

## Accounting of Long Term Employee Benefits – context and perspective

By S. N. Bhattacharya

**Abstract :** The latest revision of the Indian Accounting Standard of employee benefits (AS 15 revised 2005) has brought about a number of conceptual changes in the accounting of long term employee benefits extending the areas of actuarial valuation needed in this respect. A review of some of these changes in the light of the basic principles is undertaken in this article to understand better the overall context and perspective in terms of risk and transparency.

### 1.0 Introduction :

- 1.1 Indian Accounting Standard of employee benefits has recently been revised (AS 15 revised 2005) to align it to the International Financial Reporting Standard. As a result there have been some conceptual changes in the accounting of long term employee benefits – some benefits have now been newly brought under the purview of the new accounting norms, in some cases the accounting norms have changed. A review of the basic principles underlying these changes may be useful in properly digesting these new concepts and having a better understanding of the overall context and perspective.
- 1.2 AS 15 (revised 2005) has also resulted in extension of the areas requiring actuarial valuation. Post Retirement Benefits like Gratuity and Pension were the commonly known areas where accounting provision required actuarial valuation. Now not only all the post-employment benefits have been brought into focus (including benefits like post-employment life insurance or post-employment medical care) but other types of long term benefits like long service leave or deferred compensation and termination benefits are also now explicitly mentioned for making accounting provisions. To value the provisions for these benefits Actuarial techniques will be required. Consequently, now a better understanding of the underlying actuarial methodology has also become necessary to properly account for the employee benefits.

### 2.0 What is new?

- 2.1 The important new aspects of Revised AS 15 relating to long term employee benefits are –
  - i) All “Employee Benefits” are covered under AS 15 (revised 2005) whereas AS 15 (issued 1995) related to “Retirement Benefits”. Employee Benefits mean all forms of consideration given by an entity in exchange for service rendered by employees.
  - ii) It is now clearly mentioned that appropriate provision should be made for –
    - a) the post-employment benefits (such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care),
    - b) other long term employee benefits (including long service leave or sabbatical leave, jubilee or other long service benefits, long term disability benefits, and profit sharing, bonuses and deferred compensation that are not payable wholly within 12 months after the end of the period), and
    - c) termination benefits.

As a result, appropriate provision is now to be made for many new items, e.g., long service leave. Other Retirement Benefits may include regular benefits like reimbursement of relocation expenses following retirement or a special pension granted to a retiring senior executive.

- iii) All post-employment Defined Benefit schemes would require actuarial valuation. Such schemes will include schemes having –
- (a) a plan benefit formula that is not linked solely to the amount of contributions; or
  - (b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions, or
  - (c) Informal practices that give rise to an obligation, for example, an obligation may arise where an enterprise has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

As a result, appropriate provision is now to be made for new items like the interest guarantee liability for a self-administered Provident Fund where the interest rate allowed for accumulation should not be less than that prescribed by the EPFO. Similarly, possibility of voluntary pension increases in future now needs to be included in the process of calculating the pension liability.

- iv) Elaborate disclosure requirement reconciling the flow of the liabilities and the value of the assets (for funded schemes) from the beginning of the accounting period to the end of the accounting period.
- v) Prescriptive instructions regarding measurement of the provisions for the liabilities. Assets to be taken at fair value.

### **3.0 The underlying principles :**

- 3.1 An Accounting Standard is based on some basic principles to give a “true & fair” view of the financial position of a company. The two fundamental principles underlying the Revised AS 15 (following the International Accounting Standard) are “accrual basis” and “ongoing concern basis”.
- 3.2 The “accrual basis” principle explains many of the new concepts in the revised accounting norms. This principle fundamentally implies that any benefit accruing to an employee in a particular accounting period should be treated as a cost during that accounting period and accounted for accordingly although the actual expense may be incurred at a much later date. So, if a special benefit becomes payable at the time of retirement the cost is actually incurred at the time of retirement but the liability really accrued over the entire period of service. Therefore for fair accounting it is necessary to account for the liability accruing in a particular financial year in that financial year itself.
- 3.3 Similarly, for the benefits payable during the post retirement period of an employee the costs are actually incurred when the employee is no more in service (and therefore does not contribute to the income of the company) but his entitlement to these benefits arose out of the service provided to the company during his employment. As such it is logical and reasonable to consider the entire benefit accruing during his service period only, and therefore the liability accruing in each accounting period should be accounted for in that particular accounting period – so that the financial position at a particular point of time does not get burdened by past liability not accounted for in the past years..
- 3.4 The same logic applies in case of long term benefits. For example, in respect of a reward payable to an employee on completion of say 25 years of service the cost is actually incurred

when the employee completes 25 years of service but this entitlement comes out of the entire period of his 25 years of service, and therefore the cost of accrual for that benefit for a particular year of service should be accounted for as a cost for that year of service by way of accounting provisions.

- 3.5 The objective of the “accrual basis” principle is to ensure that, to the extent practicable, the current financial picture does not get distorted due to the burden of past liabilities that accrued in the earlier years but were not appropriately provided for in the past. Since it is not always possible to make exact provisions due to the related uncertainties, it becomes necessary to fine-tune the provisions from year to year to ensure that the total provision up to a particular point of time is appropriate for the liability accrued up to that point of time.
- 3.6 The measurements of the liabilities are based on “ongoing concern basis” principle. This principle assumes that in normal circumstances the company will remain a going concern in the foreseeable future and the provisions for the liabilities are made on that basis.
- 3.7 Elaborate disclosures are expected to bring in more “clarity” and “transparency” about the financial position.
- 3.8 The various prescriptive measures regarding measurement of the liabilities including the discount rate based on government bond rates attempt to narrow down the differences in the bases of valuation so that the liabilities of different companies become comparable. This follows “Comparability” principle.

#### **4.0 Leave Benefit (Compensated Absence) – an interesting example :**

- 4.1 Accounting for leave benefit (compensated absence) accumulated and carried forward is an interesting example of a new concept resulting from application of the new accounting standard. Now, not only accounting is to be made for leave encashment allowed at a future date (including retirement or death), but now accounting provision is also required for the leave earned in the past that can be availed at a later date.
- 4.2 The basic concepts are that - Leave availed or encashed is a ‘cost’ to the company, and Leave accumulated in past years but to be encashed or availed in future gives rise to accrued liability. These concepts are already familiar in respect of Leave encashment but not quite so in respect of Leave accumulated in the past years to be availed in future.
- 4.3 Accrued liability to be treated as - a) Short term when wholly encashed or availed within 12 months (for which no actuarial valuation is required), and b) Long term when not solely encashed or availed within 12 months (which requires actuarial valuation).
- 4.4 Measurement of liabilities relating to accumulated leave that can be encashed in future will be quite different from measurement of the liabilities relating to accumulated leave that can only be availed in future but cannot be encashed, because - the ‘cost’ relating to availing leave is likely to be different from the ‘cost’ of encashing leave, the patterns of encashment and availing of leave in the future years out of past accumulation will be different, and there will be big difference in the liabilities incurred at the point of exit in respect of the residual leave not availed (so forfeited) and the residual leave encashed at that time.

**5.0 Another case – Interest rate guarantee in respect of a self- managed Provident Fund :**

- 5.1 In India, all the Provident Funds were usually considered as Defined Contribution scheme. But now since any scheme having a guarantee, either indirectly through a plan or directly, of a specified return on contributions falls under the category of Defined Benefit scheme, self-administered Provident Funds are now to be considered as Defined Benefit schemes because one of the conditions they have to fulfill is that the interest rate allowed on the individual members' accumulations will not be less than that prescribed by the EPFO (Employees Provident Fund Organization). This is clearly a new concept.
- 5.2 It is easily understood that in any year if the interest earned by the Fund is not enough to allow interest at the rate prescribed by the EPFO the balance is to be made good either from the reserve fund (if available) or by the employer directly. The newness of the concept is that the value of any such deficit to be made up in the future years (during the remaining service period of the concerned members) on the contributions to the members' accounts in a particular year is a 'cost' relating to that year, and as such the cost of such interest guarantee should be provided for when the contributions come into the Fund rather than when the deficits are actually made up. Accordingly the value of such deficits to be made up in the future years in respect of the members' accumulated balances at a particular point of time is a liability relating to the past years of service and form accrued liability in this respect although the actual deficits are 'expected' to arise only at future points of time.

**6.0 The "Risk" aspect involved :**

- 6.1 The principle underlying all of the detailed requirements of the new Accounting Standard is that the cost of providing employee benefits should be recognized in the period in which the benefit is earned by the employee, rather than when it is paid or payable. The basic risk involved in not accounting for the accruing liabilities as explicitly and as closely as possible as and when they accrue is that these liabilities, although accruing over the years, may remain unidentified and as such invisible and the magnitude also unknown. However the actual liability unavoidably arises as and when due whether already provided for or not, and such situation invariably affects the financial condition of the company adversely at that point of time. The level of destabilization caused to the financial circumstances of a company depends on the level of the unaccounted for past liability. In case of merger and acquisition also, when all such unrecognized and undisclosed liabilities are taken into consideration, the financial equation may get significantly changed. Therefore not recognizing and appropriately providing for all the liabilities as and when they accrue not only fails to give a "true & fair" financial position of a company, it may also cause financial disruption in future – the magnitude depending on the nature and dimension of the liabilities involved.
- 6.2 By the same logic, the provisions also need to be appropriate. Long tem liabilities necessarily involve future uncertainties. Therefore the more scientific is the approach in valuation of such liabilities, the more appropriate the measurements are expected to be.

**7.0 The relevance of Actuarial Valuation :**

- 7.1 Identifying the liabilities already accrued but to be incurred in future is not enough. It is necessary to quantify the amount of accrual for accounting purpose. For convenience, the accounting standard divides the accrued liabilities in two groups - Short term & Long term. Short term liabilities involve the liabilities expected to wholly occur within 12 month from the

accounting date. Although conceptually all the considerations for long time liabilities are applicable for short term liabilities also, more simplified method of making provisions for the short term liabilities is considered to be the reasonable practical approach.

- 7.2 As discussed earlier, the basic principle adopted in the measurements of the long term liabilities is "ongoing concern basis". Besides, the three main issues involved in valuing the long term liabilities are - the possibility of incurring the liabilities at different points of time in future, value of the relevant benefit parameters at the time of actual incurrence, and the time value of money. Future being always uncertain, it is impossible to ascertain any of the above factors with absolute certainty. So, accounting has to be made on the basis of best possible estimation.
- 7.3 To take care of above issues in the process of best possible estimation of the long term liabilities, a statistical framework is required with related probabilities of incidence, the future value of the relevant parameters need to be estimated on the basis of the respective assumptions, and then the estimated costs to be incurred in different points of time in future need to be discounted to the date of accounting to arrive at the present value. This process essentially involves Actuarial techniques and methodology. Hence the need for actuarial valuation in the measurements of the long term liabilities.

### **8.0 Commonplace for the Accountants and the Actuaries :**

- 8.1 To properly act as per the new accounting standard the actuaries need to have some understanding of the relevant accounting principles, and the accountants also need to have some basic idea about the actuarial methodology employed in respect of valuation of the long term employee benefits. This is an interesting professional development with immeasurable implications in future.
- 8.2 Accounting Standard being their area of jurisdiction, the Accounting profession has taken the lead by requiring elaborate disclosures for the long term liabilities (and the related assets) for better "understandability" of the results of the actuarial valuations and also by prescribing stricter norms of measurement for better "comparability" of the results. Incidentally they have also extended the scope of actuarial valuations recognising the application of the actuarial techniques and methods as the reliable and recommended approach for the purpose of valuing the long term liabilities. Now it is the turn of the Actuarial profession to respond and set the direction for itself.

**Disclaimer :** This article reflects only personal understanding and perception of the author, not of any company or institution he is attached to. The readers should apply their own judgment regarding the assertions made herein.

### About the Author :

The author, **Mr. Sampad Narayan Bhattacharya**, is at present the Head of the Benefits Practice of Watson Wyatt India Pvt. Ltd. Prior to that he was the Appointed Actuary of the Bajaj Allianz Life Insurance Co. in Pune. Before joining the private sector in 2001, he had a long stint with the Life Insurance Corporation of India, working in various capacities in various offices, both in the Administrative wing and in the Marketing side, as also both in technical departments and as general executive, dealing with individual insurance as well as Pension & Group Schemes, and took voluntary retirement from LIC as Regional Manager (Actuarial) of South Central Zone in the cadre of Deputy Zonal Manager.

Born in 1953, he is an Honours graduate in Physics from Calcutta University and a National Scholar and National Science Talent Search Scholar (NCERT) at H.S. level. He is a Fellow of the Institute of Actuaries of India, an Associate of the Institute of Actuaries, London, and a Fellow of the Insurance Institute of India.

He frequently acted as a guest Faculty at the Zonal Training Centers & the Management Development Center of L.I.C and is quite often invited as guest Faculty and Speaker at the National Insurance Academy in Pune. He also acted as the examiner of Calcutta University in subjects related to Life Insurance and Actuarial science.

He has been contributing Actuarial papers in different forums, both national and international, since 1996. His papers have been accepted in three consecutive **International Congress of Actuaries (in Birmingham, Mexico and Paris)**. He also acted as Guest Speaker, on invitation, in the **'International Conference on Banking and Insurance'** organised by **National Foundation of Indian Engineers** backed by Assocham in New Delhi in July 2001, in the **'Global Symposium on Pension'** in **National Insurance Academy** in Pune in February 2002, in the **Financial Journalists' Seminar** organized by Aviva Life Insurance Co. in **Sri Lanka** in July 2003 and in the **'C D Deshmukh Seminar on Insurance and Pension'** in **National Insurance Academy**, Pune, in September 2004. The related papers were published accordingly.

His paper **"A Note on the equitable form of Reversionary Bonus"** was presented and discussed in the **26<sup>th</sup> International Congress of Actuaries held in Birmingham in 1998** and also in the **All India Conference of Actuaries** organised by the Actuarial Society of India in 1997. Actuarial paper **"Actuarial Profession – its Risks and Re-orientation"** was accepted for presentation and publication in the **27<sup>th</sup> International Congress of Actuaries held in Mexico in March 2002**, and was also presented and discussed in the **4<sup>th</sup> Global Conference of Actuaries** held in New Delhi in February 2002. Actuarial paper **"Actuaries in the changing context"** was accepted for presentation and publication in the **28<sup>th</sup> International Congress of Actuaries held in Paris in May-June 2006** and was also presented and discussed in the **9<sup>th</sup> Global Conference of Actuaries** held in Mumbai in February 2007.

His first Actuarial paper **"Index linked Pension – Some Actuarial Aspects"** was presented and discussed in the **All India Conference of Actuaries** organised by the Actuarial Society of India in 1996. Actuarial paper **"Problems and Potentialities of Pension Products in the present context"** was presented and discussed in the **2<sup>nd</sup> Global Conference of Actuaries** held in New Delhi in February 2000. Actuarial paper **"Concept of 'Profit' & 'Profitability' in Life Insurance Business"** was submitted in the **3<sup>rd</sup> Global Conference of Actuaries** held in New Delhi in February 2001. Actuarial paper **"Defined Benefit Pension Scheme – Can it survive?"** was presented and discussed in the **6<sup>th</sup> Global Conference of Actuaries** held in New Delhi in February 2004 which won **Prof. G S Diwan Memorial Prize**. Actuarial paper **"Appointed**

**Actuary – Insure thyself**” was selected for presentation in the **13<sup>th</sup> East Asian Actuarial Conference** held in **Bali, Indonesia**, in September 2005 and was also presented and discussed in the **8<sup>th</sup> Global Conference of Actuaries** held in Mumbai in March 2006.