EFFECT OF CURRENT INDIAN ECONOMIC SCENARIO USE OF DISCOUNTING RATE UNDER AS 15 R (G SEC RATE) FOR THE VALUATION OF EMPLOYEE BENEFITS AS ON 31-3-2014

About the Author

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Employers are mandated to provide for employee benefit liability into their books of account as per provisions of the applicable Accounting Standard in India. Valuation of employee benefit liability and disclosing the same as per the disclosure requirements of Accounting Standard 15 (R).

As per the Indian Income Tax Act 1961 financial year is 1st April to 31st March for calculation of taxable profit. Majority of the companies follow the same as their accounting period and close their books as on 31st March each year.

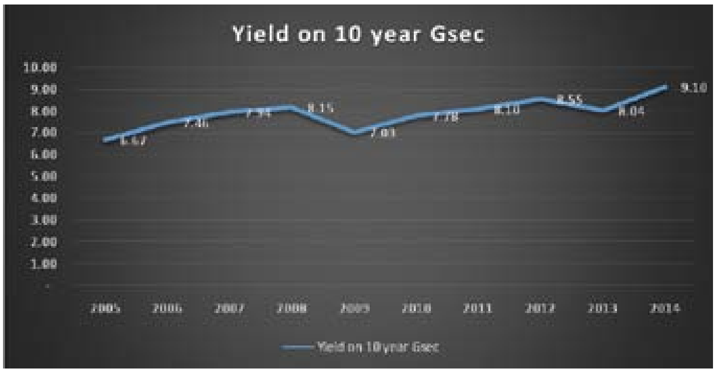
While making the valuation of retirement benefits, Actuaries use several financial and demographic assumptions, one of the key assumption is the Discount rate which affects the value of estimated liability substantially in any year of volatile interest rates.

Para 78 of the Accounting Standard states:

"78. 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 settlement of post-employment benefit obligations."

Effect on value of Actuarial Liability:

As stated in accounting standard 15 to use **market yields at the balance sheet date on government bonds** for discounting the liabilities, a close look at the movement on the yield on the government securities will throw up the impending issue of volatility in the G. Sec yield in the last 10 years. Diagram below, shows movement in rates, it can be noticed that these fluctuation is to the tune of 2.50% in 10 years, though for most period it was around 8.00%.



2014 rate is as on February 2014 all other rates are as of March each years.

One can observe that the yield has gone up from 8.04% to 9.10% from March 2013 to February 2014, this will have an impact on the valuation figures of the liability, and with all other parameters remaining same, there will be substantial reduction in the Liability figures and this will give huge Actuarial Gain.

As Accounting standard 15 mandates routing of Actuarial Gain / Loss through Profit and Loss account, there will be a reduction in the amount charged to the P&L (This is expected to be negative in most of the cases, and may bring reversal in B/S) due to Actuarial Gain on account of higher discount rate. This will distort comparison of employee benefit costs between two years.

Effect on Assets:

Para 100-102 of Accounting Standard 15 deals with the Fair value of Assets:

100. The fair value of any plan assets is deducted in determining the amount recognised in the balance sheet under paragraph 55. When no market price is available, the fair value of plan assets is estimated; for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).

102. Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations, as described in paragraph 55 (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

As per the Indian Tax Laws, the pattern of Investments for retirement benefit trusts includes major portion of G- Sec. As part of approved investments. With yield on G-Sec. Going up there are fair chances that the fair value of the asset will go down and will result in the substantial Actuarial Loss on the plan Assets and ideally will nullify the impact of Actuarial Gain on the Obligation and there will be a neutral impact on the Profit and Loss of the enterprise.

Indian Scenario

Majority of the funded are funded with Insurance companies, either in their

a) Traditional plan or b) Unit linked plan.

Investment value under the Unit linked plan is a fair value as on the data and will represent the yield movement but, traditional plans are considered to be a cash plan and the value of Investment do not change with the change in the yields and this will mute the neutralisation effect on P&L and there will be an actuarial gain booked on the liability.

Those companies (with some exceptions) who have their investments outside the insurance companies, prefer to consider their investments as a HTM (held to maturity) category and do not revalue investments and this will also mute the effect of yield change on the investments.

Actuaries will have tough time explaining the reduction in the P&L and Liability values.

Probable solution to this anomalies can be found in Ind As (19) which routes Actuarial gain/loss through other comprehensive Income. Other solution is to use the average rate of past few years , such as average of past 7 years as is adopted in one of the European country, but this unless provided in the standard may not meet accounting requirement.

Probable way of knowing impact of higher yield on the accounts:

As a reader of the accounts of an organisation, one would be able to know the impact by looking at the disclosure of the movement in the assets and liabilities of the retirement benefits in the accounts.

As per accounting standard 15 (R), entities which have to give the reconciliation in the accounts as to the liability and asset movement also shows the Actuarial gain/loss on experience, by comparing the experience actuarial gain/loss with the reported actuarial gain or loss, one will be able to arrive at the impact the effect of the higher yield has on the accounts.

Note : As one of the requirement under Accounting standard is to show Experience adjustment, which requires calculation of liabilities with last year assumptions, this will justify the difference in liabilities, though Actuaries may advise the company of PBO based on Last year's assumption, this will be more simpler for companies to understand the effect. Also Valuation of Assets wherever there is a privately managed fund to be performed by Actuary to arrive at Asset values and minimise the effect on P/L.

Example: Let's consider an Example where previous year valuation liability was worked out using discount rate of 8.25% p.a. and in current year at 9.25% p.a. This will obviously lead to a reduced expense and PBO at end due to reduction in calculated liability value (PBO). Below values are considered based on assumed situation for representation purpose only (but in reality this can be actual situation).

As an example we have also tried to reproduce some tables considering revaluation of assets, which also resulted drop in the value of assets due to assumption.

Comparison of Liability & Assets:	April-13 to Mar 14
Closing Assets	325,182,000
Closing Assets (Mark – To – Mark (MTM) / Re-value)	305,182,000
Closing PBO	338,700,000
Closing PBO on Last year's Assumptions	365,420,000

Though it is not compulsory to disclose the PBO on earlier assumptions, in some situation like this, disclosure of PBO on earlier assumptions also helps client to understand inconsistency in the accounting.

Below are three tables showing comparison of Charge to P & L as Expense, B/S Liability and Experience Adjustment: -

	Before Revaluation / MTM of Assets	After Revaluation / MTM of Assets
EXPENSES RECOGNIZED IN THE INCOME STATEMENT:	April-13 To Mar 14	April-13 to Mar 14
CURRENT SERVICE COST	27,632,000	27,632,000
INTEREST COST	24,646,875	24,646,875
(EXPECTED RETURN ON PLAN ASSETS)	(21,808,875)	(21,808,875)
ACTUARIAL (GAINS)/LOSSES	2,348,000	22,348,000
EXPENSE RECOGNIZED IN THE INCOME STATEMENT	**32,818,000**	**52,818,000**

From above table we can see the charge to profit & loss has increased because of re-valuation of assets which is actually true & fair view which needs to be disclosed.

AMOUNT RECOGNIZED IN THE BALANCE SHEET:	April-13 to Mar 14	April-13 to Mar 14
FAIR VALUE OF PLAN ASSETS AT THE END OF THE PERIOD	325,182,000	305,182,000
(PRESENT VALUE OF BENEFIT OBLIGATION AS AT THE END OF THE PERIOD)	(338,700,000)	(338,700,000)
DIFFERENCE	**(13,518,000)**	**(33,518,000)**
NET (LIABILITY)/ASSET RECOGNIZED IN THE BALANCE SHEET	**(13,518,000)**	**(33,518,000)**

Similarly from above table we can see the balance sheet value shows true & fair view when we consider actual revalued assets.

Lastly below table shows the experience adjustment when we consider actual revalued asset v/s original asset value

	Before Revaluation / MTM of Assets	After Revaluation / MTM of Assets
EXPERIENCE ADJUSTMENT	April-13 to Mar-14	April-13 to Mar-14
ON PLAN LIABILITY (GAINS)/LOSSES	32,108,000	32,108,000
ON PLAN ASSETS (LOSSES)/GAINS	3,040,000	(16,960,000)

So we can say, revaluation of assets would give smooth charge to profit & loss and balance sheet value. This will be consistent with increase in discount rate for liability calculations and vice versa where discount rate reduces similar methodology can be adopted to revalue assets which would again lead to consistent calculations. This is possible if assets durations are matched with durations of the liabilities. This would be an additional work for Actuarial portfolio as the volatile phenomenon of discount rate can be tackled to an extent with valuation of assets.