contribution to gratuity and post-employment medical benefits which are based on actuarial valuation done on an overall Company basis.

Gratuity and other post-employment benefit plans

The Company has a defined benefit gratuity plan. Every employee who has completed five years or more of service gets a gratuity on departure at 15 days salary (last drawn salary) for each completed year of service. The scheme is funded with an insurance company in the form of a qualifying insurance policy.

The Company has also agreed to provide certain additional post-employment healthcare benefits to senior employees. These benefits are unfunded.

The following tables summarise the components of net benefit expense recognised in the profit and loss account and the funded status and amounts recognised in the balance sheet for the respective plans.

Net employee benefit expense (recognised in cost of sales)

(Amount in Rs. '000)

	Gratuity		Post-employment medical benefits	
	2007	2006	2007	2006
Current service cost	(275)	(262)	(82)	(85)
Interest cost on benefit obligation	(130)	(120)	(5)	(1)
Expected return on plan assets	160	148	-	-
Net actuarial gain / (loss) recognised in the year	(62)	(7)	(2)	5
Past service cost	(58)	(44)	-	-
Net benefit expense	**(365)**	**(285)**	**(89)**	**(81)**
Actual return on plan assets	146	156		

Balance sheet

(Amount in Rs. '000)

	Gratuity		Post-employment medical benefits	
	2007	2006	2007	2006
Defined benefit obligation	(2,371)	(2,487)	(254)	(165)
Fair value of plan assets	2,332	2,357	-	-
	(39)	(130)	(254)	(165)
Unrecognised past service cost	24	82	-	-
Plan asset / (liability)	(15)	(48)	(254)	(165)

Changes in the present value of the defined benefit obligation are as follows:

	Gratuity		*Post-employment medical benefits*	
	2007	2006	2007	2006
Opening defined benefit obligation	2,487	2,973	165	84
Interest cost	130	120	5	1
Current service cost	275	262	82	85
Benefits paid	(569)	(883)	-	-
Actuarial (gains) / losses on obligation	48	15	2	(5)
Closing defined benefit obligation	2,371	2,487	254	165

Changes in the fair value of plan assets are as follows:

	Gratuity	
	2007	2006
Opening fair value of plan assets	2,375	2,134
Expected return	160	148
Contributions by employer	398	950
Benefits paid	(569)	(883)
Actuarial gains / (losses)	(14)	8
Closing fair value of plan assets	2,332	2,357

The Company expects to contribute Rs. 460 to gratuity in 2007-08.

The major categories of plan assets as a percentage of the fair value of total plan assets are as follows:

	Gratuity	
	2007	*2006*
	%	*%*
Investments with insurer	100	100

The overall expected rate of return on assets is determined based on the market prices prevailing on that date, applicable to the period over which the obligation is to be settled. There has been a significant change in the expected rate of return on assets due to the improved stock market scenario.

The principal assumptions used in determining gratuity and post-employment medical benefit obligations for the Company's plans are shown below:

	2007	*2006*
	%	*%*
Discount rate	4.9	5.2
Expected rate of return on assets	7.2	7.5
Employee turnover	35	29
Healthcare cost increase rate	7.2	7.4

The estimates of future salary increases, considered in actuarial valuation, take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.

Assumed healthcare cost trend rates have a significant effect on the amounts recognised in the profit and loss account. At present, healthcare costs, as indicated in the principal actuarial assumption given above, are expected to increase at 7.2% p.a. A one percentage point change in assumed healthcare cost trend rates would have the following effects on the aggregate of the service cost and interest cost and defined benefit obligation:

	One percentage point increase	One percentage point decrease
Effect on the aggregate of the service cost and interest cost	40	(34)
Effect on defined benefit obligation	110	(127)

Amounts for the current and previous four periods are as follows:

	Gratuity				
	2007	2006	2005	2004	2003
Defined benefit obligation	(2,371)	(2,487)	(2,973)	(2,539)	(2,039)
Plan assets	2,332	2,357	2,134	1,948	1,895
Surplus / (deficit)	(39)	(130)	(839)	(591)	(144)
Experience adjustments on plan liabilities	(18)	23	12	(12)	24
Experience adjustments on plan assets	(14)	8	(16)	12	17

	Post-employment medical benefits				
	2007	2006	2005	2004	2003
Defined benefit obligation	(254)	(165)	(84)	(80)	(78)
Experience adjustments on plan liabilities	(5)	8	2	5	2

Query

Should the defined benefit plan expense be presented as a single line on the face of the income statement or be split into its separate components?

Response

Paragraph 118 of AS 15 states, “This Standard does not specify whether an entity should present current service cost, interest cost and the expected return on plan assets as components of a single item of income or expense on the face of the income statement.” Thus all elements of defined benefit plan expense can either be aggregated into one line item in the income statement or split according to their nature and included in more than one income statement line, in particular the expected return on assets and the interest cost being located with other financial items.

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