ASB Guidance on Implementing
AS 15, Employee Benefits (revised 2005)

This Guidance on Implementing Accounting Standard (AS) 15, Employee Benefits (revised 2005), issued by the Accounting Standards Board of the Institute of Chartered Accountants of India, does not form part of the Standard. The purpose of this Guidance is to illustrate and to assist in clarifying the application of the Standard.

1. What are the kinds of employees covered in the revised AS 15 and whether a formal employer-employee relationship is necessary or not, for benefits to be covered under the Standard?

The Standard does not define the term “employee”. Paragraph 6 of the Standard states that ‘an employee may provide services to an enterprise on a full-time, part-time, permanent, casual or temporary basis and the term would also include the whole-time directors and other management personnel. The Standard is applicable to all forms of employer-employee relationships. There is no requirement for a formal employer-employee relationship. Several factors need to be considered to determine the nature of relationship.

Generally ‘outsourcing contracts’ may not meet the definition of employer-employee relationship. However, such contracts need to be carefully examined to distinguish between a “contract of service” and a “contract for services”. A ‘contract for services’ implies a contract for rendering services, e.g., professional or technical services which is subject to limited direction and control whereas a ‘contract of service’ implies a relationship of an employer and employee and the person is obliged to obey orders in the work to be performed and as to its mode and manner of performance.

2. Whether an enterprise is required to provide for employee benefits arising from informal practices.

Paragraph 3(c) of the Standard defines employee benefits to include those informal practices that give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. The historical pattern of granting such benefits, the expectation created and the impact on the relationship with employees in the event such benefit is withdrawn should be considered in determining whether the informal practice gives rise to a benefit covered by the Standard. For example, where an employer has a practice of making a lumpsum payment on the occasion of a festival or regularly grants advances against informal benefits to employees it would be necessary to provide for such benefits. Careful judgement should be applied in assessing whether an obligation has arisen particularly in instances where an enterprise's practice is to provide improvements only during the collective bargaining process and not during any informal process. If the employer has not set a pattern of benefits that can be projected reliably to give rise to an obligation there is no requirement to provide for the benefits. However, if the practice established by an employer was that of a consistent benefit granted either as part of union negotiations or otherwise that clearly established a pattern (e.g., a cost of living adjustment or fixed rupee increase), it could be concluded that an obligation exists and that those additional benefits should be included in the measurement of the benefit obligation.

3. Whether an entitlement to earned leave which can be carried forward to future periods is a short-term employee benefit or a long-term employee benefit.

Paragraph 7.2 of the Standard defines 'Short-term' benefits as 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. Paragraph 8(b) of the Standard illustrates the term 'Short-term benefits' to include "*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 service*". Paragraph 7.2 of the Standard uses "***falls due"*** as the basis, paragraph 8(b) of the Standard uses "***expected to occur"*** as the basis to illustrate classification of short term compensated absences. A reading of paragraph 8(b) together with paragraph 7.2 would imply that the classification of short-term compensated absences should be only when absences have ***"fallen due"*** and are also "***expected to occur"***. In other words, where employees are entitled to earned leave which can be carried forward to future periods the benefit would be a 'short-term benefit' provided the employee is ***entitled*** to either encash/utilise the benefit during the twelve months after the end of the period when he became entitled to the leave and is also ***expected to do so***. Where there are restrictions on encashment/availment, clearly the compensated absence has not fallen due and the benefit of compensated absences is more likely to be a long term benefit. For example, where an employee has 100 days of earned leave which he is entitled to an unlimited carry forward but the rules of the enterprise allow him to encash/utilise only 30 days during the next twelve months, the benefit would be considered as a 'long-term' benefit. In some situations where there is no restriction but the absence is not expected to wholly occur in the next twelve months, the benefit should be considered as 'long-term'. For example, where an employee has 400 days carry forward earned leave and the past pattern indicates that the employees are unlikely to avail/encash the entire carry forward during the next twelve months, the benefit would not be 'short term'. Whilst it is necessary to consider the earned leave which ***"falls due"***, the pattern of actual utilisation/encashment by employees, although reflective of the behavioural pattern of employees, does determine the status of the benefit, i.e., whether 'short term' or 'long term'. The value of short-term benefits should be determined without discounting and if the benefit is determined as long term, it would be recognised and measured as

"Other long term benefits" in accordance with paragraph 129 of the Standard. The categorisation in 'short-term' or 'long-term' employee benefits should be done on the basis of the overall behavioural pattern of all the employees of the enterprise and not on individual basis.

4. What is an appropriate measure of cost of compensated absences which can be carried forward for their availment and/or encashment in future period(s)?

The cost of compensated absences should be measured as the additional amount the enterprise expects to pay as a result of the unused entitlement. When an employee avails the leave at a future date the cost of such leave would be the compensation and other benefits which the employee would be paid for the period of his absence. In some enterprises the amount payable to an employee on encashment would not be the same as the compensation and other benefits the employee would be paid in case the leave is availed. For instance, an enterprise could have a practice of paying only basic wage when leave is encashed whereas the employee would be entitled to basic wage, allowances and other benefits when the leave is availed. Such situations would require estimation of the additional amount the enterprise expects to pay. This may involve considering the pattern of relative proportion of encashment and availment in order to estimate the likely amounts payable in the future periods. For example, where the past pattern indicates that 97% of leave is encashed and only 3% is availed, it would be necessary to consider the relative proportion and the amounts payable in each condition while estimating the additional amount the enterprise expects to pay in future. The additional amount the enterprise expects to pay would also include payments as a consequence of the settlement of the benefit even though such payments are not directly to the employee. For instance, in cases where leave is encashable, the cost of compensated absences would include the applicable employer's contribution to provident fund. This is because it is a directly related inherent cost of receiving services from employees and as a result of the consideration paid in order to be able to receive the services.

5. What would happen in a case where the rules of an enterprise allow sick leave to be carried forward up to the time of retirement?

Sick leave is one of the types of compensated absences. Sick leave is conditional on the future event of an employee reporting sick. An obligation arises as the employee renders service which increases the employee's entitlement (conditional or unconditional) to future compensated absences. Accumulating paid sick leave creates an obligation because any unused entitlement increases the employee's entitlement to sick leave in future periods. The probability that the employee will be sick in those future periods affects the measurement of that obligation, but does not determine whether that obligation exists. The example illustrating paragraphs 14 and 15 contained in AS 15 is merely to illustrate the individual LIFO approach as the appropriate approach instead of the group LIFO approach or the FIFO approach. Where the rules of an enterprise allow such leave to be carried forward up to the time of retirement, a liability should be recorded for the cost of the entitlement which should be estimated having regard to the probability of the employee availing the sick leave in future periods. In case the rules of the enterprise permit encashment of accumulated unutilised sick leave the liability should be recorded in the manner explained in response to question 4 above.

6. ***In case an enterprise allows unutilised employee benefits, e.g., medical care, leave travel, etc., to be carried forward, whether it is required to recognise a provision in respect of carried forward benefits.***

A provision should be recognised for all benefits (conditional or unconditional) which an employee becomes entitled to as a result of rendering of the service and should be recorded as part of the cost of service rendered during the period in which the service was rendered which resulted the entitlement. In estimating the cost of such benefit the probability of the employee availing such benefit should be considered.

7. ***How are short-term employee benefits determined for interim reporting periods, i.e., whether employee benefits payable within twelve months from the end of the interim reporting period are considered to be short-term or employee benefits payable within twelve months from the end of the financial year are considered to be short-term?***

The principles for recognising assets, liabilities, income and expenses for interim periods are the same as in annual financial statements. However, the frequency of reporting should not affect the measurement of annual results. Therefore, short-term employee benefits in the interim periods should be reckoned as benefits payable within twelve months from the end of the financial year.

8. ***Whether concessional loan provided by an enterprise to its employees is an employee benefit and how should such concessional loan be treated in the financial statements of the enterprise?***

The granting of a loan by an enterprise to an employee at a concessional rate of interest results in a benefit to an employee. At present the value of such benefit is recognised over the period of the loan by accounting for the interest income at the stipulated rate instead of at the market rate. ICAI has issued a draft Accounting Standard (AS) 30, *Financial Instruments: Recognition and Measurement*. This proposed Standard requires such loans (which are financial assets) to be initially recorded at fair value and the difference between the fair value and the amount of loan disbursed would be “employee benefit” to be recorded in accordance with AS 15. Till such time the Standard is finalised and is applicable, loans at concessional rate of interest would continue to be recorded at face value and the interest income recognised at the stipulated rate. There would be no recording of the embedded employee benefit in the granting of such loans.

9. Whether a provident fund which guarantees a specified rate of return is a defined benefit plan or a defined contribution plan.

Section 17 of the Employees Provident Funds (EPF) Act, 1952 empowers the Government to exempt any establishment from the provisions of the Employees' Provident Scheme, 1952 provided that the rules of the provident fund set up by the establishment are not less favourable than those specified in section 6 of the EPF Act and the employees are also in enjoyment of other provident fund benefits which on the whole are not less favourable to the employees than the benefits provided under the Act. The rules of the provident funds set up by such establishments (referred to as exempt provident funds) generally provide for the deficiency in the rate of interest on the contributions based on its return on investment as compared to the rate declared for Employees' Provident Fund by the Government under paragraph 60 of the Employees' Provident Fund Scheme, 1952 to be met by the employer. Such provision in the rules of the provident fund would tantamount to a guarantee of a specified rate of return. As per AS 15, where in terms of any plan the enterprise's obligation is to provide the agreed benefits to current and former employees and the actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise, the plan would be a defined benefit plan. Accordingly, provident funds set up by employers which require interest shortfall to be met by the employer would be in effect defined benefit plans in accordance with the requirements of paragraph 26(b) of AS 15.

10. What is the nature of a gratuity benefit scheme covered under a Group Gratuity Scheme with an Insurance Company? Whether it is a defined benefit plan or a defined contribution plan and whether or not the assets and liabilities of the scheme held by the Insurance Company are required to be disclosed in the financial statements of the concerned enterprise.

A key distinction between defined contribution plans and defined benefit plans is that in the case of defined benefit plans the actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the enterprise. If actuarial or investment experience are worse than expected, the enterprise's obligation may be increased. Where a gratuity scheme is covered under an insurance policy, the payments to the insurance company under the policy would not be considered as defined contributions if the actuarial risk and investment risk is borne by the enterprise. In the case of the Group Gratuity Scheme, the employer makes the funding through a Gratuity Trust, to an account maintained at an Insurance Company. The Insurance Company takes care of the investment of the funds in accordance with the pattern prescribed by the Income-tax Act. The return on such funds is passed on as interest from time to time. The gratuity claims as per the Rules of the Employer are withdrawn from the fund and paid to the employees through the Gratuity Trust. An actuarial valuation is generally conducted by the Insurance Company as on the date of commencement and also at yearly intervals to assess the present value of the gratuity liability and to indicate the fund required to meet the liability. The gratuity benefit scheme covered under such a scheme with an Insurance Company would, consequently, be a defined benefit plan. The assets held by the Insurance Company would be required to be considered by the enterprise while recognising the amount of defined benefit liability in the Balance Sheet.

11. In case an enterprise has created a separate trust to administer a defined benefit plan, whether or not the assets and liabilities of the trust would appear in the financial statements of the enterprise.

Where an enterprise has created a separate trust to administer a defined benefit plan, the fair value of the trust assets (net of liabilities) out of which the obligations are to be settled directly would be deducted from the present value of the defined benefit obligation and the net total would be recognised in the Balance Sheet. The assets and liabilities of the trust individually would not appear in the separate financial statements of the enterprise.

12. In case of defined benefit schemes covered under a Group Gratuity or other defined benefit scheme with an insurance company, where the actuarial risk and investment risk have not been transferred from the enterprise, whether an enterprise can rely upon actuarial valuation certificate provided by the insurance company or a separate certificate from a qualified actuary is required to be obtained for determination of actuarial liability.

In the case of defined benefit schemes covered under a Group Gratuity or other defined benefit scheme with an insurance company where the actuarial risk and investment risk have not been transferred from the enterprise, 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. A separate certificate from another qualified actuary is not necessary.

13. What is the meaning of the phrase 'market yields at the balance sheet date on government bonds' used in paragraph 78 of AS 15 (revised 2005) in the context of the discount rate?

The discount rate reflects the time value of money. It does not reflect the company's own credit rating. The term 'market yields at the balance sheet date on government bonds' means the market yields at the balance sheet date on government bonds of appropriate currency and term consistent with the currency and estimated term of the post-employment benefit obligations. The market yields on government bonds vary from time to time and are affected by a number of factors including prevalent interest. The purpose of using the words 'market yields at the balance sheet date' is to ensure that the yields prevalent on that date are considered instead of a long-term average rate, based on past experience over a number of years or any other rate during the financial year.

14. In case the rules of an enterprise provide that no gratuity would be payable if an employee leaves during the first five years of service, whether the enterprise is required to create a provision in respect of gratuity payable during the first five years of service of an employee.

In this case, the employee's right to receive the benefit is conditional on future employment for a period of five years. Although there is a possibility that the benefit may not vest, there is also a probability that the employee would serve for the minimum period of five years and become eligible for gratuity. An obligation exists even if a benefit is not vested. The obligation arises when the employee renders the service though the benefit is not vested. The measurement of this obligation at its present value takes into account the probability that the benefit may not vest and this is appropriately factored in the calculation of the present value of the defined benefit obligation. An enterprise should, therefore, create a provision in respect of gratuity payable during the first five years of service of an employee.

15. In case an enterprise was not creating full provision for retirement benefits, such as, gratuity, pension, etc., as per the requirements of pre-revised AS 15, how should the amount of under provisioning be treated?

Enterprises to which the pre-revised AS 15 was applicable, were required to comply with the provisions of the Standard in the preparation and presentation of the financial statements. In case an enterprise had not created a provision for retirement benefits as per the earlier Standard, the amount of benefit as at the commencement of the financial year when the revised Standard is first applied would be a prior period item as it represents an omission in the preparation of the financial statements of earlier periods. The amount of such benefit should be charged to the profit and loss account in the period when it is first accounted for and should be dealt with in accordance with AS 5. The enterprise would not be entitled to use the transitional provisions of the revised AS 15 to account for such under-provisioning.

16. In case an enterprise was not creating appropriate provision(s) for employee benefits, such as, sick leave, etc., which are not covered in the pre-revised AS 15, whether the transitional provisions of revised AS 15 can be applied to the entire liability arising on the first application of the revised AS 15.

The transitional provisions of revised AS 15 can be applied only to those items where the revised Standard requires recognition and measurement for the first time and to changes in the principles of recognition and measurement in the revised Standard as compared to the pre-revised Standard. As mentioned in response to question 15 above, the transitional provisions cannot be utilised to recognise or provide for errors in measurement based on the pre-revised Standard for the periods in which that Standard was applicable. Such errors in measurement based on the pre-revised Standard should be dealt with in accordance with AS 5.

17. Is the application of the revised Standard a change in accounting policy and what would be the disclosures required?

Accounting policies refer to the specific accounting principles and the methods of applying those principles in the preparation and presentation of financial statements. Accordingly, any change in the application of the principles of accounting for employee benefits based on the revised AS 15 as compared to the pre-revised Standard including the methods of applying those principles would be a change in accounting policy and should be dealt with as per the requirements of paragraph 32 of AS 5. Whether the application of the revised Standard would result in a change in accounting policy or a change in accounting estimate should be carefully examined and would depend on the facts and circumstances of each case. For instance, where an enterprise measures post employment benefits using the Projected Unit Credit Method as against the Aggregate Method in the past, such a change would be a change in accounting policy. However, where the enterprise has always been measuring such benefits based on the Projected Unit Credit Method and there are changes in discount rate and other assumptions, this would more likely be a change in estimate and should be dealt with in accordance with paragraph 23 of AS 5 and disclosed in accordance with paragraph 27 of AS 5.

18. Where an enterprise does an early application of the revised Accounting Standard 15, can it comply with the measurement principles of the Standard prematurely without complying with the disclosure requirements of the Standards?

No. The revised Standard has to be implemented in its entirety including disclosure requirements specified in the Standard.

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