

AN INCONSISTENT AND AVOIDABLE CARVE-OUT

This discussion argues against the seemingly unintended position of Ind AS 19's classifying actuarial gains and losses on other long-term employee benefits under 'Other Comprehensive Income.' Standard drafters are urged to weigh the compliance effort and cost of this IFRS carve-out.

Introduction

Convergence among accounting standards aids comparability and arguably enhances transparency in financial reporting. As the accounting standard setting body, the Institute of Chartered Accountants of India has taken steps toward convergence with IFRS, however with certain carve-outs or exceptions. One such carve-out from IAS19R, and of interest to the Indian actuarial profession, emerges through Ind AS 19's paragraph 129A:

In measuring its liability for other long-term employee benefits in accordance with paragraph 128, an entity shall recognise in other comprehensive income all of the actuarial gains and losses and any adjustments arising from the limit in paragraph 58(b) and apply paragraphs 93B, 93C and 93D.

Paragraph 129A hence envisages that entities should route the 'actuarial gains and losses on Other Long-term Employee Benefits (Other LT EB) through Other Comprehensive Income (OCI).' On the other hand, IAS19R does not recognise actuarial gains and losses of Other LT EB in OCI, but considers them as a charge to

the Statement of Comprehensive Income or Profit and Loss Account.

The OCI classification under IAS19R is restricted to actuarial gains and losses on post-employment benefits only. The Indian standard-drafters are presently holding on to the other end of the stick.

We discuss the implications of this divergence of Ind AS 19 from IAS19R for the compliance effort and the associated cost. We argue against the carve-out from IAS19R. The discussion is structured as follows:

- We examine whether actuarial gains and losses on Other LT EB, relatively smaller in magnitude and short-term in tenure as compared with defined benefit post-employment pension, can contend to be under OCI.
- We evaluate the carve-out with regard to the other provisions of the proposed accounting standard as to whether the proportionality principle is compromised.
- We explain the process of computing actuarial gains and losses, which we feel has not been appreciated by the accounting standard drafters.

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- We have put forth the complexity of different estimates of actuarial gains and losses that can emerge when the employee benefit is not periodic like defined benefit post-employment pension.
- We believe more granular effort in the break-down of the liability movement between current and past service cost and curtailment cost is necessary to quantify the actuarial gains and losses.
- We argue that greater effort toward activities involved in (d) and (e) will lead to higher cost of actuarial services, in effect a higher compliance cost for the carve-out.
- We contend that this Ind AS 19 carve-out is unnecessary and that IAS19R has wisely restricted the classification under OCI to actuarial gains and losses on post-employment defined benefit plans alone.
- We finally urge the accounting standard-setters to dispense with the carve-out based on consideration of accounting impact and cost of compliance.

OCI for large and volatile expense heads

In the normal course, expenses or income could be charged to the Statement of Comprehensive Income or the Profit and Loss Account. Most revenue is a part of the Statement of Comprehensive Income.



Only large, volatile and unrealized revenue is charged to or appropriated from Other Comprehensive Income because it is expected that either the uncertainty will 'even out' over long periods or that the asset or liability variation should not be recognized as reported earnings, unless realized.

An illustrative list of OCI items reads:

1. Unrealized gains and losses on available-for-sale securities [IAS 39/ FAS 115]
2. Gains and losses on derivatives held as cash flow hedges (only for effective portions) [IAS 39/ FAS 133]
3. Gains and losses resulting from translating the financial statements of foreign subsidiaries [IAS 21/ FAS 52]
4. Actuarial gains and losses on post-employment defined benefit plans recognized [IAS 19/ FAS 158]
5. Changes in the revaluation surplus [IAS 16 and IAS 38].

Ind AS 19 has extended the OCI items' list to include

actuarial gains and losses on Other LT EB, which relative to an entity's financial statements are neither likely to be large (as compared with post-employment defined benefit plans) nor volatile (as the time window is not as long as post-employment defined benefit plans). We argue against this carve-out of Ind AS 19 from IAS19R in respect of the treatment of actuarial gains and losses on Other LT EB on grounds of relative insignificance and lower contribution to volatility to the financial statements as well as the higher cost of compliance.

Only one channel, not two

Actuarial gains and losses can emanate

from liabilities as well as assets. Other LT EB is usually unfunded, so the asset side's contribution to actuarial gains and losses is normally obviated. The avenues of actuarial gains and losses hence reduce as compared with the post-employment defined benefit plans that are usually funded.

If only one channel i.e., liabilities accounts for the actuarial gains and losses, the value of actuarial gains and losses would arguably be smaller (for Other LT EB) as compared with that of post-employment defined benefit plans where both liabilities and assets stream into actuarial gains and losses. The one-source contribution of actuarial gains and losses on Other LT EB to OCI is likely to further reduce the impact as compared with the two-source effect of post-employment defined benefit plans.

Is 'Other LT EB' large enough?

Unlike post-employment defined benefit plans like pensions, post-retirement medical benefits and gratuity (a lump sum pension), Other LT EB comprise of Privilege leave, Medical leave, Loyalty bonus, Deferred incentive, Retirement settlement allowance and Long service awards. As Other LT EB is wholly or partly consumed while in employment, the benefit obligation might not be as substantial when compared with lifelong benefits like pensions and post-retirement medical benefits and lump-sum retirement benefits like gratuity. An obverse situation can prevail in entities where carry forward caps of leave balances are higher, but it is just that – an exception.

Hence actuarial gains and losses arising from Other LT EB being small in magnitude are unlikely to contribute much toward current earnings volatility as compared with the contribution of actuarial gains and losses on post employment defined benefit plans.

In view of the shorter payout window, the measurement of Other LT EB is not usually subject to the same degree of uncertainty as the measurement of post-employment benefits (Paragraph 127 of the proposed Ind AS 19). Paragraph 131 validates the argument further as setting the default position of other LT EB as 'insignificant' and 'no specific disclosures.' Its extract reads:

131. Although this Standard does not require specific disclosures about other long-term employee benefits, other Standards may require disclosures, for example, where the expense resulting from such benefits is material and so would require disclosure in accordance with Ind AS 1.

In this backdrop, is it necessary to separately identify and classify the actuarial gains and losses on Other LT EB as OCI? As discussed later, how are the shades of grey addressed in calculating the actuarial gains and losses on Other LT EB as compared with the relatively well-defined practice of actuarial gains and losses on post-employment defined benefit plans? Was enough thought given to the implication on deferred taxation of Other LT EB when classified in OCI?

Proportionality principle

The Ind AS 19 carve-out hence posits the issue of treatment of actuarial gains and losses on other LT EB at the intersection of:

- a. Paragraph 129A: treat actuarial gains and losses as part of OCI, and
- b. Paragraph 131: disregard specific disclosures unless the benefits are material.

If Other LT EB costs are to be bifurcated between the Statement of Comprehensive Income (P&L) and OCI, greater effort is needed to calculate the actuarial gains and losses for the relatively small value benefits. Hence the essence of proportionality is compromised.

On one hand, no specific disclosures are needed (paragraph 131) while on the other, requiring actuarial gains and losses to be taken to OCI (paragraph 129A) needs a breakdown of liability (and if funded, asset) movement and hence an elaborate exercise of capturing all the movement heads viz. current service cost, interest cost, past service cost, curtailment, settlement and actuarial gains and losses.



Understanding the process of Benefit Obligation Computation

Ind AS 19 requires all employee benefit obligations to be computed using the Projected Unit Credit method where the 'projected accrued benefit' is based on the employee benefit accrual formula and upon the service as at the end of the year, but using a member's final compensation and decrements like withdrawal and mortality, projected to the age at which the employee is assumed to receive benefits. Essentially the Benefit Obligation is computed on a prospective basis to arrive at its expected present value or the actuarial value at the valuation date. The 'chicken or egg first' dilemma between the benefit obligation and the

associated actuarial gains and losses does not exist. Actuarial gains and losses are derived from and calculated ONLY AFTER the benefit obligation is ascertained.

Only when utilization and lapse is possible in service as in the case of compensated absences, complexities of calculating actuarial gains and losses increase.

Computing actuarial gains and losses for OCI hence needs breakdown of benefit obligation in one or more of its different components: service cost, interest cost, past service cost, effects of curtailment and settlement, and finally fitting the balancing figure of actuarial gains and losses in order to reconcile the opening and closing benefit obligation.

Different Estimate of Service Cost

This position not only leads to additional efforts but different estimates of actuarial gains and losses of the same accrued benefit. To start, the service cost component of the employer expenses needs to be computed. Service cost is defined as 'the actuarial present value of benefits attributed by the plan's benefit formula to services rendered by employees during the period.'

Consider an employee with 15 days of privilege leave balance at start of year, credit of 24 days and utilization of 20 days. That is, the closing accrued benefit is 19 days which needs to be valued. The entity allows the employee to cash leave at basic salary on date of retirement or resignation, whichever happens earlier. For the same closing benefit obligation in this case, the actuarial gain or loss could be different. We will see how. Assume

salary has increased for this employee in the valuation year. If the last-in-first-out (LIFO) method were applied, the service cost will be lower as the incremental accrual of 4 days alone will be attributed to the current year's credit. On the other hand, if the first-in-first-out method (FIFO) were applied, the service cost will be higher as the entire closing balance of 19 days is from the current year's credit. Hence the actuarial loss (gain) will be higher (lower) and lower (higher) under the LIFO and FIFO methods respectively.

Such complexity does not arise for periodic accrual rate post-retirement defined benefits like gratuity ('15/26 per year of service' factor) and pension (usually '1/66 per year of service' factor). Only when utilization and lapse is possible in service as in the case of compensated absences, complexities of calculating actuarial gains and losses increase.

Entities will also need to share the privilege and medical leave movement during the year to enable the actuary to compute the actuarial gains and losses. Else year-end balances suffice for liability calculation.

Curtailment and Past Service Cost Events

Unlike post-employment pension, Other LT EB is not defined by law. Example, an employer has more flexibility in altering the compensated absences benefit and long-service awards and with greater frequency than post-employment pension. A reduction and increase leads to curtailment and past service cost respectively. If the actuarial gains and losses were to be quantified, curtailment and past service cost calculations would need to be allowed for. Under IAS19R, this effort would be unnecessary for Other LT EB as only the liability (and not the actuarial gains and losses) ought to be disclosed. In contrast, Ind AS 19's requirement to separately compute actuarial gains and losses on Other LT EB would push the valuation process to compute the curtailment and past service cost.

Higher cost proportional to greater effort

The benefits under Other LT EB arise as and when they are utilized. Some part of

the benefit is not even carried forward as it gets availed in the current financial year. Retrieving data from the client will become an additional task as they will be required to provide the movement of such benefits availed during the year. This granular data may or may not be available with the client. These benefits (e.g. loyalty bonus, long service award, privilege leave, medical leave, and resettlement allowance) are not significant when compared with post-retirement benefits like gratuity and pensions. However, if separate calculation of actuarial gains and losses is needed, a higher effort is warranted. This in turn would lead to (an avoidable) increased cost of actuarial valuation on entities, especially small and medium-sized ones.

Why to continue with IAS19R treatment on Other LT EB

If assumptions are set different than experience, actuarial gains and losses arise. Apart from the computational complexities and efforts, the latitude offered to treat 'actuarial gains and losses on Other LT EB' to OCI would mean that the assumption-setting process has no bearing on current profitability. Indeed if assumptions are materially different than experience, the company has no lever to revise them to realistic levels when the resulting actuarial gains and losses are clubbed under OCI. Knowing that actuarial gains and losses do not affect earnings, clients may be tempted to package medium-term incentives in such a way that the costs show actuarial losses in order to reduce volatility – an unhealthy precedent.

Position on Carve-outs

The Indian Ministry of Corporate Affairs and the Indian Accounting Profession has recognized that carve-outs should be indeed exceptional and only if required under a long-term view of the local setting. See Box 1 for relevant excerpts.

Box 1:

"Let me make it very clear that India is a signatory to accept IFRS. By accept, I mean convergence to IFRS by April 2011 and not adoption. We stand by that. There is no reason to change that date or extend the time," Mr. R. Bandyopadhyay, Secretary, Ministry of Corporate Affairs, said at 'IFRS Summit 2009' organised by the Confederation of Indian Industry (CII). [Source: CII IFRS Summit, 2009]



In any debate on convergence or adoption or carve-outs, India must first aspire to uphold the purity of IFRS and be fully IFRS-compliant nation and second it should take a stand that it has full belief in the proposed deviations as being the best practices and then the confidence and conviction to influence the International Accounting Standards Board (IASB) through consensus about what it believes is right and the need to bring the required improvement/amendments in IFRS rather than remaining as a carved-out nation. We cannot just take short-term nationalist and local view rather we need to take long-term global view on IFRS. If carve-outs/deviations are managed with this objective and attitude, then India and Indian entities would benefit in the long term.

[Source: Shailesh Haribhakti (2011); "Is India watering down IFRS?" BCAS Journal January 2011]

Conclusion

- As Other Long-term employee benefits are much smaller in value relative to post-retirement employee benefits like pensions, fewer disclosures are advised (paragraph 131). But in the form envisaged by paragraph 129A, Other LT EB will need more effort and potentially higher disclosure.

- For the relatively insignificant actuarial gains and losses on Other LT EB as compared with post-retirement employee benefits, a separate effort is arguably futile.
- More effort will lead to higher costs, particularly affecting small and medium-sized companies.
- The classification of actuarial gains and losses on Other LT EB also needs a deferred tax adjustment, which could be avoided if these become part of the Profit and Loss Account.
- Actuarial gains and losses could change under different methods applied to non-periodic accrual benefits like privilege and medical leave. This is not a matter of contention with periodic accrual post-employment defined benefits like pension and gratuity.
- Curtailment and settlement costs are more likely for the numerous Other LT EB that are optional and not enacted under the law. These lead to more frequent re-measurement of actuarial gains and losses, which

is not required if actuarial gains and losses were at the outset not to be quantified.

- Moreover, dispensing with this carve-out would lead to closer IFRS convergence.

If separate calculation of actuarial gains and losses is needed, a higher effort is warranted and higher costs are likely. It seems that the aspects of effort, proportionality, disclosure and costs have been inadvertently glossed over when drafting the Ind AS 19 that classifies 'actuarial gains and losses on Other Long-term Employee Benefits as part of Other Comprehensive Income.'

During the Union Budget 2014-15, the Honourable Finance Minister announced that Ind AS would be applicable voluntarily from financial year 2015-16 and mandatorily from financial year 2016-17. As the Ind AS notification gathers momentum amidst voices dissenting carve-outs, we hope that the carve-out of Ind AS 19 on actuarial gains and losses on Other Long-term Employee Benefits is scuppered and put paid to.

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