

# Accounting Standard 15 (revised 2005): **Are You Prepared?**



# A Watson Wyatt India survey of CFOs' views on, and preparedness for, India's new accounting standard for measuring the cost of employee benefits

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## Executive Summary

AS 15 (revised 2005) (referred to AS 15 (R 2005) in this study) replaces AS 15 and comes into effect for accounting periods commencing on or after 1 April 2006. First quarter results will therefore need to reflect the new Standard. It aligns the Indian accounting standard with global practice and changes the way employee benefits are reported in India. Watson Wyatt has conducted this survey to gauge the level of understanding of CFOs and to identify their concerns associated with the implementation of the new Standard. We surveyed 225 companies which are required to adopt AS 15 (R 2005). Here are our key findings:

1) 13% of the respondents were 'not at all' familiar with the new Standard.

*Of the remaining,*

2) 78% of the respondents think that AS 15 (R 2005) will improve the quality of financial reporting in India.

3) 75% of the respondents expect that the need for actuarial services will increase.

4) Volatility of reported cost from year to year on account of specificity of actuarial assumptions emerges as the biggest concern; closely followed by the concern that contributions (i.e. cash-flow) can no longer be taken as the reported P&L cost of employee benefits.

5) 44% of the companies are little or not at all prepared to implement the new Standard.

6) Larger companies have a better understanding, are better prepared and less concerned than smaller companies.

Our study found some disparity between the preparedness for the new Standard claimed by companies and their actual level of knowledge. We therefore urge all CFOs to ensure in advance that their finance team has properly considered the likely impact of the new Standard before it takes effect in the first quarter of the coming financial year.

## What is AS 15 (R 2005)?

The Institute of Chartered Accountants of India (ICAI) has made effective the implementation of Accounting Standard 15 (R 2005) for accounting periods commencing on or after 1 April 2006. This will affect the manner in which companies measure, recognize and disclose the cost of employee benefits in India. The new Standard is regarded as an improvement over AS 15 (1995). It is a 'market based' standard that measures employee benefit liabilities on a basis that is consistent with financial markets. Its scope extends beyond retirement benefits to cover all employee benefits (defined as all forms of deferred compensation given by an enterprise in exchange for service rendered by employees).

The new Standard has significant financial reporting implications since:

- 1) All forms of employee benefits are now covered.
- 2) In line with global practice, the new Standard requires liabilities, and any assets, to be 'marked to market' – i.e. their value has to be consistent with current financial market conditions.

- 3) Prescribed actuarial assumptions and method for assessment of (market consistent) liabilities.
- 4) Immediate recognition of net benefit liabilities on the company's balance sheet.
- 5) Significantly more onerous disclosure requirements.

In spite of the concerns expressed, the majority of respondents understand that AS 15 (R 2005) is part of a trend towards harmonization of Indian accounting standards with global norms which will benefit Indian companies and investors. In fact, 78% of the respondents believe that AS 15 (R 2005) will improve the quality of financial reporting in India.

## Participants in the study

This pan-India study was conducted between October 2006 and January 2007. Participants in the study were drawn from the full range of companies that are

required to adopt AS 15 (R 2005) from 1 April 2006 (as seen in Table 1).

Employee benefit liabilities exceeded 10% of the total balance sheet liabilities for about 25% of the companies in our sample.

**Table 1** | Breakdown of responding companies by AS 15 (R 2005)'s sector classification

Listed companies	141
Unlisted companies (with turnover > 50 crores )	29
Unlisted companies (with turnover < 50 crores and employees > 50)	29
Financial <sup>1</sup>	16
Others <sup>2</sup>	10
<b>Total number of companies</b>	<b>225</b>

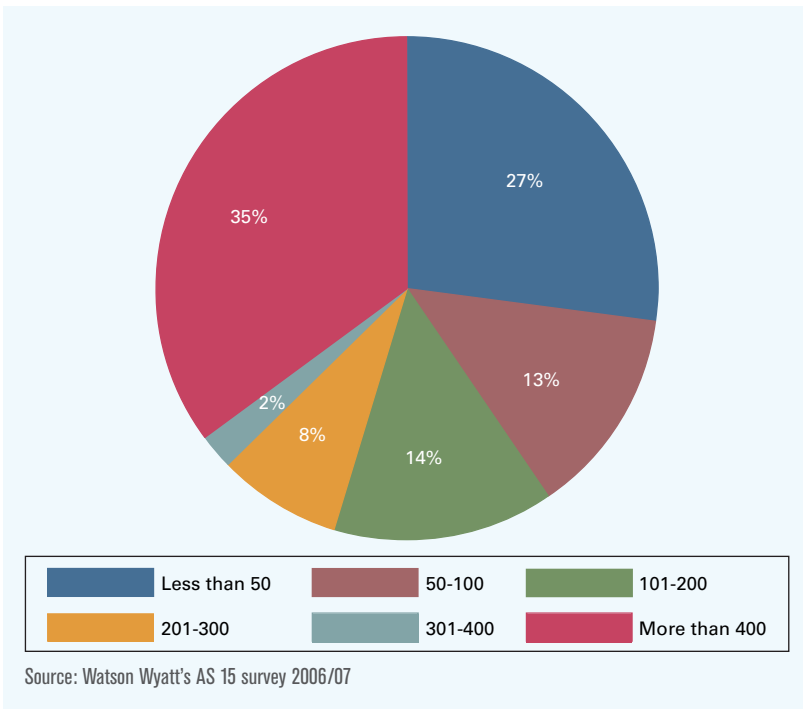
**Table 2** | Classification of participants by industry

Business and Professional Services	11
Construction, Real Estate and Engineering	28
Financial	16
Information, Mass Media and Information	4
Leisure and Entertainment	1
Manufacturing	117
Minerals and Natural Resources	5
Transport, Storage and Logistics	1
Education, Healthcare and Medical services	5
Others	37
<b>Total number of companies</b>	<b>225</b>

<sup>1</sup>'Financial' comprises of Banks, Insurance companies, Firms carrying on insurance business and Financial Institutions

<sup>2</sup>'Others' comprises of commercial enterprises which have public deposits in excess of 10 crores and holding and subsidiary enterprises of any of the listed companies

**Figure 1 |** Distribution of participant companies by turnover (in Rs crores)



## Existing employee benefit accounting

We assessed the level of compliance with the current version of AS 15 and 80% of participants responded positively to the question: "Does your company report retirement benefit costs under the existing AS 15?" However, this still leaves 20% of companies who are apparently not reporting under the existing AS 15 though they provide employee benefits.

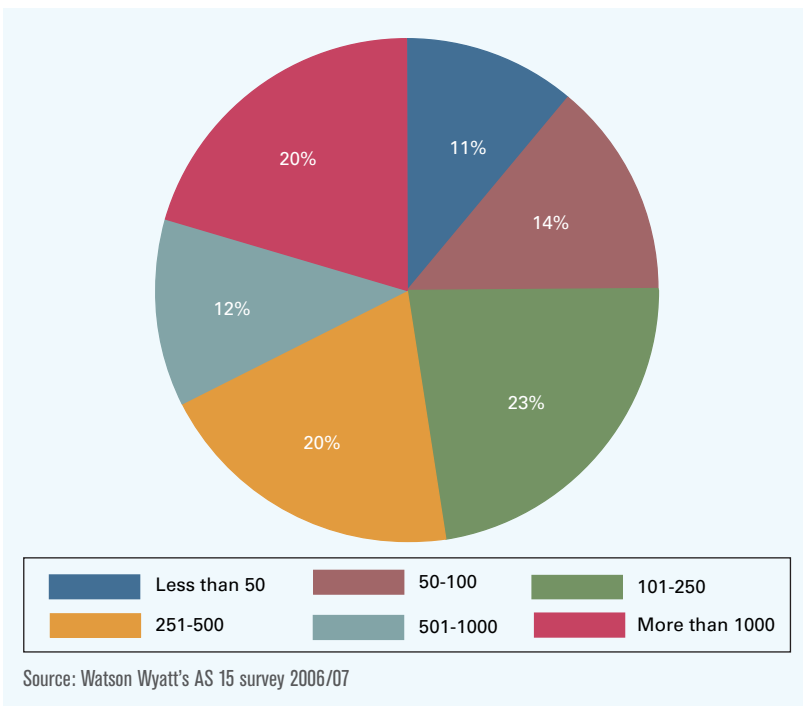
Some participants are listed on overseas stock exchanges or are subsidiaries of foreign owned corporations. Thus 23% and 11% report employee benefits under IAS 19 and FAS 87 respectively.

Leave encashment, post-retirement benefit and long term service awards are generally unfunded in nature. The majority of the funded schemes gratuity and superannuation are managed by LIC.

For those participants with gratuity and defined benefit superannuation plans we asked how contributions (i.e. cash flow) and reported cost are determined. For 45% of the employers providing gratuity, and 43% of employers providing defined benefit superannuation, these are calculated by the insurance company with which the fund is invested.

Under the existing AS 15 it is possible for contributions and reported cost to be the same and we find that this is a strong preference for most companies: 61% of employers with a funded gratuity plan, and 77% of those with a DB superannuation plan, report a cost of retirement benefits in their P&L account which is equal to the cash contributions paid into the fund.

**Figure 2 |** Distribution of participant companies by number of employees



Participants provide a variety of retirement and other employee benefits as follows:

**Table 3 | Provision of employee benefits**

Benefit	% of participants providing the benefit
Gratuity	96%
Defined Benefit Superannuation	38%
Leave Encashment	87%
Post Retirement Medical/Healthcare	15%
Long Term Service Award	15%

These benefits are financed by a variety of different approaches as follows:

**Table 4 | Financing of different kinds of employee benefits**

	Gratuity (%)	Superannuation (%)	Leave Encashment (%)	Post Retirement Medical (%)	Long Service Award (%)
Unfunded scheme	30	17	79	77	78
Funded – Invested under Rule 67 of Income Tax Rules	12	10	5	6	3
Funded – Invested by LIC	50	58	9	9	11
Funded – Invested by Life Insurer other than LIC	6	8	2	3	0
Funded – Combination of any of the above approaches	1	4	1	3	3
Can't say	1	3	4	2	5
Total	100	100	100	100	100

### Understanding of AS 15 (R 2005)

Although AS 15 (R 2005) becomes mandatory from 1 April 2006 not all companies are yet fully aware of the new Standard and its implications: 13% of participants admitted that they are “Not at all familiar” with the new Standard.

Our further analysis is restricted to 196 responses above who say that they have

some familiarity with the revised Standard. We verified CFOs’ self-reported familiarity with the new Standard by asking the following questions:

- 1) Does AS 15 (R 2005) require recognition of “other long term benefits”, in particular “accumulating compensated absences” such as sick leave? A clear majority (81%) of the survey participants were aware that all

employee benefits, not only retirement benefits, fall under the scope of the new Standard.

2) Do you know whose responsibility is it to set actuarial assumptions under AS 15 (revised 2005)? 60% of the respondents didn't know that it is the employer who is ultimately responsible for the validity of the actuarial assumptions (i.e. the employer will take advice from the actuary but it is the employer, rather than the actuary, who has responsibility for the final decision).

35% of participants could answer both these questions correctly (high understanding) while 14% did not get either answer correct (low understanding).

Out of the companies who have an Exempt Provident Fund, only 14% knew that it is to be treated as a defined benefit scheme and not a defined contribution scheme.

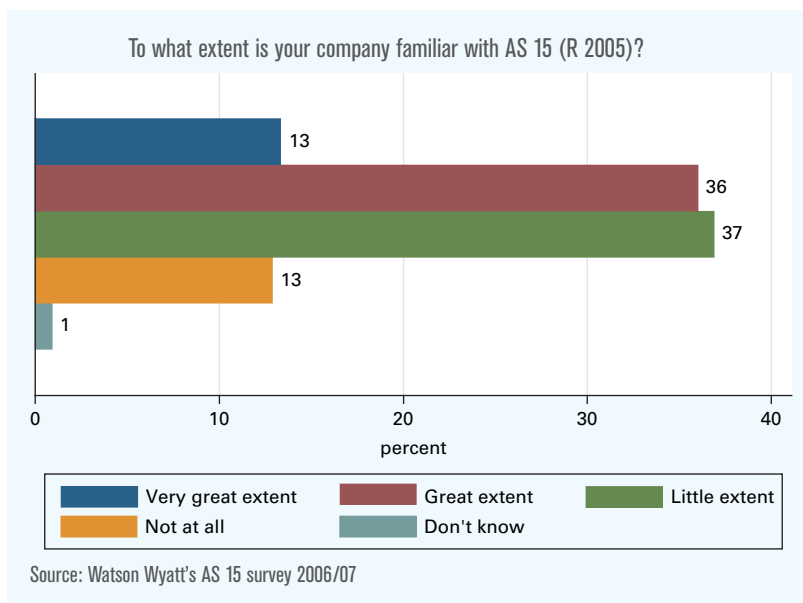
Clearly for many companies there remains some work to be done prior to preparing the first quarter results in the coming financial year else the potential for an unexpected cost impact will be high.

Demonstrated understanding is higher in the financial sector (see figure 4) and for companies where employee benefit liabilities are more than 10% of the total liabilities. Results also indicate that understanding seems to be greater for companies with a larger turnover and employee strength. For instance, understanding is higher for companies whose turnover is greater than 400 crores, i.e. 52% of such companies demonstrated a high understanding as against 23% for companies with turnover less than 400 crores.

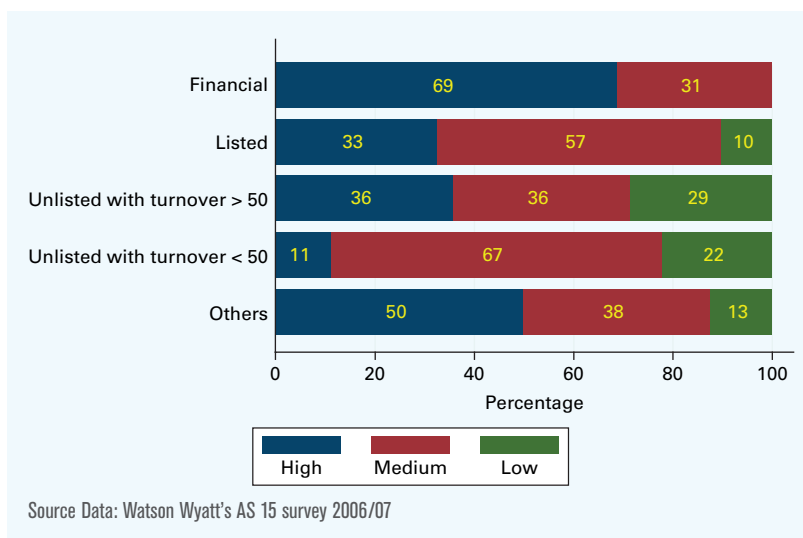
### Preparedness for AS 15 (R 2005)

We asked participants whether they expect the need for actuarial services to increase

**Figure 3 | Familiarity with AS 15 (R 2005)**

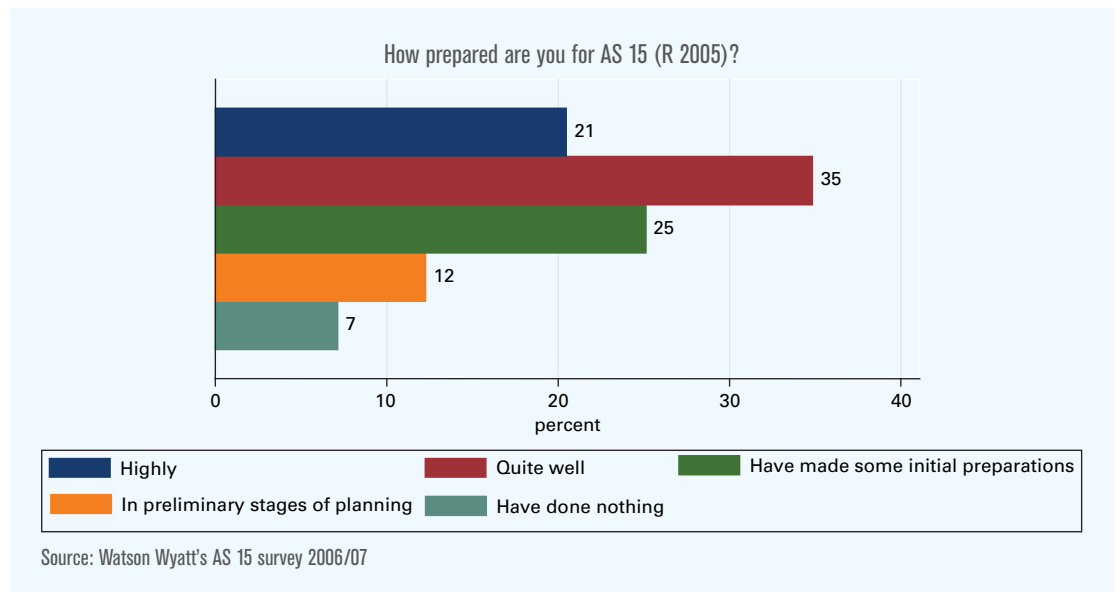


**Figure 4 | Understanding classified by AS 15 (R 2005) sector classification**



after the implementation of the new Standard and 75% believed that it will. This may be indicative of the preparations that they are making to ensure appropriate adoption of AS 15 (R 2005) as the majority of participants may have already looked at the implications of the new Standard with the help of their actuary (see figure 5).

**Figure 5 | Preparedness for AS 15 (R 2005)**



We also find that larger firms are better prepared: 51% of companies with turnover below 400 crores described themselves as 'highly' or 'quite well' prepared as compared to 62% of companies with a higher turnover.

### Concerns related to AS 15 (R 2005)

AS 15 (R 2005) is very different to the current Standard and 56% of the participants are concerned that it will not be easy to reconcile previous year results with those of AS15 (R 2005) in the first year of adoption.

Specifically, the main concerns were:

- Volatility of reported cost from year-to-year on account of prescribed, market consistent, actuarial assumptions.
- Volatility of reported cost from year-to-year on account of showing the assets of a funded scheme at their fair market value in the company's financial statements.

- Impact on the company's Balance Sheet.
- Discount rate for calculating liabilities based purely on the yield on government securities even if a higher return is expected to be earned.
- Immediate recognition of volatile asset and liability changes in the company's P&L.
- Contributions (cash flow) to a funded scheme and reported employee benefits cost can no longer be linked.

For each of the issues above, over 50% of participants were either 'concerned' or 'very concerned'. Participants with a high level of understanding of the new Standard were just as concerned as those with more limited knowledge.

The concern most strongly voiced by participants was the volatility of reported employee benefits cost from year-to-year on account of prescribed, market consistent, actuarial assumptions.

**Table 5 | Sector wise analysis of CFO's concerns reveals the following –**

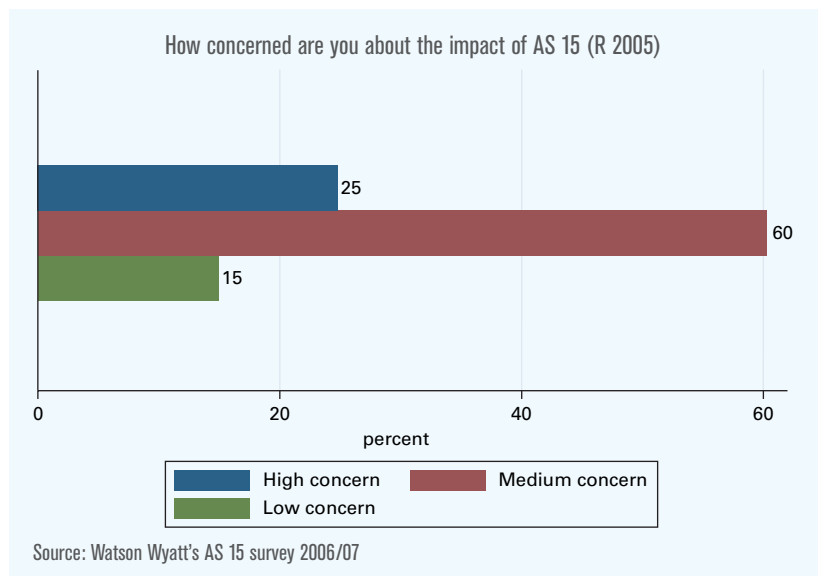
	<b>Most Important Concern</b>
Financial	Volatility of reported cost from year-to-year on account of prescribed, market consistent, actuarial assumptions
Listed Companies	Volatility of reported cost from year-to-year on account of showing the assets at their fair market value in the company's financial statements AND Impact on the company's Balance Sheet.
Unlisted Companies with turnover > 50	Volatility of reported cost from year-to-year on account of prescribed, market consistent, actuarial assumptions.
Unlisted Companies with turnover < 50	Immediate recognition of volatile asset and liability changes in the company's P&L.
Others	Contributions to a funded scheme and reported employee benefits cost can no longer be linked.

The second most commonly expressed concern was that the contributions (cash flow) to a funded scheme and reported cost can no longer be linked. In view of the fact that many companies report contributions as equal to the (cash-flow) cost, it is not surprising that this emerges as one of the greatest concerns.

In Watson Wyatt's experience, the volatility of reported cost and the flexibility of actuarial assumptions are the two most actively discussed issues that are discussed between employer and actuary under the existing AS 15. The removal of any discretion on these issues under AS 15 (R 2005) is certain to cause some headaches for CFOs.

In our final chart we summarise the overall level of CFO's concerns about the new Standard. A 'High' level of concern shows a participant is 'highly concerned' about the majority of the above issues (see figure 6). Results also indicate that concern seems to be greater for smaller companies. For instance, concern is greater for companies whose turnover is less than 400 crores i.e. 28% of such companies were 'highly concerned' or 'concerned' as compared to 18% for companies with a higher turnover.

**Figure 6 | Concerns about the impact of AS 15 (R 2005)**



Clearly employee benefits will be high on the agenda of many of India's CFOs in the coming financial year.

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### Further information

R J (Bob) Charles, Head of benefits consulting in Asia, FIA, FASI. His consulting work covers retirement plan design, actuarial advice and general benefits consulting. During his stay in India (2001-2003), he has advised some of the largest private sector retirement schemes in Asia. He is now located in Hong Kong.

**R J (Bob) Charles**  
+852 2820 0068  
Bob.Charles@watsonwyatt.com

R. Arunachalam, Associate Member of Actuarial Society of India, a member of the Institute of Actuaries, London and a Cost Accountant. He has 14 years of experience in handling the actuarial pricing & valuation of insurance & pension products.

**R. Arunachalam**  
+91 80 4115 6187  
R.Arun@watsonwyatt.com

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Sandip Goenka, Senior Actuarial Manager - member of Actuarial Society of India and Institute of Actuaries, London. He has a significant experience in the HR and benefits consulting business and valuations.

**Sandip Goenka**  
+91 33 2465 3827  
Sandip.Goenka@watsonwyatt.com

Neha Sand is working as an economist. She is a part of the research team and pension risk is her main research area.

**Neha Sand**  
+91 124 4337038  
Neha.Sand@watsonwyatt.com



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**Watson Wyatt India Pvt Ltd**  
2nd Floor, Merlin Links, 166B, S P Mukherjee Road  
Kolkata 700 026, West Bengal, India  
Phone: +91 33 2465 3827  
Fax: +91 33 2465 3828

**Watson Wyatt Hong Kong Ltd.**  
27/F & 29/F Sun Hung Kai Centre, 30 Harbour Road  
Wanchai, Hong Kong  
Phone: +852 2827 8833  
Fax: +852 2827 7700, +852 2827 8899

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