

Query No. 1

Subject: Accounting treatment and disclosure requirement for contribution to exempt provident fund.¹

A. Facts of the Case

1. The querist is a Government company (hereinafter referred to as the ‘company or corporation’) within the meaning of section 2(45) of the Companies Act, 2013. The shares of the company are listed with recognised stock exchanges. The company is engaged in the business of refining of crude oil and marketing of petroleum products. It has two refineries and lube blending/filling plants. The company also has depots, installation and LPG plants across India, besides having administrative offices at Delhi, Chennai, Kolkata, Mumbai and other major cities.

2. The querist has stated that the company has an independent exempt provident fund (PF) trust (hereinafter referred to as the ‘trust’) to manage the PF contributions of its members which are made to the trust as per the Rules of the Provident Fund Scheme. The trust invests the contributions in securities as prescribed by the Employee Provident Fund Organisation (EPFO). The investments of the trust were held to maturity up to 29th May, 2015, when the new investment pattern was made applicable to the trusts. As per the new investment pattern, trusts are required to invest a minimum of 5% of accretions in ‘Equity & Related Investments’. The pattern also allows that the turnover ratio (the value of securities traded in the year to the average of the portfolio at the beginning and end of the year) shall not exceed ‘two’, implying that the securities are allowed to be traded subject to conditions.

3. The querist has further stated that all exempt provident fund trusts have to mandatorily declare interest rate not below the rate announced by the EPFO. If the trust is not able to meet such interest rates, the employer has to make good the shortfall. Currently, the corporation treats the contributions to the trust as ‘defined contribution’ making necessary disclosures required for defined contribution plan as per Accounting Standard (AS) 15, ‘Employee Benefits’.

4. During the audit of financial year 2014-15, statutory auditors have questioned the treatment of PF scheme as a ‘defined contribution scheme’ and recommended that the entire scheme be treated as ‘defined benefit scheme’ as cited in an earlier opinion (published as Query No. 19 of Volume XXXIII of the Compendium of Opinions) of the Expert Advisory Committee (EAC) of the Institute of Chartered Accountants of India (ICAI). According to the querist, the opinion reads that as the interest portion is in the category of a defined benefit, the entire scheme tantamount to be a ‘defined benefit scheme’. Actuarial valuation of the liability vis-a-vis assets of the fund should be done (assets to be at fair value instead of book value) and the accounting treatment and the disclosures should be made as per defined benefit scheme as per the provisions of AS 15.

5. *The corporation’s point of view:*

Accounting Standard (AS) 15, ‘Employee Benefits’, does not have any specific guideline on the valuation and disclosure of liability towards an Exempt Provident Fund Trust wherein

¹ Opinion finalised by the Committee on 7.7.2016.

the interest portion is a 'defined benefit' and the contribution made has the characteristic of 'defined contribution'. The provisions for disclosure and valuation significantly differ for 'defined benefit plans' and 'defined contribution plans' under AS 15. The corporation has disclosed the following in its notes forming part of its financial statements for the year 2014-15:

“The Corporation’s contribution to the Provident Fund is remitted to a separate trust established for this purpose based on a fixed percentage of the eligible employee’s salary and charged to Statement of Profit and Loss. Shortfall, if any, in the fund assets, based on the Government specified minimum rate of return, will be made good by the Corporation and charged to Statement of Profit and Loss”.

Although the corporation has treated the scheme as 'Defined Contribution Scheme', it has obtained the interest service sufficiency/coverage certificate from the actuary which indicated sufficient interest coverage of the fund in line with the declared interest rates by the Employee Provident Fund Organisation.

6. The querist has also stated that the following points should be considered in favour of treating this scheme as 'Defined Contribution Scheme':

- (i) The liability of the corporation is limited to the extent of employer’s contribution and any shortfall in the interest obligation, if any. There is no further obligation on the part of the corporation as the PF Act does not allow recognition/assumption of any liability/surplus on account of any changes in the fair value of plan assets/actuarial valuation. Any change in the liability/fund status upon actuarial valuation/fair valuation of assets would only be a notional shortfall/surplus. The corporation is neither allowed to contribute beyond the statutory contribution nor withdraw from the fund.
- (ii) The fund assets are mostly held to maturity and can be sold subject to the provisions laid down in the new investment pattern. Hence, fair valuation of the fund assets would only result in notional surplus/deficit based on actuarial assumptions.
- (iii) The rules governing exempt trusts allow PF trusts to transfer the corpus to the PF authorities in which case it becomes an 'Un-exempt Trust'.
- (iv) There is no reasonable basis to estimate the interest rate that will be announced by EPFO from time to time. It cannot be predicted in a scientific manner like expected yield on assets, rate of growth of compensation or attrition / mortality rate, etc. The current interest rate as well as the Government securities (G-Sec) rates cannot be taken as the benchmark for prediction of the future interest rate.
- (v) The maximum liability for the corporation at any point of time is the discontinuance liability. In case of PF, the discontinuance liability is the corpus of the fund which is represented by its investments. There shall be no additional liability on account of interest shortfall in future as it is a future liability and not discontinuance liability.
- (vi) AS 15 mandates use of projected unit credit method of valuation. However, in case of guarantee of interest shortfall, it would be difficult to allocate the same as the unit credit which has to be considered for each year of extra service. As a result, it would not be possible to assign a figure as service cost, which is nothing but an increase in liability due to additional years of service. The liability does not change with each year of service as it is related to current corpus payable in future with the differential rate of earning for the future period.

- (vii) AS 15 requires the disclosure tables to be made for long term employee benefits. As the liability is a provisional figure, it will be difficult to allocate the liability to each year so as to disclose the requirement under AS 15 of interest cost, service cost and actuarial gain or loss.

B. Query

7. In view of the above, the querist has sought the opinion of the Committee on the following issues:

- (i) Whether the accounting treatment followed by the corporation as defined contribution plan is proper or it should be treated as defined benefit plan.
- (ii) If the fund is to be treated as defined benefit plan, whether the plan assets are required to be fair valued and the liability to be actuarially valued and what will be the accounting treatment of the resultant surplus/deficit in the plan?
- (iii) Is it correct to recognise in corporation's books of account in respect of resultant deficit/surplus based on the fair valuation of fund assets though there is no obligation on the corporation to contribute for the deficit or adjust the surplus in the subsequent contribution to the extent of surplus in any financial year?
- (iv) What disclosure needs to be made by the corporation?

The above position may be clarified from the perspective of AS 15 as well as Indian Accounting Standard (Ind AS) 19, 'Employee Benefits'.

C. Points considered by the Committee

8. The Committee restricts itself to the issues raised by the querist in paragraph 7 above from the perspective of AS 15 and Ind AS 19 and has not examined any other issue that may arise from the Facts of the Case, such as, accounting treatment in the financial statements of the Trust, etc.

Views of the Committee considering the requirements of AS 15:

9. The Committee notes the definitions of the terms 'defined contribution plans' and 'defined benefit plans' as contained in paragraphs 7.5 and 7.6 of Accounting Standard (AS) 15, 'Employee Benefits', notified under the Companies (Accounting Standards) Rules, 2006, reproduced as below:

"7.5 Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods."

"7.6 Defined benefit plans are post-employment benefit plans other than defined contribution plans."

The Committee further notes paragraphs 26 and 50 of AS 15 and paragraph 9 of ‘ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)’, issued by the Accounting Standards Board of the ICAI, which provide as follows:

AS 15

“26. Examples of cases where an enterprise’s obligation is not limited to the amount that it agrees to contribute to the fund are when the enterprise has an obligation through:

...

- (b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; ...”.

“50. Defined benefit plans may be unfunded, or they may be wholly or partly funded by contributions by an enterprise, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting enterprise and from which the employee benefits are paid. The payment of funded benefits when they fall due depends not only on the financial position and the investment performance of the fund but also on an enterprise’s ability to make good any shortfall in the fund’s assets. Therefore, the enterprise is, in substance, underwriting the actuarial and investment risks associated with the plan. Consequently, the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period.”

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

“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.”

From the definition of defined contribution plan, the Committee notes that in a defined contribution plan, the liability of an enterprise is restricted only to the amount it contributes to a separate fund for the benefit of its employees and has no further obligation whatsoever beyond its contribution. The Committee notes from the Facts of the Case that the company in the extant case has an independent Exempt Provident Fund Trust which manages its provident fund obligation towards its employees. The Committee further notes that the querist has stated that all Exempt Provident Fund Trusts have to mandatorily declare interest rate not below the rate announced by the Employee Provident Fund Organisation (EPFO) and if the Trust is not able to meet such interest rates, the employer has to make good the shortfall. Thus, the employer (company) guarantees a specified rate of return on the contributions made and the liability of the enterprise is not restricted to the contribution it makes to the separate fund but also extends to any deficiency in the rate of interest earned by the separate fund as compared to the rate declared by the EPFO. Accordingly, the Committee is of the view that, in the extant case, actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance on the company and that the provident fund obligation in the extant case falls within the definition given in paragraph 26(b) of AS 15. Therefore, the Exempt Provident Fund set up by the company is a defined benefit plan under AS 15.

10. The Committee is further of the view that once an employee benefit scheme is treated as defined benefit scheme, all the requirements relating to recognition, measurement and disclosures of the defined benefit expense, obligation and plan assets, etc. as contained in AS 15 shall follow. Accordingly, in terms of the explicit requirements of AS 15 at the reporting date, all plan assets should be fair valued and the present value of the defined benefit obligation should be determined using actuarial valuation technique (viz., the Projected Unit Credit Method) and defined benefit liability would be recognised at net of these two amounts (assuming that there is no impact of any past service cost as the same is not referred to in the facts of the extant case). Further, any actuarial gains and losses resulting from the actuarial valuation and changes in fair value of plan assets should be included while determining the expense for the current year in respect of defined benefit obligation to be recognised in the statement of profit and loss. Thus, any surplus/deficit based on the fair valuation of plan (fund) assets and actuarial valuation would automatically be reflected as a part of defined benefit obligation for provident fund in the financial statements. Further, the company is required to make the disclosures in terms of paragraphs 119 to 125 of AS 15.

11. With regard to the difficulties mentioned by the querist in determination of current service cost, etc. and various estimates related to expected yield on assets, rate of growth of compensation or attrition/mortality rate, the Committee notes that paragraph 64 of AS 15 specifically requires actuarial valuation for determining defined benefit obligation and current service cost due to uncertainties inherent in the process of estimation and due to long-term nature of employment benefit plan. Accordingly, the services of an expert, such as, an actuary, may be used, as also suggested in paragraph 49 of AS 15. In this regard, the Committee also wishes to point out that the Institute of Actuaries of India has also issued guidance note 29 (GN 29) on valuation of interest rate guarantees on exempt provident funds under AS 15, which provides relevant guidance on the issue of actuarial valuation.

Views of the Committee considering the requirements of Ind AS 19:

12. As far as determination of post-employment benefit plan (provident fund plan) as defined contribution or defined benefit plan is concerned, the Committee notes that under Ind

AS 19, similar requirements corresponding to AS 15 requirements have been provided and therefore, there would be no change in the views of the Committee. Accordingly, under Ind AS 19 also, the provident fund plan should be treated as defined benefit plan and disclosures are required to be made considering it as defined benefit plan as per paragraphs 135 to 152 of Ind AS 19. Further, under Ind AS 19 also, the plan asset is to be measured at fair value and defined benefit obligation is to be measured at its present value using actuarial technique, projected unit credit method and the difference between the two is to be recognised as net defined benefit liability (asset) in the balance sheet. However, gains and losses resulting from the remeasurement of net defined liability (asset) including actuarial gains and losses are to be recognised in other comprehensive income instead of the statement of profit and loss as under AS 15. In this regard, the Committee notes paragraph 57 of Ind AS 19 as follows:

“57. Accounting by an entity for defined benefit plans involves the following steps:

- (a) determining the deficit or surplus. This involves:
 - (i) using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods (see paragraphs 67–69). This requires an entity to determine how much benefit is attributable to the current and prior periods (see paragraphs 70–74) and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will affect the cost of the benefit (see paragraphs 75–98).
 - (ii) discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost (see paragraphs 67–69 and 83–86).
 - (iii) deducting the fair value of any plan assets (see paragraphs 113–115) from the present value of the defined benefit obligation.
- (b) determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (a), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling (see paragraph 64).
- (c) determining amounts to be recognised in profit or loss:
 - (i) current service cost (see paragraphs 70–74).
 - (ii) any past service cost and gain or loss on settlement (see paragraphs 99–112).
 - (iii) net interest on the net defined benefit liability (asset) (see paragraphs 123–126).
- (d) determining the remeasurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:
 - (i) actuarial gains and losses (see paragraphs 128 and 129);
 - (ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset) (see paragraph 130); and
 - (iii) any change in the effect of the asset ceiling (see paragraph 64), excluding amounts included in net interest on the net defined benefit liability (asset).

Where an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately.”

D. Opinion

13. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 7 above:

- (i) The accounting treatment followed by the corporation in respect of exempt provident fund plan as defined contribution plan is not proper; instead it should be treated as defined benefit plan under AS 15 and Ind AS 19, as discussed in paragraphs 9 and 12 above.
- (ii) and (iii) Since the exempt provident fund plan is to be treated as defined benefit plan, as per the requirements of AS 15 and Ind AS 19, the plan assets are required to be fair valued and the liability to be actuarially valued and difference between the two is to be recognised as defined benefit liability/net defined benefit liability (asset) in the balance sheet and accordingly, the resultant surplus/deficit in the plan would be automatically reflected in the financial statements of the company, considering the requirements of AS 15 and Ind AS 19, as discussed in paragraphs 10 and 12 above.
- (iii) Disclosure needs to be made by the company as per paragraphs 119 to 125 of AS 15 and paragraphs 135 to 152 of Ind AS 19.
