

Accounting Treatment for Leave Encashment

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1 A company was incorporated as a limited company in 1986 under the Companies Act, 1956, for manufacturing of engineering goods like Tractions and Power Conditioning Equipments. The company acquired the present business from its holding company as a going concern in the year 1997. The company is having a turnover of Rs. 38 crore and net worth of Rs. 10 crore. Total capital employed in the company is Rs. 26 crore and it has 240 employees.

2 A liability of Rs. 32.81 lakh for leave encashment of the then existing employees, on the date of transfer of business, was also transferred to the company by its holding company along with other assets and liabilities.

3 The rules of leave encashment being followed by the company are described hereunder :

“The leave will be available to an employee after completion of one year’s service. It can be accumulated upto a maximum of 240 days. However, if an employee so desires, accumulation of leave over and above 60 days can be encashed by him at any time.”

4 As per the querist, the company provides for the liability in respect of leave encashment on the basis of actual computation (i.e., number of leaves accumulated x last

salary drawn) in respect of total earned leaves to the credit of employees at the year-end due to the following reasons:

- (i) An employee has an option to encash the earned leave accumulated over and above 60 days during the employment, i.e., he/she is not required to wait till retirement for availing leave encashment.
- (ii) The present business/unit was established by the holding company in the year 1989. 813 employees joined the company between 1989 to 2001, out of which 563 employees left over the last 11 years. Therefore, average stay of an employee in the company is less than 5 years.
- (iii) The total leave encashment liability as on 31.03.2001 was Rs. 81.24 lakh. The break-up of the same is given as under:
 - (a) The liability for leave encashment for 60 days, which is encashable only at the time of retirement or resignation: Rs. 33.20 lakh
 - (b) The liability for leave encashment over 60 days, which is encashable at any time at the option of the employee: Rs. 48.04 lakh
- (iv) The liability for encashment of leave benefit is not funded through creation of trust, i.e., the company is making payment for leave encashment out of its own funds. Therefore, it is necessary to make a provision for accruing liability on actual basis.
- (v) Out of 240 days leave allowed to be accumulated by the company, an employee is having an option to encash leaves upto 180 days during employment.
- (vi) If the company provides for leave encashment liability based on actuarial valuation, liability for leave encashment presently provided for in the financial statements would be grossly understated.
- (vii) The objective of Accounting Standard (AS) 15, ‘Accounting for Retirement Benefits in the Financial Statements of Employers’, is that proper liability in respect of retirement benefits is accounted for and that appropriate disclosure in

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.

2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in 21 volumes which are available for sale at the Institute’s office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.

respect thereof is made in the financial statements. The liability for retirement benefits arises on account of services rendered by employees to the employer. Consequently, the cost of retirement benefits should be accounted for during the period for which the services are rendered. Contrary to the above, provision for retirement benefits in the books of account on cash basis, i.e., when employees are paid retirement benefits, does not meet the objective of allocation of expenses during the period when the services are rendered.

B. Query

5 As The querist has sought the opinion of the Expert Advisory Committee as to whether the auditor of the company is required to qualify his audit report stating that the company has provided for the liability of leave encashment on the basis of actual computation instead of providing the same on actuarial valuation, which is required as per AS 15 issued by the Institute of Chartered Accountants of India.

C. Points considered by the Committee

6 The Committee notes that AS 15 is based on the accrual basis of accounting which is also required to be followed by the Companies Act, 1956. This fact is recognised in the Guidance Note on Accrual Basis of Accounting, issued by the Institute of Chartered Accountants of India, paragraph 8.1 of which, inter alia, states as below:

“The Council of the ICAI and its various committees have issued various Guidance Notes, Statements and Accounting Standards. The accounting treatments contained in these documents are primarily based on accrual accounting. Thus, adoption of accounting treatments recommended in these documents would ensure that a company has followed accrual basis of accounting.”

7 On the basis of the above, the Committee is of the view that the principles of measurement laid down in AS 15 are relevant even in respect of leave encashment benefit which is not exclusively payable at the time of retirement or superannuation but is also available during the tenure of employment of the employees.

8 The Committee notes that paragraph 28 of AS 15, inter alia, provides the following:

“28. In respect of gratuity benefit and other defined benefit schemes, the accounting treatment will

depend on the type of arrangement which the employer has chosen to make.

(i) If the employer has chosen to make payment for retirement benefits out of his own funds, an appropriate charge to the statement of profit and loss for the year should be made through a provision for the accruing liability. The accruing liability should be calculated according to actuarial valuation. However, those enterprises which employ only a few persons may calculate the accrued liability by reference to any other rational method e.g. a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.”

9 On the basis of paragraphs 7 and 8 above, the Committee is of the view that since the company is employing a fairly large number of employees, the amount of the provision for leave encashment benefit should be based on actuarial valuation both in case of leave encashment at the time of retirement and during the tenure of employment.

10 The Committee is further of the view that since the company has not provided for leave encashment benefit payable on retirement on actuarial basis, the auditor should qualify his report both with regard to section 227(2) and section 227(3)(d) of the Companies Act, 1956, being not in consonance with AS 15. However, as far as non-provision of leave encashment benefit payable during the tenure of employment is concerned, the auditor should qualify his report only with regard to section 227(2) of the Companies Act, 1956, since AS 15 as such is not applicable in this case.

D. Opinion

11 On the basis of the above, the Committee is of the opinion that since the company has not provided for leave encashment benefit payable on retirement on actuarial basis, the auditor should qualify his report both with regard to section 227(2) and section 227(3)(d) of the Companies Act, 1956, being not in consonance with AS 15. However, as far as non-provision of leave encashment benefit payable during the tenure of employment is concerned, the auditor should qualify his report only with regard to section 227(2) of the Companies Act, 1956, since AS 15 as such is not applicable in this case. ■