

Query No. 19

Subject: Accounting treatment of amount invested in LIC's leave encashment plan for meeting the company's leave encashment liability.¹

A. Facts of the Case

1. A company (hereinafter referred to as 'the company'), as per terms and conditions of employment, has a long term compensated absence scheme under which employees are entitled to certain quantum of paid annual leave (AL) and paid half pay leave (HPL), every year, while in service. They can also encash the AL (subject to certain limits) while in service and can encash AL and HPL on resignation / retirement (subject to certain conditions and limits).
2. As per the querist, the above being a defined benefit scheme, the company in line with the requirements of the Accounting Standard (AS) 15 and Indian Accounting Standard (Ind AS) 19, 'Employee Benefits' with effect from the financial year (F.Y.) 2016-17, has been accounting for the liability based on actuarial valuation. The scheme is an unfunded scheme and the amount of liability is retained in the company's books.
3. As a part of good corporate governance, the company has, during the F.Y. 2015-16, decided to segregate the amount required to meet the above liability from the company's common pool of funds and deposit the amount representing the liability in a separate identifiable and dedicated asset.
4. Accordingly, the company has, during F.Y. 2015-16 deposited the amount of Rs. 241.06 crore (representing an amount of liability on 31st March, 2015) in New Group Leave Encashment Plan of the Life Insurance Corporation of India (LIC). Also, an amount equivalent to incremental liability will be deposited in the above scheme each year. A copy of the scheme has been supplied by the querist for the perusal of the Committee. The querist has separately informed that no separate trust is created to administer/manage the funds maintained in respect of amount invested in LIC's new group leave encashment plan for meeting company's leave encashment liability.

Accounting treatment of the amount deposited with the LIC and interest earned thereon

5. As informed by the querist, the company has deposited the amount equivalent to the leave encashment liability with the LIC. The amount deposited with the LIC has been grouped under non-current investment in the financial statements and the corresponding liability towards leave encashment is grouped under long-term/short-term provisions (as applicable).
6. The interest earned on the investment has been credited to incremental expense to be booked against leave encashment liability and hence, netted off under employee benefit expenses.

7. The reason for the above classification / accounting treatment is explained below:

Reason for retention of leave encashment liability in the books of account:

As per paragraph 55 of Accounting Standard (AS) 15, 'Employee Benefits' (revised 2005), ***"The amount recognised 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;***

¹ Opinion finalised by the Committee on 10.11.2017 and 11.11.2017.

- (b) *minus any past service cost not yet recognised;*
- (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.”*

Thus, the company should recognise present value of the obligation in respect of leave encashment liability at the balance sheet date and this value can be reduced to the extent of fair value of a plan asset (if any). Accordingly, as per provisions of AS 15 (revised 2005), the company would be able to adjust the leave encashment liability against the investment made to meet the liability, only if the instrument in which the amount is invested qualifies as a plan asset which is defined as follows in AS 15:

“Plan assets comprise:

- (a) *assets held by a long-term employee benefit fund; and*
- (b) *qualifying insurance policies.”*

As the company has invested the amount in an insurance policy, the test of whether the investment made by the company qualifies as a plan asset would be whether the policy taken is a qualifying policy. As per AS 15 (Revised), a qualifying insurance policy would be required to meet the following conditions:

- can be used only to pay or fund employee benefits under a defined benefit plan; and
- are not available to the reporting enterprise’s own creditors (even in bankruptcy) and cannot be paid to the reporting enterprise, unless either:
 - (i) the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or
 - (ii) the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid.

In the extant case, the policy taken by the company does not satisfy the above conditions due to incorporation of the following clauses in the policy:

- The Grantees and the Corporation reserves the right to terminate the scheme by giving three months notice to either party. In that event, the Life Cover Benefit under this Policy shall terminate forthwith and the benefit available under this policy shall be as per Schedule IV. (Clause 17 of General Conditions)
- The Policy can be surrendered by the Grantees at any time by giving an advance notice of three months. (Point 8 of Schedule IV to the Policy)

Therefore, as the condition for plan asset as specified in AS 15 (revised) is not met by LIC’s New Group Leave Encashment Plan, the company has treated the investment as a non-plan asset and accordingly, not reduced the fair value of the investment from the present value of obligation in respect of leave encashment liability as on 31st March, 2016.

Reason for adjustment of interest earned out of investment against incremental leave encashment liability instead of showing it as interest income:

As per paragraph 61 of AS 15 (revised 2005), an enterprise while arriving at the amount to be recognised in the statement of profit and loss can reduce from the current service cost and interest cost, the expected return on any plan assets and on any reimbursement rights.

As per paragraph 103 of AS 15 (revised 2005), in the statement of profit and loss, the expense relating to a defined benefit plan may be presented *net of the amount recognised for a reimbursement* (emphasis supplied by the querist). Since interest earned by the company every year on the investment is credited to Policy account periodically (Refer Schedule II) and the interest so credited is adjusted against the incremental liability each year in order to arrive at the net amount payable to LIC, the interest earned for the year on investment is in nature of reimbursement of the money to the company. In view of this, the interest income earned for the year under the LIC policy is adjusted against the incremental liability (for the year) as determined by the actuary and the net amount is recognised in the statement of profit and loss.

B. Query

8. On the basis of the above, the querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) Whether the company is right in considering the investment made in New Group Leave Encashment Plan of Life Insurance Corporation of India towards meeting its leave encashment liability as a Non-Plan investment.
- (ii) Whether the company is right in accounting the leave encashment liability in its books and the corresponding amount deposited with LIC under 'Non-current Investment'.
- (iii) Whether the company is right in recognising the net amount (i.e., incremental liability for the year as determined by actuary less interest income earned for the year under the LIC Policy) as the leave encashment liability in the statement of profit and loss.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised in the query relate to (i) whether the investment made in New Group Leave Encashment Plan of Life Insurance Corporation of India (LIC Policy) towards meeting its leave encashment liability should be considered as a 'qualifying insurance policy/plan asset' and accordingly, whether it should be disclosed as a separate asset or as a deduction from the related leave encashment liability in the financial statements and (ii) whether the expense recognized in the statement of profit and loss (referred to as 'incremental liability' by the querist) in respect of leave encashment liability for the current year as per the requirements of AS 15 should be recognized net of interest income earned for the year on such LIC Policy. Accordingly, the Committee, while answering the query, has considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, measurement of employee benefit obligations/liability and the investments (LIC Policy) made in relation thereto, accounting for any other employee benefit other than leave encashment liability, nature and type of the employee benefits and benefit plans as per the requirements of AS 15, viz., short term/long-term/other long-term employee benefits and the defined contribution or defined benefit plans etc. The Committee also wishes to point out that although at one place, the querist has made a reference of Ind AS 19, but since throughout the facts of the case, the querist has referred to the requirements of AS 15 (revised) and the financial year being referred to in the extant case is financial year 2015-16, the Committee has expressed its opinion in the context of accounting standards notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules') and not Ind ASs.

10. At the outset, the Committee wishes to clarify that leave encashment is not a post-employment benefit plan; rather it will be other short-term employee benefits or other long-term employee benefits depending on the terms and condition. The Committee further notes that the company has taken a comprehensive LIC policy in respect of life cover benefit and leave encashment benefit for its employees, some of the significant features of which are as follows:

General Conditions

- “10 As soon as a Member or a beneficiary becomes entitled to receive the benefits under the scheme, the Grantees shall send the relevant particulars to the Corporation whereupon the Corporation shall pay to the Grantees appropriate benefits.”
- “13 Notwithstanding anything herein contained to the contrary, the Corporations’ liability to the Grantees under this policy shall be limited to the Life Cover Benefit under this plan effected in respect of the Members subject to the terms and condition applicable to them and Policy Account Value standing to the credit of the Grantees.
- 14 The Corporation shall issue the Grantees as the policyholder at the end of each financial year a statement of the Policy Account showing various transactions during the financial year.”
- “17 The Grantees and the Corporation reserves the right to terminate the scheme by giving three months notice to either party. In that event, the Life Cover Benefit under this Policy shall terminate forthwith and the benefit available under this policy shall be as per Schedule IV.”
- “20. The LIC’s New Group Leave Encashment Cash Accumulation Plan is a Non Participating Variable Insurance Plan and will not participate in the profits of the Corporation.”

Schedule – I

16.	Policy Account	Policy Account shall mean the account to be maintained by the Corporation in favour of the Grantees to which will be credited the Contribution (as described in Schedule – II). Leave Encashment Benefits shall be paid out of Policy Account.
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Schedule II – Contribution and Management of Policy Account

- 1. Contributions:** Such amount as is required to secure the Life Cover Benefit and Leave Encashment Benefits in respect of the members of the scheme. The amount payable towards past service Leave Encashment Benefit may be wholly paid on the date of entry and partly on Annual Renewal Date as specified in the scheme rules and amount payable every year as required to secure the Leave Encashment Benefit relating to the current year service as per AS – 15 (Revised).
- ...
- 2. Management of policy Account:** All the Contributions paid

by the Grantees will be credited to the maintained Policy Account.

A single Policy Account shall be maintained in respect of all contributions received from Grantees.

Member's Leave Encashment Benefits shall be paid out of the Policy Account of the scheme on the happening of the events as described in the scheme rules.

3. Interest payable on Policy Account:

The following types of interest rates shall be provided on the Policy Account Value:

- (a) Minimum Floor Rate (MFR): MFR is a guaranteed interest rate that Policy Account shall earn during the entire policy term. This plan offers a Minimum Floor Rate (MFR) of 0.5% p.a.
- (b) Additional Interest Rate (AIR): In addition to MFR, the Corporation shall also declare a non zero-positive Additional Interest Rate (AIR) at the beginning of every financial quarter on the Policy Account and AIR shall remain guaranteed for that financial quarter. This AIR shall remain guaranteed for that quarter.
- (c) Residual Addition (RA): Starting from the fifth policy anniversary, in addition to MFR and AIR, the Corporation may also declare a non zero-positive Residual Addition (RA) on Policy Account at the end each policy year.

...

The interest amount earned by way of MFR and AIR will be credited to the Policy Account at the end of each quarter/at the time of exit. The interest amount earned by way of RA, if any, will be credited to the Policy Account at the end of each policy year starting from policy year 5.

Schedule III - Benefits

6. The benefits payable on various events are as follows:

a. Benefits payable on death of Member before Normal Retirement Age:

On death of a Member whilst in service before Normal Retirement Age, the benefit payable will be equal to the sum of following:

- (i) Sum assured
- (ii) Leave Encashment Benefit as per the scheme rules.

However, for the Leave Encashment Benefit, the Corporation's liability towards the Policyholder shall be limited to the Policy Account Value remaining in the Policy Account.

b. Benefits payable on retirement/Leaving Service:

On retirement of a Member, the Leave Encashment Benefit shall be payable as specified in the scheme rules. However, the Corporation's liability towards the policyholder shall be limited to the Policy Account Value remaining in the Policy Account.

Schedule IV – Discontinuance of Contributions

8. Surrender: The Policy can be surrendered by the Grantees at any time by giving an advance notice of 3 months. The benefit available on surrender shall be

higher of Guaranteed Surrender Value and Special Surrender Value. The policy will terminate on surrender. **The Life Cover Benefit effected in this policy carries no Surrender Value.**

Guaranteed Surrender Value:

The Guaranteed Surrender Value shall be equal to the 90% of the total Contributions (net of Mortality charges and Policy Administration Charges already deducted till date) paid less all the benefits paid since the inception of the policy.

Special Surrender Value:

The Special Surrender Value shall be equal to the policy Account Value on the day of surrender less the applicable surrender charges, less Market Value Adjustment, if any, as mentioned in Para 4(iv) of Schedule II

...”

11. With regard to the first issue raised by the company relating to whether the investment made in New Group Leave Encashment Plan of Life Insurance Corporation of India towards meeting its leave encashment liability can be considered as a ‘plan asset’, the Committee notes from the facts of the case that the company is not treating the investments as a plan asset. The Committee further notes the following paragraphs of Accounting Standard (AS) 15, ‘Employee Benefits’, notified under the Rules:

“7.14 Plan assets comprise:

- (a) *assets held by a long-term employee benefit fund; and*
- (b) *qualifying insurance policies.*

7.15 Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting enterprise) that:

- (a) *are held by an entity (a fund) that is legally separate from the reporting enterprise and exists solely to pay or fund employee benefits; and*
- (b) *are available to be used only to pay or fund employee benefits, are not available to the reporting enterprise’s own creditors (even in bankruptcy), and cannot be returned to the reporting enterprise, unless either:*
 - (i) *the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting enterprise; or*
 - (ii) *the assets are returned to the reporting enterprise to reimburse it for employee benefits already paid.*

7.16 A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in AS 18 Related Party Disclosures) of the reporting enterprise, if the proceeds of the policy:

- (a) *can be used only to pay or fund employee benefits under a defined benefit plan; and*
- (b) *are not available to the reporting enterprise’s own creditors (even in bankruptcy) and cannot be paid to the reporting enterprise, unless either:*

- (i) *the proceeds represent surplus assets that are not needed for the policy to meet all the related employee benefit obligations; or*
- (ii) *the proceeds are returned to the reporting enterprise to reimburse it for employee benefits already paid.”*

12. From the above, the Committee notes that plan assets comprise assets held by a long-term employee benefit fund and qualifying insurance policies. In the extant case, there is a comprehensive LIC policy covering both life cover benefits and leave encashment benefits, but no separate fund exists solely to pay or fund the leave encashment benefits. The Committee notes that as per the definition of plan assets (assets held by a long-term employee benefit fund and qualifying insurance policy), the assets held by the fund/proceeds of such insurance policy can be only to pay or fund employee benefits and are not available to the reporting enterprise’s own creditors and cannot be paid to the reporting enterprise except in certain circumstances as described in the definition. In this context, the Committee notes from the terms of the LIC policy reproduced in paragraph 11 above that whenever an employee (who is a member or a beneficiary as per the policy) becomes entitled to receive the benefits under the scheme, the company (grantees) shall send the relevant particulars to the insurer (Corporation) whereupon it shall pay to the Grantees appropriate benefits. Thus, apparently, the insurer pays to the company, appropriate benefits on its becoming due to the employee on intimation sent by the company and not only to reimburse the company for employee benefits *already paid* by it. Further, the Policy gives a right to the company to terminate insurance policy at any time and in that case, the insurer would pay a specified amount to the company as per the terms of the Policy. The Committee is of the view that the existence of such a right implies that the company can use the proceeds of the Policy for other than to pay or fund employee benefits under the plan i.e. the company has the ability to use such funds for any other purpose than to pay or fund employee benefits under a defined benefit plan. The Committee further notes the requirements of AS 15 in this regard as follows:

“103. When, and only when, it is virtually certain that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation, an enterprise should recognise its right to reimbursement as a separate asset. The enterprise should measure the asset at fair value. In all other respects, an enterprise should treat that asset in the same way as plan assets. In the statement of profit and loss, the expense relating to a defined benefit plan may be presented net of the amount recognised for a reimbursement.”

“105. When an insurance policy is not a qualifying insurance policy, that insurance policy is not a plan asset. Paragraph 103 deals with such cases: the enterprise recognises its right to reimbursement under the insurance policy as a separate asset, rather than as a deduction in determining the defined benefit liability recognised under paragraph 55; in all other respects, including for determination of the fair value, the enterprise treats that asset in the same way as plan assets. Paragraph 120(f)(iii) requires the enterprise to disclose a brief description of the link between the reimbursement right and the related obligation.”

“107. The expected return on plan assets is a component of the expense recognised in the statement of profit and loss. The difference between the expected return on plan assets and the actual return on plan assets is an actuarial gain or loss.”

On the basis of the above, the Committee is of the view that although, the LIC policy is

not a plan asset, the same should be recognised as a reimbursement right in the financial statements as a separate asset and not as a deduction in determining the defined benefit liability in respect of leave encashment plan as per the requirements of paragraph 55 of AS 15. Further, for classification and presentation of the said insurance policy, the Committee is of the view that the company should also follow the requirements of Schedule III to the Companies Act, 2013 in this regard.

13. With regard to the issue raised by the querist relating to treatment of interest income on the said insurance policy in the extant case, the Committee notes the following requirements of AS 15:

“61. An enterprise should recognise the net total of the following amounts in the statement of profit and loss, except to the extent that another Accounting Standard requires or permits their inclusion in the cost of an asset:

- (a) current service cost (see paragraphs 64-91);***
- (b) interest cost (see paragraph 82);***
- (c) the expected return on any plan assets (see paragraphs 107-109) and on any reimbursement rights (see paragraph 103);***
- (d) actuarial gains and losses (see paragraphs 92-93);***
- (e) past service cost to the extent that paragraph 94 requires an enterprise to recognise it;***
- (f) the effect of any curtailments or settlements (see paragraphs 110 and 111); and***
- (g) the effect of the limit in paragraph 59 (b), i.e., the extent to which the amount determined under paragraph 55 (if negative) exceeds the amount determined under paragraph 59 (b).”***

“92. Actuarial gains and losses should be recognised immediately in the statement of profit and loss as income or expense (see paragraph 61).

93. Actuarial gains and losses may result from increases or decreases in either the present value of a defined benefit obligation or the fair value of any related plan assets. Causes of actuarial gains and losses include, for example:

- (a) unexpectedly high or low rates of employee turnover, early retirement or mortality or of increases in salaries, benefits (if the terms of a plan provide for inflationary benefit increases) or medical costs;***
- (b) the effect of changes in estimates of future employee turnover, early retirement or mortality or of increases in salaries, benefits (if the terms of a plan provide for inflationary benefit increases) or medical costs;***
- (c) the effect of changes in the discount rate; and***
- (d) differences between the actual return on plan assets and the expected return on plan assets (see paragraphs 107-109).”***

“120. An enterprise should disclose the following information about defined benefit plans:

- (a) the enterprise’s accounting policy for recognising actuarial gains and losses.***

...

(c) *a reconciliation of opening and closing balances of the present value of the defined benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following:*

(i) *current service cost,*

(ii) *interest cost,*

(iii) *contributions by plan participants,*

(iv) *actuarial gains and losses,*

(v) *foreign currency exchange rate changes on plans measured in a currency different from the enterprise's reporting currency,*

(vi) *benefits paid,*

(vii) *past service cost,*

(viii) *amalgamations,*

(ix) *curtailments, and*

(x) *settlements.*

...

(g) *the total expense recognised in the statement of profit and loss for each of the following, and the line item(s) of the statement of profit and loss in which they are included:*

(i) *current service cost;*

(ii) *interest cost;*

(iii) *expected return on plan assets;*

(iv) *expected return on any reimbursement right recognised as an asset in accordance with paragraph 103;*

(v) *actuarial gains and losses;*

(vi) *past service cost;*

(vii) *the effect of any curtailment or settlement; and*

(viii) *the effect of the limit in paragraph 59 (b), i.e., the extent to which the amount determined in accordance with paragraph 55 (if negative) exceeds the amount determined in accordance with paragraph 59 (b).*

...”

From the above, the Committee notes that the Standard requires that unless otherwise required by any other accounting standard, the company should recognize in the statement of profit and loss, expected return and not actual return on the reimbursement rights and the difference between the actual return and expected return on reimbursement rights as actuarial gains and losses. Thus, the return on reimbursement rights is to be recognized as two separate elements in the statement of profit and loss rather than as a single element.

D. Opinion

14. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 8 above:

- (i) and (ii) Yes, the company is correct in not considering the investment made in New Group Leave Encashment Plan of Life Insurance Corporation of India towards meeting its leave encashment liability as a ‘plan asset’ as per the requirements of AS 15 discussed in paragraph 12 above. The same should be recognised as a reimbursement right in the financial statements as a separate asset and not as a deduction in determining the defined benefit liability in respect of leave encashment plan as per the requirements of paragraph 55 of AS 15. Further, for classification and presentation of the said LIC policy, the company should also follow the requirements of Schedule III to the Companies Act, 2013 in this regard, as discussed in paragraph 12 above.
- (iii) While recognising the amount in respect of leave encashment liability, the company should recognize in the statement of profit and loss, expected return and not actual return on the reimbursement rights (LIC Policy) and the difference between the actual return and expected return on reimbursement rights as actuarial gains and losses as per the requirements of AS 15. Thus, the return on reimbursement rights (LIC Policy) is to be recognized as two separate elements in the statement of profit and loss rather than as a single element, as discussed in paragraph 13 above.
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