The rise of the new DC

Latent once upon a time, deferred compensation is progressively becoming popular with overwhelming possibilities.

Mayur Ankolekar discusses why so, what to expect and which skills actuaries should hone for the new DC opportunity

In the new millennium, pensions practice has deliberated considerably on DB and DC. Over the same period, the fourth industrial revolution that is blurring the lines between the physical, digital and biological spheres has fast-tracked many technologies and debunked established business models and products.

We live in an age where the speed of current breakthroughs has no historical precedent and the possibilities of billions of people connected by mobile devices are unlimited. Organisations craft their business plans on the supply-side miracle delivered by technology. Even as automation substitutes for labour across the world economy - ironically - employee skills increasingly differentiate one company from the other.

At the risk of sounding clichéd, it is true that companies greatly covet human skills. And human skills alone can harness technology for delivering cutting-edge products and services. In this backdrop, employers try to attract and retain talent with a new DC - "Deferred Compensation" available whilst employed, not the old DC - "Defined Contribution" waiting on retirement.

The medium-term narrative

Pension actuaries as a result are expected to measure, recognise and disclose on a greater variety of in-service employee benefits. These include the new DC or "Deferred Compensation" that is spreading fast and wide across many industries and deep within employee levels as employers realise that 'yesterday's winning capabilities become tomorrow's table stakes.' Medium-term compensation is also a sandbox of sorts - a tool with course correction embedded within.

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The new DC benefit is posited on the principle that disruptive business models provide a large long-term upside if the right employee team performs over the medium term. With stock markets discovering a company's value, designing compensation programmes linked to an employee's contribution to the company's value has witnessed great momentum. If the company's shares are not listed, deferred cash often linked to a proxy of the company's value is fast becoming the new currency of compensation. Both constituencies i.e., employers and employees progressively view the medium-term as the engagement narrative of choice.

DEFERRED COMPENSATION

In its detail

The new DC is a payout that vests over the medium-term (3 to 5 years) and linked to the long-term value the effort creates. Examples include the already popular viz., Employee Stock Option Plans and Deferred Cash Payments, and the new found viz., Deferred cash linked to enterprise value metric and Advance cash with claw-back features.

Table 1 summarises the new DC benefits within the new landscape of the IFRS-adapted Ind AS standards.

ESOP as the new DC

Whilst measuring the fair value of share options is a fundamental skill for ESOP/ ESPS under Ind AS 102, variants like restricted shares, share appreciation rights and share-based payments with cash alternatives require a more sophisticated application and greater professional judgement. Example, measuring restricted shares as compared with a vanilla ESOP will require a culling of the value of the opportunity lost

during the additional holding period. And share-based payments with cash alternatives are valued as a compound financial instrument i.e., the debt and equity component is separated.

Midway changes in ESOP plans are possible. For example - it is not abnormal for an employer to think differently as the company's share price spirals, and offer during the term of the ESOP a cash option with an added sweetener of premium to the share price to employees who already hold equity-settled options.

And beyond ESOPs

Deferred remuneration is defined in paragraph 153(d) of Ind AS 19. The standard requires an entity to recognise a liability when an employee has provided service in

Table 1 : Deferred Compensation benefits

Benefit Description	Accounting Standard	Measurement	Recognition
ESOP/ ESPS	Ind AS 102	Fair value at inception for Share Options and Restricted Shares. Frequency is higher for Share Appreciation Rights and Share-based payments with Cash Alternatives.	Over the vesting period of the option with adjustments necessary for withdrawal, forfeiture and service and performance conditions.
Deferred cash payment	Ind AS 19	Projected Unit Credit method (paragraphs 67 and 68) to decide the expected present value of the cash payment.	Over the vesting period of the cash payout, with adjustments for employee withdrawal rate, forfeiture and service and performance conditions.
Deferred cash payment linked to a company value proxy	Ind AS 19	Estimated present value of the cash payment. The value is based on the company's value proxy e.g., a certain multiple the change between current and future EBITDA. The expected present value of the cash payment is calculated using the Projected Unit Credit method.	Over the vesting period of the cash payout, with adjustments for employee withdrawal rate, forfeiture and service and performance conditions.
Advance cash payment, with claw-back on exit before vesting	Ind AS 19	Estimated cash payment to vest with employees after expected claw-back. Note that the historical cost convention applies as there are no future cash flows.	Over the vesting period of the cash payout, with adjustments for employee withdrawal rate, forfeiture and service and performance conditions.

exchange of employee benefits to be paid in the future. Benefits need to be attributed to the periods of service as an obligation arises when the service is rendered (paragraph 157, Ind AS 19). Indeed employee service before the vesting date gives rise to a constructive obligation because at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit reduces.

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The possibilities to design the new DC are immense - from a simple cash payout to payouts derived from a proxy of enterprise value. At the other end of the spectrum, some companies in the high technology domain pay a joining bonus to campus recruits with a claw-back on the recruit's withdrawal before a predefined period. Don't be surprised if a flavour of deterrence is applied for the recruit's leaving with a shorter notice period. It is a different calibration for a profession that has long valued future cash flows using projected unit models to now model past cash with a future prospect of retrieval on defined and often new decrements.

Tax, inevitably

Actuaries must weigh the considerations of their attest services in the new DC on stakeholders. Medium term employee benefit provisions are usually tax-deductible, however sometimes the tax authorities have deferred the deductibility of ESOP expenses to the time of actual exercise. On the other hand, provisions of employee benefits have varied tax treatments: gratuity expense is deductible only if actually paid or if contributed to an approved fund, but leave expense is deductible only when paid. The new IFRS-adapted accounting standards are yet to be fully tested among investors and tax authorities. The jury on the implications of attest work on taxability of deferred compensation is still out.

Many benefit structures

The Hungarian mathematician Paul Erdos once attempted to prove the infinity of primes to a fellow colleague. Erdos reasoned, “Just consider P, Q and R as simultaneous prime numbers. PQR + 1 is not divisible by P, but PQR is. So primes are infinite.” The colleague quipped, “Why did you lie to me? Why did you tell me those are the only primes when they aren't?” Like primes, the new DC truly has infinite structures and possibilities. Employers will unleash innovative compensation programmes tuned with the notes of dynamic business.

Clients view employee benefit actuaries as the preferred counsel on most attest work in the area. The question is whether actuaries can sew their technical skills into the new IFRS-adapted accounting standards and communicate to expectations.

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