Accounting Standard – 15 [Revised 2005] – Recent Developments

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Abstract:

Accounting Standard 15 [Revised 2005] hereinafter called AS15R came into force for all enterprises from the Financial Year commencing on and after 07 12 06. A paper on the subject was presented at the IX Global Conference. Since then a number of Guidelines, expert opinion and revision to accounting standard have been issued by Institute of Chartered Accountants of India [ICAI]. Also Actuaries have gained valuable experience in AS15R valuations during this period. Thus the time has come to have a re-look into the matter and review all these developments which have taken place during the past one year. This paper aims to capture all such developments so as to generate a fruitful discussion and plan the further steps ahead.

Key Words:

Fair Value of Plan Assets, Actuarial Losses / (Gains), Past Service Cost, Vested and Non-Vested Benefits, Long Term and Short Term Compensated Absences, Transitional Liability, Unrecognized past service cost, Experience Analysis, Revenue reserves and surplus, Actuarial Practice.

1 Introduction:

Accounting Standard 15 [Revised 2005] hereinafter called AS15R came into force for all enterprises from the Financial Year commencing on and after 07 12 06. A paper on the subject was presented by the author jointly with Dr. K. Sriram at the IX Global Conference of Actuaries held during February, 2007. Since then a number of Guidelines, expert opinion and revision to accounting standard have been issued by Institute of Chartered Accountants of India [ICAI]. Also many actuarial valuations under the AS15R have been done by the Actuaries thus enabling them to gain valuable experience in this regard. Thus the time has come to have a re-look into the matter and review all these developments which have taken place during the past one year. This paper aims to capture all such developments so as to generate a fruitful discussion and plan the further steps ahead. Thus this is the most opportune time as Actuaries will all be flooded with requests for actuarial valuation of all employee benefit as per new standard in the coming months.

2 Developments during the last One Year

A list of major developments which have taken place during the past one year are as under:

1. Guidelines Issued by Accounting Standard Board [ASB] during May, '07[June, '07 issue of **CHARTERED ACCOUNTANT**].

2. Expert Advisory Committee [EAC] report on 'Leave Valuation'. [October 2007 issue of **CHARTERED ACCOUNTANT]**.

3. Limited revision to AS15R relating to treatment of Transitional Liability [December, '07 issue of **CHARTERED ACCOUNTANT**].

4. Presentation of papers on AS15R and discussions on the same in the CIRB conference held in June, 07.

3. Employees' Provident fund

As per para 26[b] of AS15R where an enterprise's obligation is not limited to its contribution to the Fund and there is an interest guarantee the plan fall under defined benefit category. There has been some doubts as to whether EPF is indeed a defined benefit plan and if so what methodology should be adopted for such valuation particularly in the light of AS15R requirement that all Actuarial valuations should be done using Projected Unit Credit Method and Disclosures be made as per Annexures A and B of AS15R. The guidelines issued ASB of ICAI has set at rest all doubts in this regard vide para 9 of the ASB guidelines. They have now clearly come out with the ruling that such plans come under Defined Benefit Category. A separate paper is being presented in this conference on this subject and accordingly this subject is not dealt with further in this paper.

4. Actuarial Valuation of long term compensated absence (leave valuation)

4.1 Leave valuation is one area where there has been difference of opinion amongst all concerned – (Actuaries / Auditors / Enterprises) in the matter of interpretations and implications of the relevant provision of AS15R and accordingly the method of implementation.

This is mainly due to the wording of certain clauses which are tuned to practices in countries which have adopted IAS19. The application of the same wording to India where practices are different causes confusion. However better clarity can be achieved if we go through all the clauses together instead of analyzing each clause in isolation.

Relevant paras relating to long and short term compensated absences are reproduced below so that all these are taken together to understand the full implication and intent of the provisions of AS15R.

Para 7.2 : 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.

Para 8 (b) : short-term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee services.

Para 7.8: Other long-term employee benefits [LTCA] are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service.

Para 129 [b]: In measuring the liability, an enterprise should apply paragraphs 49 – 91, excluding paragraphs 55 and 61.

Para 67: An enterprise discounts the whole of a post-employment benefit obligation, even if part of the obligation fall due within twelve months of the balance sheet date.

An in-depth analysis of these provisions have been made by the ASB and the guidelines issued them can be found in June, '07 issue of Chartered Accountant journal. To add further clarity Expert Advisory Committee of ICAI has taken up an Actual case (which practically covers 99% of the cases we come access) and given their opinion. Their findings are summarized below:

Para 7.2 defines 'short term' benefit as those which **fall due** within twelve months of valuation. Read in isolation this will imply practically the entire privilege leave standing to credit as on valuation date will be short term, since in most of the cases it will fall due during next twelve months and can be taken fully subject to any restriction in leave rules. Actually many enterprises proceeded on this premise. But para 8(b) adds a rider which says that short term compensated absence are those where the absences are **expected to occur** within twelve months. Taken together this means that a type of leave which can be carried forward beyond twelve months [which in India is called Privilege / Earned / Annual Leave] will be a short term if and only if the **entire** leave is encashed or availed during the next twelve months. This is in addition to availment / encashment of the leave which accrues during the next twelve months since LIFO (Last in first out) basis is adopted. It is obvious that this cannot be the case. This point has been further reiterated by the [EAC] which has given a clear cut answer to a specific question asked.

The question asked was whether 'Annual Leave' which can be carried forward subject to a limit of 300 days and which can be encashed during service or on separation or availed during service should be treated as long term or short term.

The EAC after taking into account the various considerations mentioned above has given a categorical answer that such 'annual leave' is long term employee benefit and should be provided on an Actuarial bases. The above actual case covers all the cases we come across [save certain rare exception] and the EAC opinion has put an end to all speculations, confusions and misconceptions with reference to determining status and treatment of short term and long term compensated absences.

4.2. The following is a summary of the findings of the ASB and EAC regarding leave read in conjunction with relevant provisions of AS15R:

i. [Long Term] leave at credit should be split up into three components as follows and to be valued.

a) availment during service
b) encashment during service
c) encashment on separation

This pattern should be based on behavioral pattern of all the employees of the enterprise taken as a whole and Rules of the enterprise in this regard.

ii. Once the status is determined as long term, even if part of the leave is availed / encashed within 12 months the entire leave has to be actuarially valued. In other words even if LTCA contains a portion of short term type benefit the whole liability will be treated as long term.

iii. In respect of 'availment' relevant pay should be taken as CTC [cost to company] while in respect of encashment it will be on the basis of 'relevant pay' as specified in the Rules of enterprise.

iv. In respect of sick leave the probability that an employee avail sick leave should be taken into account. In majority of cases, no encashment is allowed and in such cases the proportion of sick leave that will lapse on separation without giving rise to any liability should taken into account.

v. Although no specific disclosures are needed in respect LTCA, still disclosure statement as per paras 129 and 130 are necessary. These paras require the determination and break up of 'liability' and 'net cost'.

vi. STCA requires measurement on an Actual rather than Actuarial basis. This is done based on leave at credit [which needs to be availed within twelve months], CTC and probability that some portion of leave will lapse without giving rise to any liability. No disclosure is needed. Casual leave will come under this category. It is worthwhile to note in this regard that if Financial year and Casual leave year coincides casual leave balance will be nil.

vii. While performing interim valuation short term benefits should be treated as benefits payable within twelve months from the end of the financial year and not from the present valuation date.

To sum up in India the types of leave we come across are of the following types (practically in 99% of the cases)

a. Privilege / Earned / Annual Leave
b. Sick Leave
c. Casual Leave.

While (a) and (b) will be treated as LTCA, (c) will be treated as STCA.

5. The other findings ff the ASB are dealt with below:

5.1 **Concessional loans** provided by an enterprise is no doubt an employee benefit but actuarial valuation is not needed until ICAI takes decision on accounting for the same.

5.2 Group Gratuity Scheme of Insurers

Guideline 10 clarifies that Group Gratuity Schemes offered by Insurers is a defined benefit plan – a known fact. It says that the assets held by the Insurer on behalf of the enterprise should be considered while recognizing the amount of defined benefit liability in its balance sheet. However, both AS15R and ASB are silent whether the value of the Fund as given by Insurer can be taken as 'Fair Value' for the purpose of para 55[c] of AS15R. This will depend on the question whether there is a guarantee of capital by the Insurer. Naturally this point has to be taken into account while determining the fair value.

5.3. Actuarial Certificate provided by Insurer

Guideline 12 answers an important question whether actuarial valuation certificate given by an Insurer can be relied upon for the purposes of AS15R. The ASB's response in this regard is a "guarded" one which runs as follows:

"The actuarial valuation certificate provided by the insurance company can be relied upon by the enterprise. However, the enterprise should ensure that such actuarial valuation has been carried out by a qualified actuary in accordance with AS 15 (revised 2005), the underlying data is accurate, the assumptions are appropriate and the information required for compliance with the disclosure requirements of the Standard have been provided by the insurance company".

On the other hand Institute of Actuaries of India Act, which has come into effect from 10th November 2006. specifically prohibits Insurers from doing actuarial practice.
Relevant extracts are reproduced below.

"40. Companies not to engage in actuarial practice.

No company, whether incorporated in India or elsewhere, shall practice as Actuaries".

A reading of both the provisions above will imply that Insurer cannot give Actuarial Certificate. It can be given by the employee-Actuary of the Insurer who has to give Actuarial certificate in his own right. Even for this the Actuary has to go through all the data furnished and more than this the responsibility for ensuring that all the particulars are furnished to the employee-Actuary is placed on the enterprise – a near impossibility for the enterprise . Besides there may be restrictions imposed by employer / IRDA. Keeping all these things in now it does not look practicable for the Insurer to provide Actuarial Certificate and it is high time the Regulatory authorities issues clear cut directions in this regard.

5.4 Guideline 17 draws the distinction between changes in accounting policy vis-à-vis a change in accounting estimate in the context of applying AS15 R. For example, when there is a change from the Aggregate Method of Valuation to Projected Unit Credit method now, there is a "Change in Accounting Policy " which needs to be dealt in accordance with Para 32 of AS-5. However where the Projected Unit Credit method has been applied consistently but there have been changes in discount rate and/or other assumptions during the current accounting period, then there is a "Change In Accounting Estimate" which needs to be dealt in accordance with Paris 23 and 27 of AS-5. The issue is more of an accounting nature and deals with the adjustments to net profit and types of disclosures to be made by the enterprise as per AS-5.

5.5 Guideline 18 provides that even where an enterprise opts for an earlier application of AS15R, the enterprise should comply with both the measurement principles and the disclosure requirements as laid down in AS15R. In this context we need to remember that

d) Measurement will be "as on a date".

Whereas

e) Disclosure statement will relate a period of time, say normally an year.

The valuation performed for the purpose of determining Transitional liability as on the date of adoption as per para 145 can satisfy only measurement principle. Only the valuation performed as on subsequent dates can satisfy both measurement principle and disclosure requirement.

Another point, which arises, is whether in case of interim reporting (e.g. to satisfy SEBI requirements) whether full disclosure is needed at the end of each period. Both AS15R and ASB Guidance Note are silent on this aspect. Probably it is best left to the judgment of the Company and its Auditors.

Transitional Provision:

6.1 ICAI has recently come out with a limited revision to AS15R. This revision deals with the treatment of increase in transitional liability due to switch over from old to new standard. The revised version requires that enterprise should make an irrevocable choice to recognize any increase in liability

A) Immediately as an adjustment against the opening balance of revenue reserves and surplus

Or

B) as an expense on a straight-line basis over up to five years from the date of adoption.

If an enterprise chooses (B), then it should

i) Measure any asset recognized in the balance sheet keeping in view the conditions specified in paragraph 59(b). This section limits the value of assets to present value of economic benefits available in the form of refunds or reduction in future contribution.

ii) isclose at each balance sheet date (a) the amount of the increase that remains unrecognized; and (b) the amount recognized in the current period;

iii) Limit the recognition of subsequent actuarial gains (but not negative past service cost) only to the extent that the net cumulative unrecognized actuarial gain (before recognition of that actuarial gain) exceeds the unrecognized part of the transitional liability; and

iv) Include the related part of the unrecognized transitional liability in determining any subsequent gain or loss on settlement or curtailment.

If there is a decrease, it should be adjusted against opening revenue reserves and surplus.

Consequent to this Para 92 of AS15R which requires immediate recognition of actuarial gains and losses has been modified and also consequential changes are made in Para 116 which deals with, unrecognized past service cost in curtailment cases.

In the light of the above all enterprises should do Actuarial Valuation of all employee benefits as on the first date of adoption of AS15R and take a decision as to which option they would like adopt. This process is to be completed much before next year closing.

6.2 The main thrust of Guidelines 15 and 16 is that as on the date of adoption of AS15R adjustment against reserves is not possible in case of under provisioning in the past or valuation for provisioning as required by the earlier version of the accounting standard itself was not made. In other words such under-provisioning needs to be treated as a prior period item and is not to be adjusted against the reserves. Though this issue mainly relates to accounting, still our views may be sought for whether or not certain valuations or provisioning should have been made as per pre-revised AS15[1995]. Naturally provision of not only old AS15[1995] but also of the various Guidelines Notes issued by Actuarial Society of India also have to be taken into account while judging whether past provision has

been made strictly as per old standard. Certain typical examples of these two types of situations are given below.

Type -1:

Where adjustment against reserves possible:

1. Provisioning for Long Term Service Award being made for first time.
2. Interest Guarantee Valuation on GPF being made for first time.
3. Valuation being made for contract employees for first to me.
4. Sick Leave valuation for the first time.

Type – 2:

Where adjustment against reserves not possible:

1. Difference arisen due to Projected Unit Credit method being adopted for first time.

2. No provision was made for post retirement Medical Benefit Scheme previously.

3. Gratuity provision for employees who have not completed five years not made previously.

7. Past History

AS15R requires the presentation of a five-year history of asset and liability related gains and losses passing through the Statement of Total Recognized Gains and Losses. This is intended to highlight any areas where costs are being consistently over or understated.

However to start with there are practical difficulties in giving this five year history now as corresponding figures for past five years will not be available as the old standard did not require it. AS15R and ASB are silent in this regard. However framers of IAS19 [which is the source document for AS15R] have discussed the matter and come to the conclusion that as a transitional measure entities should permitted to build up the trend information over time. Extracts from IASB discussion paper is reproduced below.

The IASB reconfirmed its view that the trend information was useful and noted that it was considerably easier for an entity to take the information from previous financial statements and present it in the current financial statement than it would be for users to find the figures for previous periods. However, the IASB agreed that as a transitional measure entities should be permitted to build up the trend information over time.

Accordingly, we may have the five-year history build up over a time and hence it may not be necessary to report this retrospectively upon adoption of the new standard.

8. Experience Analysis

Actuarial losses/gains arise on account of

1. Difference between assumptions and actual experience
2. Changes in assumption

AS15R require segregation of the actuarial losses/gains under the above categories and experience adjustments to be disclosed. This means whenever assumptions are changed- two valuations are necessary one as per the new set of assumptions and another as per the previous set of assumptions.

9. Miscellaneous Benefits

Since AS15R covers entire gamut of employee benefits, quite a large number of benefits may come up for valuation. In all such instances, the probability of the employee availing such benefits have to be taken into account, besides other factors. An illustrative list of such benefits is as follows:

a. Long Service Benefit
b. Employee incentive schemes
c. Relocation expenses on separation
d. Leave Travel concession
e. Payment of fixed monthly amount to VRS employees till normal date of retirement.
f. Medical Benefit to VRS employees

There can also be other types of employee benefits [not covered under the illustrative list given above] coming within the ambit of defined benefit plans.

10. Long Term Disability Benefit

Para 131 clearly provides that if the level of benefit depends up on length of service, valuation is to be conducted taking into account the probability of the event happening. However if level of benefit is same for any disabled employee, expected cost is recognized only when the event actually occurs. This underlying principle may come in handy when we value benefits where such features are present.

A likely benefit, which we are likely to come across, is payment of a fixed sum on death. Applying the above principle no actuarial valuation will be needed. However if the quantum of the benefit depends upon length of service, actuarial valuation will be needed.

11. Non-Vested Benefits

It is interesting to note that such benefits require different treatment depending on circumstances.

a) If it arises on account of past service cost, such cost should be recognized as an expense on a straight-line basis over the average period until the benefits become vested.
b) In the case of non-vested gratuity benefit within five years, no spreading is allowed but actuarial computation should be made normally taking into account probability of exit before five years.

c) Non-vested benefit arises when a lump sum amount is payable after certain years of service. This is a common feature in employee incentive scheme particularly in software companies which pay certain amount on completion of one year of service, two years of service etc., In such cases accrued benefit is computed taking into account pro rata benefit applicable up to the valuation date and same is actuarially valued taking into account, interalia, the attrition rate. (Para 70 of AS15[R]).

12. Measurement Report and Disclosure Report

The Actuarial Report to be given by the Actuary will consist of two parts one part dealing with measurement aspects and another with disclosure aspects. Para 120 and Appendix A and B of AS15R deal with the various measurement disclosure requirements. Salient features of such disclosures are given below to serve as a check list:

- General Description of the Plan.
- Reconciliation of the opening and closing balances of present value of obligations (PVO) indicating Interest cost / Current service cost / Benefits paid / Actuarial losses (gain) / Curtailment / Settlement cost.
- Reconcilement as above of Fair Value of Plan Assets (FVPA) indicating Expected return / Contribution / Benefits / Actuarial gains (losses).
- Liability recognized in Balance Sheet indicating PVO / FVPA / Unrecognized past service cost / unrecognized transitional liability.
- Expenses recognized in Profit and loss indicating Current Service Cost / Interest cost / Expected return / Actuarial losses (gains) / Past service cost / Transitional liability recognized / Effect of curtailments / Settlements
- Major categories of Plan Assets.
- Principal Actuarial Assumptions: Salary escalation rate / Attrition rate / Expected rate of return (all to be given by the enterprise) / Discount rate.

A letter from employer is necessary that the salary escalation rate has been fixed taking into account inflation, seniority, promotion and other inherent factors, past history of increasing benefits etc. as laid down in Para 120 and Paras 83 – 91 of AS15R.

There is a need to disclose a five-year history showing:

- Present Value of Obligation
- Fair Value of Plan Assets
- Surplus (Deficit)
- Experience adjustment on Plan Liabilities
- Experience adjustment on Plan assets

This five-year history can be built up only over a period as already stated. Initially only one-year history will be available.

A typical disclosure report can be found in Annexure to this article.

13. Summary

1. EPF is a defined benefit plan and therefore requires Actuarial Valuation.

a. While valuing leave, the guidance given by the ASB and EAC have to be taken into account.

2. It will be necessary to perform Transitional liability valuation as on first date of adoption. The option exercised by the enterprise in the manner of treatment of transitional liability should be reflected in the disclosure statement to be given.

3. While performing year closing valuation, it will be necessary to conduct repeat valuation based on same data but on the earlier basis and experience adjustment on plan liabilities and assets should be reported in the disclosure statement.

4. The final report given will consist of two parts one covering measurement principle and another one disclosure principle. It should be ensured that both together captures all the requirements as per 120 and Appendix A and B of AS15R.

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