Accounting Standard (AS) 15
(issued 1995)
Accounting for Retirement Benefits in
the Financial Statements of Employers

(This Accounting Standard includes paragraphs 27-31 set in ***bold italic*** *type and paragraphs 1-26 set in plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting S tandards[1].)*

The following is the text of Accounting Standard (AS) 15, 'Accounting for Retirement Benefits in the Financial Statements of Employers', issued by the Council of the Institute of Chartered Accountants of India.

The Standard will come into effect in respect of accounting periods commencing on or after 1.4.1995 and will be mandatory in nature.[2] The 'Statement on the Treatment of Retirement Gratuity in Accounts' issued by the Institute will stand withdrawn from the aforesaid date.

Introduction

1. This Statement deals with accounting for retirement benefits in the financial statements of employers.

2. Retirement benefits usually consist of:

   a. Provident fund

   b. Superannuation/pension

   c. Gratuity

   d. Leave encashment benefit on retirement

   e. Post-retirement health and welfare schemes

   f. Other retirement benefits.

   This Statement applies to retirement benefits in the form of provident fund, superannuation/pension and gratuity provided by an employer to employees, whether in pursuance of requirements of any law or otherwise. It also applies to retirement benefits in the form of leave encashment benefit, health and welfare schemes and other retirement benefits, if the predominant characteristics of these benefits are the same as those of provident fund, superannuation/pension or gratuity benefit, i.e. if such a retirement benefit is in the nature of either a defined contribution scheme or a defined benefit scheme as described in this Statement. This Statement does not apply to those retirement benefits for which the employer's obligation cannot be reasonably estimated, e.g., ad hoc ex-gratia payments made to employees on retirement.

1 Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2 Reference may be made to the section titled 'Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India' appearing at the beginning of this Compendium for a detailed discussion on the implications of the mandatory status of an accounting standard.

Definitions

3. The following terms are used in this Statement with the meanings specified:

Retirement benefit schemes are arrangements to provide provident fund, superannuation or pension, gratuity, or other benefits to employees on leaving service or retiring or, after an employee's death, to his or her dependants.

Defined contribution schemes are retirement benefit schemes under which amounts to be paid

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as retirement benefits are determined by contributions to a fund together with earnings thereon.

Defined benefit schemes are retirement benefit schemes under which amounts to be paid as retirement benefits are determinable usually by reference to employee's earnings and/or years of service.

Actuary means an actuary within the meaning of sub-section (1) of section (2) of the Insurance Act, 1938.

Actuarial valuation is the process used by an actuary to estimate the present value of benefits to be paid under a retirement benefit scheme and the present values of the scheme assets and, sometimes, of future contributions.

Pay-as-you-go is a method of recognising the cost of retirement benefits only at the time payments are made to employees on, or after, their retirement.

Explanation

4. Retirement benefit schemes are normally significant elements of an employer's remuneration package for employees. It is, therefore, important that retirement benefits are properly accounted for and that appropriate disclosures in respect thereof are made in the financial statements of an employer.

5. Provident fund benefit normally involves either creation of a separate trust to which contributions of both employees and employer are made periodically or remittance of such contributions to the employees' provident fund, administered by the Central Government.

6. Superannuation/pension benefit (hereinafter referred to as 'superannuation benefit') is basically of two types.

   a. The first type of benefit is known as defined contribution scheme. Under this type of benefit, the employer makes a contribution once a year (or more frequently in some cases) towards a separately created trust fund or to a scheme administered by an insurer. These contributions earn interest and the accumulated balance of contributions and interest is used to pay the retirement benefit to the employee. Superannuation available under defined contribution scheme has relevance to only total of accumulated contributions and interest and bears no relationship, whatsoever, with the final salary or number of years of service put in by an employee. The defined contribution scheme for superannuation/ pension is, in most respects, similar to the provident fund, so far as the accounting treatment is concerned. It also presupposes payment of contributions every year, either once in a year or more frequently.

   b. The second type of superannuation scheme is the defined benefit scheme. Under this scheme, the benefit payable to the employee is determined with reference to factors such as a percentage of final salary (e.g. the average of one, three or five years' salary), number of years of service and the grade of the employee. The contribution required to finance such a scheme is actuarially determined and is generally expressed as a percentage of salary for the entire group of employees covered by the scheme. For defined benefit superannuation/pension schemes, a trust fund can be created or an arrangement can be negotiated with an insurer so that the annual contributions, calculated actuarially, can be made each year. In such a case, benefits to employees on entitlement would be paid by the trust fund or by the insurer. Alternatively, the superannuation benefit can be paid by the employer as and when an employee leaves.

7. Gratuity benefit is in the nature of a defined benefit. Gratuity can be paid by the employer as and when an employee leaves. Alternatively, a trust fund can be created, or an arrangement can be negotiated with an insurer so that the annual contributions, calculated actuarially, can be made each year. Benefits to employees on entitlement would in such a case be paid by the trust fund or by the insurer.[3]

8. In certain cases, a retirement benefit scheme may stipulate the basis of contributions on which the benefits are determined and, because of this, may appear to be a defined

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contribution scheme. However, the provisions of the scheme may also result in the employer being responsible for specified benefits or a specified level of benefits. In this case, the scheme is, in substance, a defined benefit scheme and should be accounted for accordingly.

9. While provident fund schemes are generally contributory schemes from the point of view of employees, gratuity schemes are non-contributory. The superannuation schemes, on the other hand, can be contributory or noncontributory.

10. Defined benefit schemes, especially those that promise benefits related to remuneration at or near retirement, present significant difficulties in the determination of periodic charge to the statement of profit and loss. The extent of an employer's obligation under such schemes is usually uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events which are largely outside the employer's control.

11. As a result of various factors that frequently enter into the computation of retirement benefits under defined benefit schemes and the length of the period over which the benefits are earned, allocation problems arise in determining how the costs of the retirement benefits should be recognised in the financial statements of the employer. Furthermore, long-term uncertainties may give rise to adjustments of estimates of earlier years that can be very significant in relation to current service cost.

12. The cost of retirement benefits to an employer results from receiving services from the employees who are entitled to receive such benefits. Consequently, the cost of retirement benefits is accounted for in the period during which these services are rendered. Accounting for retirement benefit cost only when employees retire or receive benefit payments (i.e., as per pay-as-you-go method) does not achieve the objective of allocation of those costs to the periods in which the services were rendered.

3 A new section 4A has been inserted in the Payment of Gratuity Act by the Payment of Gratuity (Amendment) Act, 1987. From the date of this section coming into force, an employer (other than an employer or an establishment belonging to, or under the control of, the Central or a State Government) who is liable to pay gratuity under the above Act will have to obtain an insurance in the prescribed manner to meet his liability for payment of gratuity. Such insurance should be obtained from the Life Insurance Corporation of India or any other prescribed insurer. However, the Government may grant exemption to every employer who has already established an approved gratuity fund in respect of his employees and who desires to continue such fund, or to every employer who is employing 500 or more persons and who establishes an approved gratuity fund in the prescribed manner.

Funding

13. When there is a separate retirement benefit fund, it is sometimes assumed that the amount paid by an employer to the fund during an accounting period provides an appropriate charge to the statement of profit and loss. While, in many cases, the amount funded may provide a reasonable approximation of the amount to be charged to the statement of profit and loss, there is a vital distinction between the periodic funding of retirement benefits and the allocation of the cost of providing these benefits.

14. The objective of funding is to make available amounts to meet future obligations for the payment of retirement benefits. Funding is a financing procedure and in determining the periodical amounts to be funded, the employer may be influenced by such factors as the availability of money and tax considerations.

15. On the other hand, the objective of accounting for the cost of a retirement benefit scheme is to ensure that the cost of benefits is allocated to accounting periods on a systematic basis related to the receipt of the employees' services.

Accounting

16 In respect of retirement benefits in the form of provident fund and other defined contribution schemes, the contribution payable by the employer for a year is charged to the statement of profit and loss for the year. Thus, besides the amount of contribution paid, a shortfall of the amount of contribution paid compared to the amount payable for the year is also charged to the statement of profit and loss for the year. On the other hand, if contribution paid is in excess of the amount payable for the year, the excess is treated as a pre-payment.

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17. In respect of gratuity benefit and other defined benefit schemes, the accounting treatment depends on the type of arrangement which the employer has chosen to make.

    i. If the employer has chosen to make payment for retirement benefits out of his own funds, an appropriate charge to the statement of profit and loss for the year is made through a provision for the accruing liability. The accruing liability is calculated according to actuarial valuation. However, many enterprises which employ only a few persons do not calculate the accrued liability by using actuarial methods. They calculate the accrued liability by reference to some other rational method e.g. a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

    ii. In case the liability for retirement benefits is funded through creation of a trust, the cost incurred for the year is determined actuarially. Many employers undertake such valuations every year while others undertake them less frequently, usually once in every three years. If actuarial valuations are conducted every year, the annual accrual of retirement benefit cost can be easily determined. If, however, the actuarial valuations are not conducted annually, the actuary's report specifies the contributions to be made by the employer on annual basis during the inter-valuation period. This annual contribution (which is in addition to the contribution that may be required to finance unfunded past service cost) reflects proper accrual of retirement benefit cost for each of the years during the inter-valuation period and is charged to the statement of profit and loss for each such year. Where the contribution paid during a year is lower than the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the shortfall is charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the excess is treated as a prepayment.

    iii. In case the liability for retirement benefits is funded through a scheme administered by an insurer, it is usually considered necessary to obtain an actuarial certificate or a confirmation from the insurer that the contribution payable to the insurer is the appropriate accrual of the liability for the year. Where the contribution paid during a year is lower than the amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the shortfall is charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the excess is treated as a pre-payment.

Actuarial Principles

18. A number of actuarial valuation methods have been developed by the actuarial profession to estimate employer's obligations under defined benefit schemes. While these methods are primarily designed to calculate funding requirements, they are also frequently used to determine retirement benefit costs for accounting purposes.

19. The actuarial method selected for determining accrual of liability and the assumptions made can have a significant effect on the expense to be recorded in each accounting period. Therefore, in carrying out a periodical valuation, an actuary chooses a suitable valuation method and, in consultation with the employer, makes appropriate assumptions about the variable elements affecting the computations.

20. The assumptions relate to the expected inflow from future contributions and from investments as well as to the expected outgo for benefits. The uncertainty inherent in projecting future trends in rates of inflation, salary levels and earnings on investments are taken into consideration by the actuary in the actuarial valuations by using a set of compatible assumptions. Usually, these projections are extended until the expected date of death of the last pensioner in case of a superannuation scheme, expected date of death etc. of the beneficiary in case of family pension, and expected service in case of gratuity and are, accordingly, long-term.

Past Service Cost and Review of Actuarial Assumptions

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21. An actuarially determined past service cost arises on the introduction of a retirement benefit scheme for existing employees or on the making of improvements to an existing scheme, etc. This cost gives employees credit for benefits for services rendered before the occurrence of one or more of these events.

22. Views differ as to how to account for this cost. One view is that this cost should be recognised as soon as it has been determined. Others believe that the entitlement giving rise to past service cost is in return for services to be rendered by employees in future and therefore this cost ought to be allocated over the periods during which the services are to be rendered.

23. In making an actuarial valuation, the actuary may sometimes effect a change in the actuarial method used or in the assumptions adopted for determining the retirement benefit costs. Any alterations in the retirement benefit costs so arising are charged or credited to the statement of profit and loss for the year or, alternatively, spread over a period not more than the expected remaining working lives of the participating employees. A change in the actuarial method used for determining the retirement benefit costs constitutes a change in an accounting policy and is disclosed accordingly.

Retired Employees

24. When a retirement benefit scheme for retired employees is amended, due to inflation or for other reasons, to provide additional benefits to retired employees, any additional costs are charged to the statement of profit and loss of the year.

Disclosures

25. In view of the diversity of practices used for accounting of retirement benefits costs, adequate disclosure of method followed in accounting for them is essential for an understanding of the significance of such costs to an employer.

26. Retirement benefit costs are sometimes disclosed separately for statutory compliance. In other cases, they are considered to be an element of employee remuneration and their separate disclosure is not usually made.

Accounting Standard

27. In respect of retirement benefits in the form of provident fund and other defined contribution schemes, the contribution payable by the employer for a year should be charged to the statement of profit and loss for the year. Thus, besides the amount of contribution paid, a shortfall of the amount of contribution paid compared to the amount payable for the year should also be charged to the statement of profit and loss for the year. On the other hand, if contribution paid is in excess of the amount payable for the year, the excess should be treated as a pre-payment.

28. In respect of gratuity benefit and other defined benefit schemes, the accounting treatment will depend on the type of arrangement which the employer has chosen to make.

i. If the employer has chosen to make payment for retirement benefits out of his own funds, an appropriate charge to the statement of profit and loss for the year should be made through a provision for the accruing liability. The accruing liability should be calculated according to actuarial valuation. However, those enterprises which employ only a few persons may calculate the accrued liability by reference to any other rational method e.g. a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

ii. In case the liability for retirement benefits is funded through creation of a trust, the cost incurred for the year should be determined actuarially. Such actuarial valuation should normally be conducted at least once in every three years. However, where the actuarial valuations are not conducted annually, the actuary's report should specify the contributions to be made by the employer on annual basis during the inter-valuation period. This annual contribution (which is in addition to the contribution that may be

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required to finance unfunded past service cost) reflects proper accrual of retirement benefit cost for each of the years during the inter-valuation period and should be charged to the statement of profit and loss for each such year. Where the contribution paid during a year is lower than the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the shortfall should be charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary, the excess should be treated as a pre-payment.

iii. *In case the liability for retirement benefits is funded through a scheme administered by an insurer, an actuarial certificate or a confirmation from the insurer should be obtained that the contribution payable to the insurer is the appropriate accrual of the liability for the year. Where the contribution paid during a year is lower than amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the shortfall should be charged to the statement of profit and loss for the year. Where the contribution paid during a year is in excess of the amount required to be contributed during the year to meet the accrued liability as certified by the actuary or confirmed by the insurer, as the case may be, the excess should be treated as a pre-payment.*

29. *Any alterations in the retirement benefit costs arising from -*

   a. *introduction of a retirement benefit scheme for existing employees or making of improvements to an existing scheme, or*

   b. *changes in the actuarial method used or assumptions adopted,*

should be charged or credited to the statement of profit and loss as they arise in accordance with Accounting Standard (AS) 5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies'.[4] Additionally, a change in the actuarial method used should be treated as a change in an accounting policy and disclosed in accordance with Accounting Standard (AS) 5, 'Prior Period and Extraordinary Items and Changes in Accounting Policies'.

30. *When a retirement benefit scheme is amended with the result that additional benefits are provided to retired employees, the cost of the additional benefits should be accounted for in accordance with paragraph 29.*

4 AS 5 has been revised in February 1997. The title of revised AS 5 is 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

Disclosures

31. *The financial statements should disclose the method by which retirement benefit costs for the period have been determined. In case the costs related to gratuity and other defined benefit schemes are based on an actuarial valuation, the financial statements should also disclose whether the actuarial valuation was made at the end of the period or at an earlier date. In the latter case, the date of the actuarial valuation should be specified and the method by which the accrual for the period has been determined should also be briefly described, if the same is not based on the report of the actuary.*

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