CHAPTER 1

ACCOUNTING STANDARDS

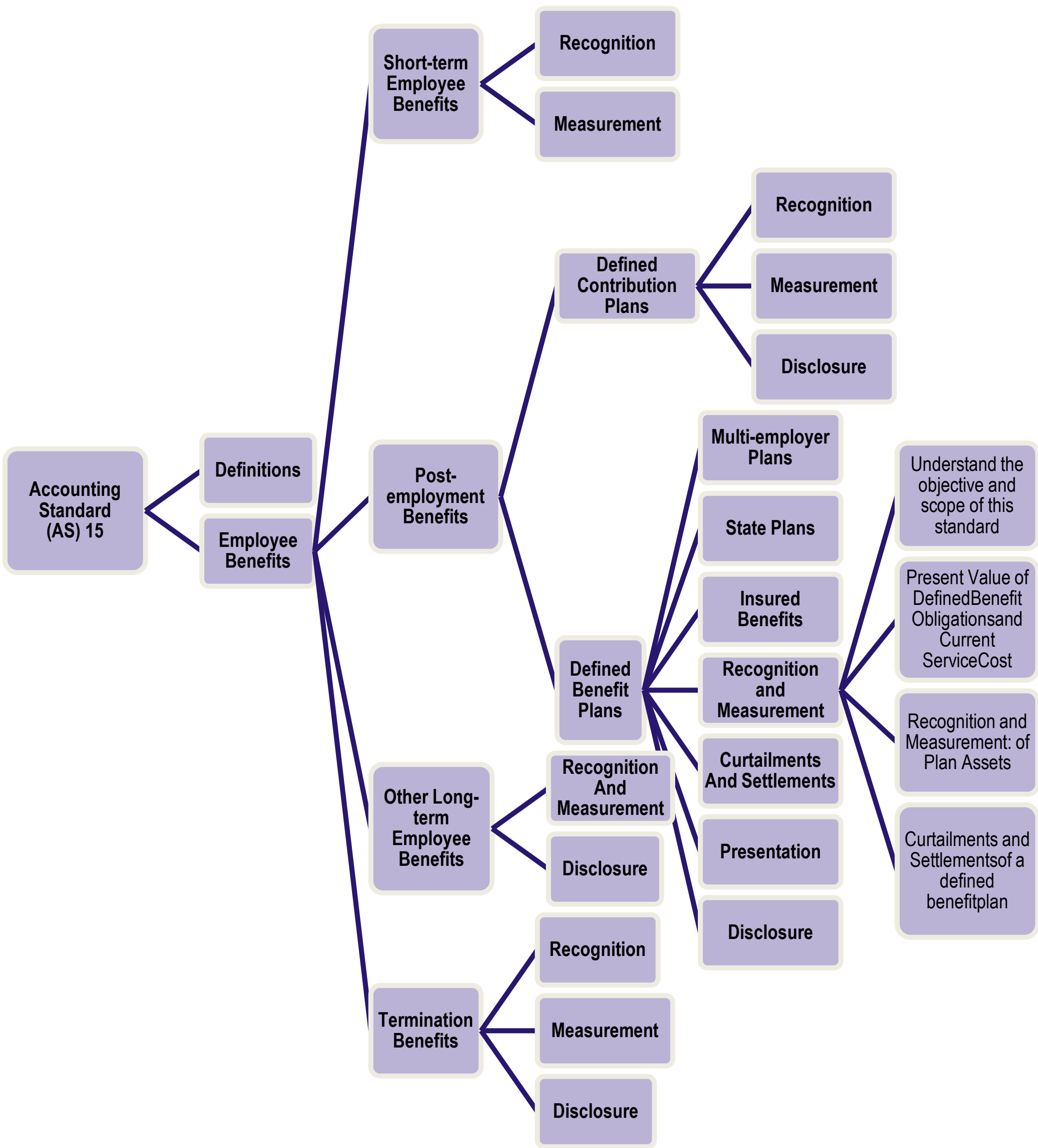
UNIT 1: ACCOUNTING STANDARD 15: EMPLOYEE BENEFITS

LEARNING OUTCOMES

After studying this unit, you will be able to:

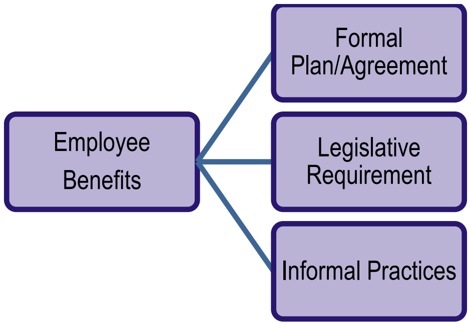
- Define 'Employee benefits', 'Short-term employee benefits', 'Post-employment benefits' and other related terms used in the standard
- Enumerate various types of employee benefits
- Recognise and measure Short-term Employee Benefits, Short-term Compensated Absences and Profit-sharing and Bonus Plans alongwith the accounting thereof
- Classify the post-employment benefits into defined contribution plans and defined benefit plans
- Examine the various aspects inherent in these post-employment benefit plans and recognize and measure the obligations under these plans
- Apply the actuarial valuation methods and assumptions while valuing the obligations under Defined benefit plans
- Calculate the actuarial gains and losses on such plans
- Recognise gains or losses on the curtailment or settlement of a defined benefit plan
- Recognise and measure other long term benefit and termination benefits
- Understand the disclosure requirement of these employee benefits and comply with the same.

UNIT OVERVIEW



1.1 INTRODUCTION

The Accounting Standard 15 - 'Employee Benefits' (AS 15), generally deals with all forms of employee benefits all forms of consideration given by an enterprise in exchange for services rendered by employees (other than inventory compensation for which a separate guidance note is promulgated).



The Standard addresses only the accounting of employee benefits by employers. The Standard makes four things very clear at the outset:

(i) the Standard is applicable to benefits provided to all types of employees (whether full-time, part-time, or casual staff;

(ii) employee benefits can be paid in cash or in kind;

(iii) employee benefits include benefits provided to employees and their dependents (spouses, children and others); and

(iv) payment can be made directly to employees, their dependent or to any other party (e.g., insurance companies, trust etc.).

Illustration 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?

Solution

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.

Illustration 2

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

Solution

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.

Employee benefits include:

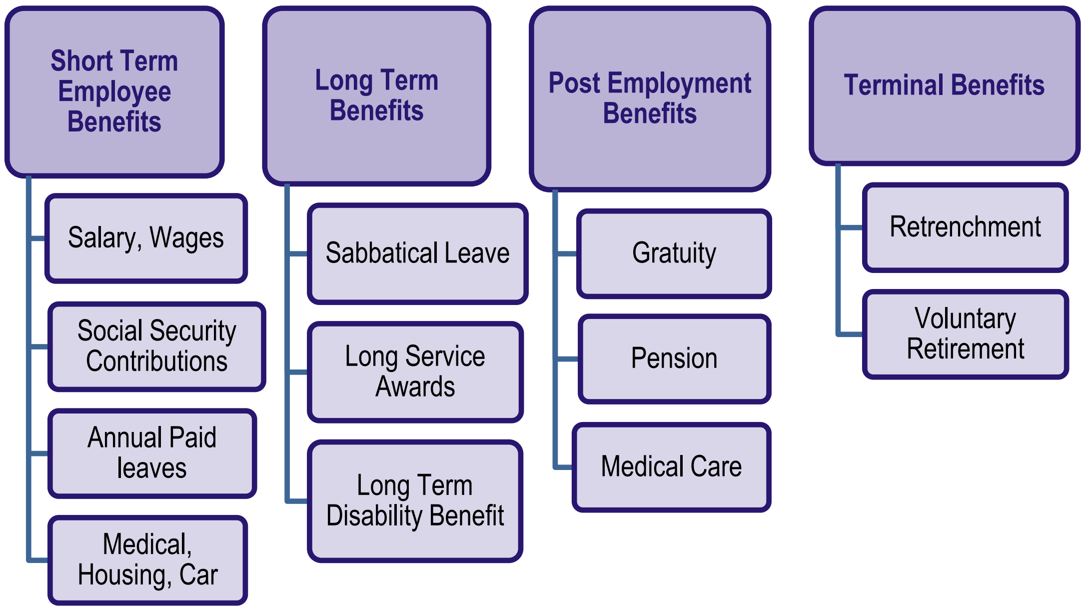
(a) Short-term employee benefits (e.g. wages, salaries, paid annual leave and sick leave, profit sharing bonuses etc.(payable within 12 months of the year-end) and non-monetary benefits for current employees;

(b) Post-employment benefits (e.g., gratuity, pension, provident fund, post-employment medical care etc.);

(c) long-term employee benefits (e.g., long-service leave, long-term disability benefits, bonuses not wholly payable within 12 months of the year end etc.); and

(d) termination benefits (e.g. VRS payments)

The Standard lays down recognition and measurement criteria and disclosure requirements for the above four types of employee benefits separately.



1.2 APPLICABILITY

The Standard applies from April 1, 2006 in its entirety for all Level 1 enterprises. Certain exemptions are given to other than Level 1 enterprises, depending upon whether they employ 50 or more employees. This standard is applicable predominantly for Level 1 enterprises, and applied to other entities with certain relaxations.

1.3 MEANING OF THE TERM "EMPLOYEE BENEFITS"

The term employee is not defined under the standard AS 15 does not define who is an 'employee', but states in that "an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel". This suggests that the intention was for the term 'employee' to apply more widely than simply to persons with a contract of employment as 'casual' and 'temporary' staff may frequently not have such contracts.

The following indicators may suggest an employee relationship may be more likely to exist, and may help in making individual judgements:

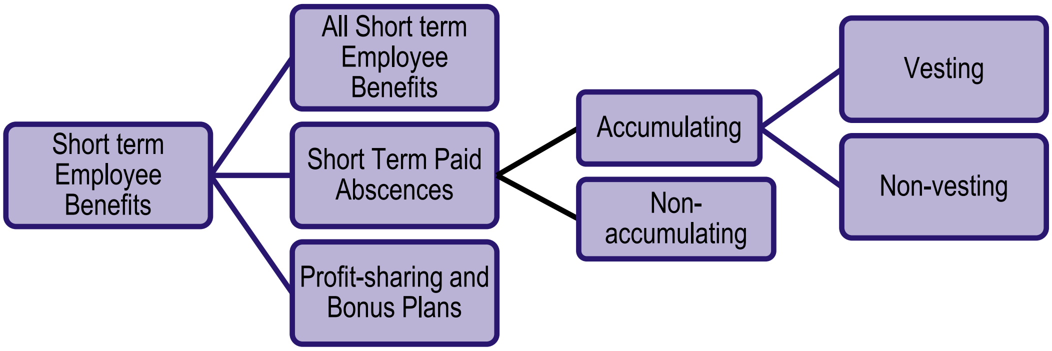
- A contract of employment exists;
- Individuals are considered employees for legal/tax/social security purposes;
- There is a large amount of oversight and direction by the employer and necessary tools, equipment and materials are provided by the employer;
- Services are performed at a location specified by the employer;

Services provided through an entity are in substance services provided by a specific individual, indications of which could be that the entity:

- Has no other clients;
- Has served the employer for a long period;
- Faces little or no financial risk;
- Requires the explicit permissions of the employer to concurrently undertake additional employment elsewhere.

1.4 SHORT-TERM EMPLOYEE BENEFITS

- Short-term employee benefits (other than termination benefits) are payable within twelve months after the end of the period in which the service is rendered.
- Accounting for these benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or cost.
- Short-term employee benefits are broadly classified into four categories:
  (i) regular period benefits (e.g., wages, salaries);
  (ii) short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.);
  (iii) profit sharing and bonuses payable within twelve months after the end of the period in which employee render the related services and
  (iv) non-monetary benefits (e.g., medical care, housing, cars etc.)



1.4.1 All Short-term Employee Benefits

- The Standard lays down some general recognition criteria for all short-term employee benefits. There are further requirements in respect of short-term compensated absences and profit sharing and bonus plans.
- The general criteria say that an enterprise should recognize as an expense (unless another accounting standard permits a different treatment) the undiscounted amount of all short-term employee benefits attributable to services that been already rendered in the period.
- Any difference between the amount of expenses so recognized and cash payments made during the period should be treated as a liability or prepayment (asset) as appropriate.

1.4.2 Short-term Compensated Absences

Entitlement to compensated absences falls into two categories:

(a) Accumulating

- ♦ Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full.
- ♦ Accumulating compensated absences may be

(i) Vesting

It implies that employees are entitled to a cash payment for unused entitlement on leaving the enterprise

(ii) Non-vesting

It implies that when employees are not entitled to a cash payment for unused entitlement on leaving. An obligation arises as employees render service that increases their entitlement to future compensated absences.

- The expected cost of accumulating compensated absences should be recognized when employees render the service that increase their entitlement to future compensated absences.
- 'An enterprise should measure the expected cost of accumulating compensated absences as the *additional amount* that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date'.
- No distinction should be made between vesting and non-vesting entitlements. However, in measuring non-vesting entitlements, the possibility of employees leaving the enterprise before receiving them should be taken into account.

Example

An enterprise has 100 employees, who are each entitled to five working days of leave for each year. Unused leave may be carried forward for one calendar year. The leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X4, the average unused entitlement is two days per employee. The enterprise expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of leave in 20X5 and that the remaining eight employees will take an average of six and a half days each.

The enterprise expects that it will pay an additional 12 days of pay as a result of the unused entitlement that has accumulated at 31 December 20X4 (one and a half days each, for eight employees). Therefore, the enterprise recognises a liability, as at 31 December 20X4, equal to 12 days of pay.

(b) Non-accumulating

- Non-accumulating compensated absences (e.g., maternity leave) do not carry forward and are not directly linked to the services rendered by employees in the past. Therefore, an enterprise recognizes no liability or expense until the time of the absence.
- In other words, the cost of non-accumulating absences should be recognized as and when they arise.

Exception

Small and Medium-sized Company and Small and Medium-sized Enterprise (Levels II and III non-corporate entities), may not comply with short term absences to the extent they deal with recognition and measurement such absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment of unused entitlement on leaving).

1.4.3 Profit-sharing and Bonus Plans

Recognition of expenses for profit sharing and bonus plans would depend on fulfillment of conditions mentioned the Standard. The conditions are:

(a) Enterprise has a present obligation to make such payments as a result of past events; and

(b) Reliable estimate of the obligation can be made.

The second condition can be satisfied only when the profit sharing and bonus plans contained a formula for determining the amount of benefit. The enterprise should recognize the expected cost of profit sharing and bonus payments in the financial statements.

Example

A profit-sharing plan requires an enterprise to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of net profit. The enterprise estimates that staff turnover will reduce the payments to 2.5% of net profit.

The enterprise recognises a liability and an expense of 2.5% of net profit.

Illustration 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.

Solution

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.

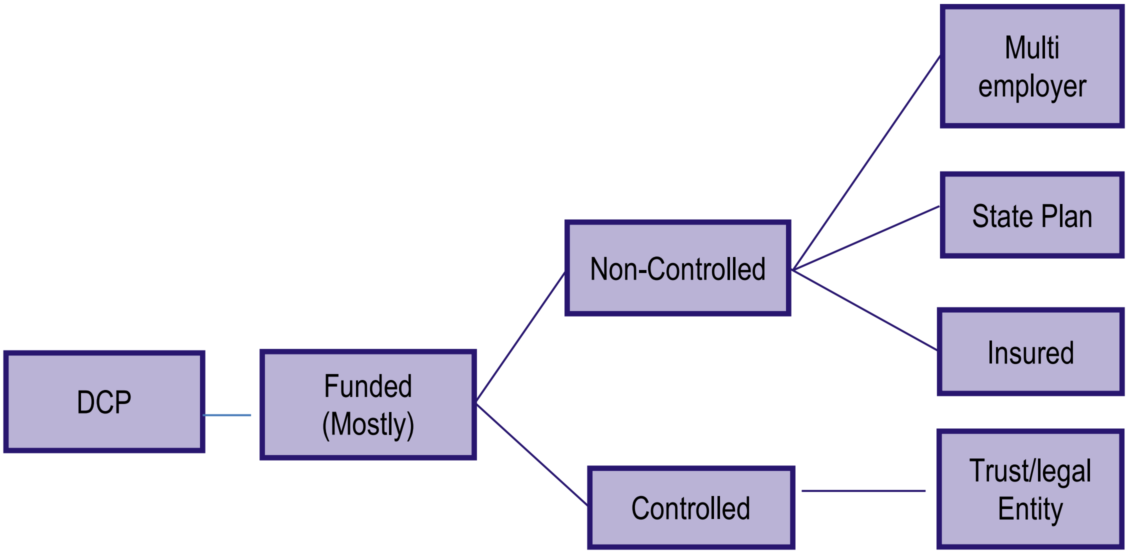
Illustration 4

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.

Solution

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.

1.5 POST EMPLOYMENT BENEFITS: DEFINED CONTRIBUTION VS DEFINED BENEFITS



The accounting treatment and disclosures required for a post-employment benefit plan depend upon whether it is a defined contribution or a defined benefit plan. In addition to addressing defined contribution and defined benefit plans generally, the Standard also gives guidance as to how its requirements should be applied to insured benefits, multi-employment benefit plans.

1. **Defined contribution plans** are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further₹ contributions. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. In defined benefits plans, the actuarial and investment risk fall on the employer.

2. **Defined benefit plans** are post-employment benefit plans other than defined contribution plans.

In defined contribution plans, the contribution is charged to income statement, whereas in defined benefit plans, detailed actuarial calculation is performed to determine the charge.

1.6 IS THE GRATUITY SCHEME A DEFINED CONTRIBUTION OR DEFINED BENEFIT SCHEME?

An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have an obligation to either:

(a) pay the employee benefits directly when they fall due;

(b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

On the asset side, a question arises as to whether the funds under the scheme as certified by LIC would be treated as plan assets or reimbursement rights. The distinction is important (though both are measured on fair valuation basis) because plan assets are reduced from the defined benefit obligation and the net amount is disclosed in the balance sheet, whereas, in the case of reimbursement rights, the defined benefit obligation and the reimbursement rights are shown separately as liability and asset on the balance sheet. This would have the impact of making the balance sheet heavy both on the asset side as well as the liabilities side.

1.7 OTHER LONG TERM EMPLOYEE BENEFITS

Other long-term employee benefits include, for example:

(a) long-term compensated absences such as long-service or sabbatical leave;

(b) jubilee or other long-service benefits;

(c) long-term disability benefits;

(d) profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and

(e) deferred compensation paid twelve months or more after the end of the period in which it is earned.

1.8 TERMINATION BENEFITS

Termination Benefits are employee benefits payable as a result of either an enterprise's decision to terminate an employee's employment before the normal retirement date or an employee's decision to accept voluntary redundancy in exchange for those benefits (e.g., payments under VRS). Termination benefits are recognized by an enterprise as a liability and an expense only when the enterprise has

(i) a detailed formal plan for the termination which is duly approved, and

(ii) a reliable estimate can be made of the amount of the obligation.

Where the termination benefits fall due within twelve months after the balance sheet date, an *undiscounted* amount of such benefits should be recognized as liability in the balance sheet with a corresponding charge to Profit & Loss Account. However, when the termination benefits fall due more than twelve months after the balance sheet date, such benefits should be discounted using an appropriate discount rate. Where an offer has been made to encourage voluntary redundancy, the termination benefits should be measured by reference to the number of employees expected to accept the offer. Where there is uncertainty with regard to the number of employees who will accept an offer of voluntary redundancy, a contingent liability exists and should be so disclosed as per AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

1.9 ACCOUNTING TREATMENT

In the Balance Sheet of the enterprise, 'the amount recognized as a defined benefit liability should be the net total of the following amounts:

(a) the present value of the defined benefit obligation at the balance sheet date;

(b) *minus*any past service cost not yet recognized;

(c) *minus*the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.'

In case where fair value of plan assets is high, it may so happen that the net amount under defined benefit liability turns negative (giving rise to net assets). AS 15 states that the enterprise, in such a situation, should measure the resulting asset at the lower of:

(i) the amount so determined; and

(ii) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The recognition of expenses relating to defined benefits in the Profit and Loss Account is stated in Para 61 of the Standard. The Standard identifies *seven* components of defined employee benefit costs:

(a) current service cost;

(b) interest cost;

(c) the expected return on any plan assets (and any reimbursement rights);

(d) actuarial gains and losses (to the extent they are recognized);

(e) past service cost (to the extent they are recognized);

(f) the effect of any curtailments or settlements; and

(g) the extent to which the negative net amount of defined benefit liability exceeds the amount mentioned in Para 59(ii) of the Standard.

The item (f) above needs explanation. A settlement occurs when an employer enters into a transaction that eliminates all further legal or constructive obligations for part or whole of the benefits provided under a defined benefit plan. For example, the commuted portion of pension. A curtailment occurs when an employer either commits to reduce the number of employees covered by a plan or reduces the benefits under a plan. The gains or losses on the settlement or curtailment of a defined benefit plan should be recognized when the settlement or curtailment occurs.

1.10 DISCLOSURES

Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists.

As required by AS 29, "Provisions, Contingent Liabilities and Contingent Assets" an enterprise discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

As required by AS 5, "Net Profit or Loss for the Period, Prior Period items and Changes in Accounting Policies" an enterprise discloses the nature and amount of an expense if it is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period.

Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

Where required by AS 18, "Related Party Disclosures", an enterprise discloses information about termination benefits for key management personnel.

When drafting AS 15 (revised), the standard setters felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallized at this stage. AS 15 requires more certainty for recognition of termination cost, for example, if the employee has sign up for the termination scheme.

1.11 ACTUARIAL ASSUMPTIONS

The actuarial assumptions should be unbiased and mutually compatible. They are an enterprise's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. They should be neither imprudent nor excessively conservative, and should reflect the economic relationships between factors such as inflation, rates of salary increase, return on plan assets and discount rates.

AS 15 explains that actuarial assumptions comprise:

(a) demographic assumptions about the future characteristics of current and former employees (and their dependents) who are eligible for benefits. Demographic assumptions deal with matters such as:

   (i) mortality, both during and after employment;

   (ii) rates of employee turnover, disability and early retirement;

   (iii) the proportion of plan members with dependents who will be eligible for benefits;

   (iv) claim rates under medical plans; and

(b) financial assumptions, dealing with items such as:

   (i) the discount rate

   (ii) future salary and benefit levels

   (iii) in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments and

   (iv) the expected rate of return on plan assets.

Financial assumptions: Financial assumptions should be based on market expectation at the balance sheet date for the period over which the post-employment benefit obligations will be settled. Discount rates and other financial assumptions should not be inflation-adjusted unless such measures are more reliable (eg where benefits are index-linked)

1.12 ACTUARIAL GAINS AND LOSSES

Actuarial gains and losses comprise:

- experience adjustments (the effects of difference between the previous actuarial assumptions and what has actually occurred); and
- the effects of changes in actuarial assumptions.

Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. While this is the general principle, as per AS 15, in case an enterprise adopts the option to defer the recognition of any subsequent actuarial gains is limited to excess of cumulative (unrecognized gains) over the unrecognized portion of increase in transitional liability.

Illustration 5

Omega Limited belongs to the engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards.

Solution

According to AS 15 (Revised 2005) 'Employee Benefits', actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 6

As on 1st April, 20X1 the fair value of plan assets was ₹ 1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 20X1 the plan paid out benefits of ₹ 19,000 and received inward contributions of ₹ 49,000. On 31st March, 20X2 the fair value of plan assets was ₹ 1,50,000 and present value of the defined benefit obligation was ₹ 1,47,920. Actuarial losses on the obligations for the year 20X1-20X2 were ₹ 600.

On 1st April, 20X1, the company made the following estimates, based on its market studies, understanding and prevailing prices.

	%
Interest & dividend income, after tax payable by the fund	*9.25*
Realised and unrealised gains on plan assets (after tax)	*2.00*
Fund administrative costs	*(1.00)*
Expected Rate of Return	*10.25*

You are required to find the expected and actual returns on plan assets.

Solution

Computation of Expected and Actual Returns on Plan Assets

		₹
Return on ₹ 1,00,000 held for 12 months at 10.25%		10,250
Return on ₹ 30,000 (49,000-19,000) held for six months at 5% (equivalent to 10.25% annually, compounded every six months)		1,500
Expected return on plan assets for 20X1-20X2		11,750
Fair value of plan assets as on 31 March, 20X2		1,50,000
Less: Fair value of plan assets as on 1 April,20X1	1,00,000	
Contributions received	49,000	(1,49,000)
		1,000
Add: Benefits paid		19,000
Actual return on plan assets		20,000

Alternatively, the above question may be solved without giving compound effect torate of return**.**

Illustration 7

Rock Star Ltd. discontinues a business segment. Under the agreement with employee's union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. If the benefits are determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.

Rock Star Ltd. estimates the share of unamortized service cost that relates to the part of the obligation at ₹ 18 (10% of ₹ 180). Calculate the gain from curtailment and liability after curtailment to be recognised in the balance sheet of Rock Star Ltd. on the basis of given information:

(a) Immediately before the curtailment, gross obligation is estimated at ₹ 6,000 based on current actuarial assumption.

(b) The fair value of plan assets on the date is estimated at ₹ 5,100.

(c) The unamortized past service cost is ₹ 180.

(d) Curtailment reduces the obligation by ₹ 600, which is 10% of the gross obligation.

Solution

Gain from curtailment is estimated as under:

	₹
Reduction in gross obligation	600
Less: Proportion of unamortised past service cost	(18)
Gain from curtailment	582

The liability to be recognised after curtailment in the balance sheet is estimated as under:

	₹
Reduced gross obligation (90% of ₹ 6,000)	5,400
Less: Fair value of plan assets	(5,100)
	300
Less: Unamortised past service cost (90% of ₹ 180)	(162)
Liability to be recognised in the balance sheet	138

Illustration 8

An employee Roshan has joined a company XYZ Ltd. in the year 20X1. The annual emoluments of Roshan as decided is ₹ 14,90,210. The company also has a policy of giving a lump sum payment of 25% of the last drawn annual salary of the employee for each completed year of service if the employee retires after completing minimum 5 years of service. The salary of the Roshan is expected to grow @ 10% per annum.

The company has inducted Roshan in the beginning of the year and it is expected that he will complete the minimum five year term before retiring.

What is the amount the company should charge in its Profit and Loss account every year as cost for the Defined Benefit obligation? Also calculate the current service cost and the interest cost to be charged per year assuming a discount rate of 8%.

(P.V factor for 8% - 0.735, 0.794, 0.857, 0.926, 1)

Solution

Calculation of Defined Benefit Obligation

Expected last drawn salary = ₹ 14,90,210 x 110% x 110% x 110% x 110% x 110%
= ₹ 24,00,000

Defined Benefit Obligation (DBO) = ₹ 24,00,000 x 25% x 5 = ₹ 30,00,000

Amount of ₹ 6,00,000 will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

Calculation of Current Service Cost

Year	*Equal apportioned amount of DBO [i.e. ₹ 30,00,000/5 years]*	*Discounting @ 8% PV factor*	*Current service cost (Present Value)*
a	b	c	d = b x c
1	6,00,000	0.735 (4 Years)	4,41,000
2	6,00,000	0.794 (3 Years)	4,76,400
3	6,00,000	0.857 (2 Years)	5,14,200
4	6,00,000	0.926 (1 Year)	5,55,600
5	6,00,000	1 (0 Year)	6,00,000

Calculation of Interest Cost to be charged per year

Year	*Opening balance*	*Interest cost*	*Current service cost*	*Closing balance*
a	b	c = b x 8%	d	e = b + c + d
1	0	0	4,41,000	4,41,000
2	4,41,000	35,280	4,76,400	9,52,680
3	9,52,680	76,214	5,14,200	15,43,094
4	15,43,094	1,23,447	5,55,600	22,22,141
5	22,22,141	1,77,859*	6,00,000	30,00,000

*Due to approximations used in calculation, this figure is adjusted accordingly.

Reference: The students are advised to refer the full text of AS 15 "Employee Benefits" (Revised 2005).

TEST YOUR KNOWLEDGE

Practical Questions

1. A company has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rule and to a lump-sum payment to cover expenses on food and stay during the travel. Alternatively, employees can claim a lump sum amount equal to one month pay last drawn.

   The company's contentions in this matter are:

   (i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the Travel rule of the company or where option for lump-sum payment is exercised, equal to the last pay drawn.

   (ii) Since it is not related to the length of service of the employees, it is accounted for on claim basis.

   State whether the contentions of the company are correct as per relevant Accounting Standard. Give reasons in support of your answer.

2. The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.20X2 calculate the actual return on plan assets:

- Benefits paid	2,00,000
- Employer contribution	2,80,000
- Fair market value of plan assets on 31.03.20X2	11,40,000
- Fair market value of plan assets as on 31.03.20X1	8,00,000

3. Kumar Ltd., is in engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of₹ 5 lakhs. The average remaining life of the employee is estimated to be 6 years.

   You are required to advise the company.

Answers to Practical Questions

1. The present case falls under the category of defined benefit scheme under Para 49 of AS 15 (Revised) "Employee Benefits". The said para encompasses cases where payment promised

to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

(1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised).

(2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

2.

	₹
Fair value of plan assets on 31.3.20X1	8,00,000
Add: Employer contribution	2,80,000
Less: Benefits paid	(2,00,000)
(A)	8,80,000
Fair market value of plan assets at 31.3.20X2 (B)	11,40,000
Actual return on plan assets (B-A)	2,60,000

3. According to para 92 of AS 15 (Revised) "Employee Benefits", actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus of ₹ 6 lakhs in the pension scheme on its actuarial valuation is required to be credited to the profit and loss statement of the current year. Hence, Kumar Ltd. cannot spread the actuarial gain of ₹ 6 lakhs over the next 2 years by reducing the annual contributions to ₹ 2 lakhs instead of ₹ 5 lakhs. It has to contribute ₹ 5 lakhs annually for its pension schemes.