ACCOUNTING STANDARD 15 (REVISED 2005): AN ACTUARIAL OVERVIEW

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"Most of the clauses of the Accounting Standard 15 (Revised 2005) bristles with Actuarial terminologies and Actuarial methodologies. It also requires elaborate disclosures and method of presentation all of which requires Actuarial inputs. This article attempts to interpret and illustrate some key aspects of Accounting Standard 15 (Revised 2005) viz. New Terminologies and Concepts, Actuarial Treatment of Various Benefits, and Disclosure requirements"

AS15 (Revised 2005) hereinafter referred to as AS15R dealing with treatment of Employee Benefit Schemes [EBS] has come into effect in respect of accounting periods commencing on or after 1St April 2006. It differs widely from its predecessor AS15 (1995) in the matter of coverage, scope, treatment, presentation and disclosures. Prerevised AS15 (1995) covered only Retirement Benefits while AS15R covers the entire gamut of employee benefits. Its scope includes shortterm employee benefits, post-employment benefits, other long-term employee benefits and termination benefits, but excludes-equity compensation benefits. It is closely aligned to the International Accounting Standard (IAS) 19 for most parts the major difference being in the method of recognition of Actuarial loss/(gain) and Transitional provisions. AS15R has introduced certain new terminologies and concepts, which were not there in AS15.

These are explained in the following sections.

NEW TERMINOLOGIES/CONCEPTS

1. Present Value Of Obligations (PVO)

This refers to actuarial liability as we understand it now. PVO is the present value of the benefits payable on exit viz. normal retirement or death or resignation or earlier retirement.

While computing this we take into account future projected salary, but service up to valuation date only. This is known as Projected Unit Credit Method. It considers each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up final obligation.

2. Discount Rate

This is the rate used to discount post-employment benefit obligations (both funded and unfunded). This is not to be based on yield on Invested Assets but determined by reference to market yields [as on the relevant balance sheet date] of Government Bonds of term which is equivalent to estimated term of the benefit obligations. This is arrived at by applying a single weighted average discount rate that reflects the estimated timing and amount of benefit payment.

This is a new concept as for the first time the discount rate has been de-linked from the yield on invested assets.

3. Expected Rate Of Return On Plan Assets

This is a new concept and refers to average rate of earning [average investment earnings rate] expected on the funds invested or to be invested to provide for the benefits included in the PVO. This rate is used for determining the expected return on Plan Assets, which is determined by taking the value of Plan Assets at the beginning of the year and adjusting it for the movements in the Plan assets during the course of the year. This `Expected Return on Plan Assets' plays a part in determining `Actuarial Loss/ (Gain)' and also in determining the `Expense Recognized in the Statement of Profit and Loss'.

4. Fair Value Of Plan Assets

Fair Value in this context is defined as the amount at which an asset could be exchanged or a liability settled between knowledgeable willing parties in an arm's length transaction. Where no market price is available, fair value is estimated by discounting expected future cash flows. All Plan Assets are to be valued at its `Fair Value'. This is at variance with the current practice of valuing Plan Assets at cost.

5. Interest Cost

This arises because the benefits are one period closer to settlement. This is a new concept and it is determined by multiplying the `Discount rate' by `PVO' at the beginning of the year after adjusting the same for any material changes in the obligation.

6. Current Service Cost

This refers to Actuarial present value of benefits attributed by the Plan's benefit formula to services rendered by the employees during the Inter-Valuation Period. The service cost component is conceptually the same for an unfunded plan as well as for a funded one. While computing the same, projected future salaries are taken into account.

7. Actuarial Losses And (Gains)

This refers to changes in the amount of either the PVO or Plan assets or both resulting from [a] Experience being different from than that assumed or [b] Changes in assumptions between two valuation dates. In other words the actuarial losses and (gains) can arise on account of [a] Actual mortality/attrition rates and/or salary escalation rates being different from the corresponding actuarial assumptions; [b] The differences between actual return on Plan Assets and expected return on Plan Assets [c] Changes in Actuarial Assumptions relating to Mortality/Attrition Rate/Rate of salary escalation/discount rate between two valuation dates.

8. Past Service Cost (Vested And Non- Vested Benefits)

Past Service Cost arises when an enterprise introduces a defined benefit plan or makes changes to an existing Plan. This may lead to changes in the present value of PVO for employees' service in prior periods resulting in the current period. The benefits may be vesting or non-vesting or a combination of both. By "vesting" we mean that the payment of benefits does not depend upon employee putting in further years of service. Conversely by "non-vesting" we mean that granting of benefits depends upon an employee completing a certain minimum service which he has not completed as on the valuation date. AS15R provides that in respect of benefits which are already vested past service cost should be recognised immediately. If the benefits remain non-vested as on valuation date, past service cost should be recognised as an expense on a straight line basis over the average period until the benefits become vested.

9. Curtailments And Settlements

Curtailment arises when there is a material reduction in number of employees, say, due to the closure of a unit. It may also arise where a benefit plan is amended or suspended. A settlement occurs when an obligation is settled say by paying a lump sum amount and the plan ceases to exist. Losses/(gains) arising on curtailment and settlements are to be recognized immediately.

10. Termination Benefits

This refers to payments / provision for benefits made to employees when their services are terminated. It may also include enhancement of retirement benefits. Voluntary Retirement Schemes will fall under this category. Termination benefits are to be recognized immediately. However, where an enterprise incurs expenditure on termination benefits before March 31, 2009, it may be deferred over the pay-back period but not beyond April 01, 2010.

DISCLOSURES

AS15[R] requires elaborate disclosures relating to

[a] Actuarial Assumptions,

[b] Reconciliation of PVO at the beginning and end of the period,

[c] Fund Movements,

[d] Computation of liability to be recognized in balance sheet and

[d] Break-up of `expense' in the profit and loss account..

Discount Rate: This is based on market yield at the balance sheet date on government bonds of a term consistent with future term of the employees as already explained.

Rate Of Return In Compensation Plans: This is estimated by the enterprise taking into account inflation, seniority, promotion and demand in employment market, past history of increasing benefit and other relevant factors.

Rate Of Return On Plan Assets: As already been explained, this refers to average investment earnings rate on funds invested or to be invested to provide for the benefits included in PVO. The manner of computing this rate by the enterprise and the quantum of expected returns is illustrated in the example given under Para 109 of AS15[R].

OTHER DISCLOSURES

a) Major categories of Plan Assets as a percentage of total plan assets viz. Government of India Securities, High Quality Corporate Bonds, Equity Shares, Property etc. (Para 120(h))

b) Key historic information over a five year period and best estimate of contributions expected to be paid for the ensuing year (Para 120 n))

c) Investments in the sponsoring entity's financial instruments or self occupied properties. (210(l))

d) Sensitivity to medical cost trend rates (Para 120m))

OTHER LONG TERM EMPLOYEE BENEFITS

This refers to long term compensated absences, long term disability benefits, deferred compensation, profit sharing / incentive bonus going beyond twelve months, jubilee or other long service benefits. Incentive bonus for continuity in service offered generally by software companies come under this heading. All these benefits require Actuarial Valuation. Short term compensated absences which cannot be carried forward beyond twelve months require a simplified approach and require no actuarial valuation (Paras 11 to 15)

LEAVE ENCASHMENT BENEFIT

While AS15 [1995] uses the term 'Leave Encashment Benefit' to refer to leave encashment on retirement, there is no explicit reference to this term in AS15R. Instead AS15 R uses the term 'Compensated Absence' as an umbrella concept to capture

i) Leave encashment payable on separation

ii) Leave encashment payable during service

iii) Availment of leave (though no cash flow is involved) Again 'Compensated Absence' is divided into two components: *'Long Term Compensated Absence'* and *'Short Term Compensated Absence'.*

Short Term Compensated Absence refers to such leave-related benefits falling due within twelve months of the valuation date. This is again split into two constituents: *accumulating and non-accumulating.* 'Non- Accumulating

Compensated Absence' refers to that part of the credited leave which lapses on the valuation date without resulting in any future liability. On the other hand, 'Accumulating Compensated Absence' refers to that part of the credited leave, which can be carried forward up to twelve months from the valuation date. Although Actuarial Valuation is not needed to value this component, it needs to be valued [as on the valuation date] taking into account the proportion of that leave which is expected to be availed during the next twelve months. The mechanics of this valuation is explained in Para 15 of AS15R through an example.

On the other hand Long Term Compensated Absences, which include leave encashment benefit both on retirement & during service as also availment needs Actuarial Valuation. Based on the company's experience, the leave on credit has to be split up into three proportions. This proportion has to follow the LIFO (Last in First Out) approach. This means any leave availed or encashed after valuation date will first be taken from fresh accruals and after exhausting the same the leave on credit will be utilized. The components of pay for the purposes of leave encashment would be as per company's rules while for availment it has to be based on cost to company (CTC). As regards sick leave (if applicable) generally no encashment is allowed and sick leave not availed lapses after the ceiling is reached or on exit. This benefit has to be valued taking into account the probability of a portion of this leave lapsing without giving rise to any liability.

A frequently asked question is how leave availed which does not involve a cash flow can give rise to a liability. Although when leave is availed the enterprise pays salary for that particular day without getting any economic benefit in return, the fact is that this economic benefit has already been derived [as on the valuation date] through the services rendered by the employee before that date. Thus a liability has already arisen but not emerged. Based on accrual principle this liability as on valuation date has to be recognized.

SHORT-TERM EMPLOYEE BENEFITS

These include wages, salaries, and short-term compensated periods of absence, death-in-service benefits and profit sharing plans [including bonus plans] payable not more than twelve months after the balance sheet date. The enterprise must measure, recognize and disclose the cost as the undiscounted amount of such benefits expected to be paid after the close of the accounting period in exchange for services rendered during that period.

NON-VESTED BENEFITS

These refer to non-vested benefits pertaining to an existing benefit scheme. These benefits require a treatment different from what applies to non-vested benefits pertaining to past service cost [which was covered in our discussion on past service cost]. For example when service is less than five years a non-vested gratuity benefit arises. There is no provision for spreading this liability over the vesting period. The valuation has to be conducted normally taking into account service up to valuation date and the allowance made for attrition rate is supposed to take care of exits before the vesting date.

Employee Incentive Scheme which is generally popular with software companies contains a non-vested element and requires special treatment. A typical scheme may provide payment of lump sum benefits at the end of six months, twelve months etc., from the date of inception. Here, the vested portion is computed taking the pro rata benefit applicable up to the valuation date and the same is actuarially valued taking into account; *inter alia,* the attrition rate.

EXEMPTED PROVIDENT FUNDS

Certain Provident Funds administered by employers may have an obligation to credit interest at a rate declared by the Government irrespective of what the fund earns. This means a guarantee of a specified return and the provisions of Para 26[b] are attracted which in turn implies the need for actuarial valuation. What needs to be actuarially valued is the differential in interest earnings as a result of difference between guaranteed rate of interest and actual rate of interest being earned. The differentials will relate to future term of existing liabilities as on valuation date.

SCHEMES FUNDED WITH INSURANCE

COMPANIES – WHAT SUCH ENTERPRISES SHOULD DO

Here AS15R makes a clear distinction between `Financial Decision' which means paying premium under an Insurance Policy or making contribution to a self-administered fund and `Accounting Provision' which refers to provision to be made in the Accounts.

While `Financial Decision' will be influenced by various factors such as profitability, taxation and cash flow, as regards `Accounting Provision' the new standard specifies that the premium paid to the Insurer forms part of Plan Assets and for making Accounting Provision the services of a qualified Actuary are to be utilized. This will have a major impact on such enterprises since it is no longer possible to treat the amount quantified by Insurer as provision to be made in the accounts. They have to restate their Actuarial liability on the date of adoption both under AS15 (1995) and AS15R

TRANSITIONAL PROVISIONS

As on date of first adoption, two valuations have to be conducted one as per AS15R and another as per AS15. From the present value of obligation so arrived at as per AS15R, fair value of plan assets as on the date of adoption will be deducted to arrive at the transitional liability. The difference between this transitional liability (as adjusted by related tax expense) and the liability that would have been recognized at the same date as per pre-revised AS15 should be adjusted against opening balance of revenue reserves and surplus.

PARTICULARS NEEDED FOR ACTUARIALVALUATION.

The particulars to be furnished by the Enterprise for Actuarial Valuation have increased considerably and at the minimum the following particulars are to be furnished.

a) Name and address of the enterprise and name and contact numbers of authorized person.

b) A summary of the benefits to be valued and the valuation date.

c) Age of retirement

d) Employee particulars indicating Name / Date of Birth (mm/dd/yyyy) / Date of joining (mm/dd/yyyy) / Salary applicable to the Plan / CTC.

e) Movement in the Fund as follows:

Opening balance at the beginning of the year (valued using the fair value approach) + Contribution + Actual Return on Assets - Benefits paid = Closing balance as on valuation date

f) Amount of leave encashment paid on retirement / during service.

g) Major categories of Plan Assets such as Government Securities, Corporate Bonds classified as per different credit rating categories, equities, real estate etc. and their percentages of the total invested assets

h) Expected rate of return on Plan Assets computed in the manner specified in paragraphs 107-109 of AS15R

i) Salary escalation rate taking into account inflation, seniority, promotion, past practice of increasing benefits etc. as per paragraphs 83 – 91 of AS15R.

SUMMARY

To sum up AS15R calls for [a] an in-depth analysis of all employee benefits which are in vogue in an enterprise and [b] delineate those benefits, which fall under the purview of AS 15 [R]. It is fair to say that facilitating a smooth transition

from AS 15[1995] to AS 15R will require upfront investment of time and efforts on the part of all stakeholders associated with this process – the Actuary, the Auditor, the CFO, the HR Head and the CEO.

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