

# Accounting for leave liability

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

## A. Facts of the Case

1. A public sector company is engaged in the manufacture of power equipments. The company has manufacturing units, power sector regions, service centers and regional offices besides project sites spread all over India and abroad. The shares of the company are listed in stock exchanges at NSE and BSE. The turnover of the company was Rs. 34,154 crore in the year 2009-10. The company had employee strength of 46,274 Nos. as on 31.03.2010.
2. The rules of the company relating to the leaves are as below:

### Earned Leave (EL):

The entitlement of earned leave is related to the number of years of service put in by the employee as under:

Number of completed years of service	Entitlement of earned leave per annum (days)
Upto 5 years	22
Above 5, upto 10 years	24
Above 10, upto 15 years	26
Above 15, upto 20 years	28
Above 20 years	30

The earned leave has two components, viz., encashable (EEL) and non-encashable (NEL). The company gives advance credit of leave in terms of encashable and non-encashable leave on the existing standard dates as given below:

No. of completed years of service	Entitlement of EL per annum (days)	Credit No. of days			
		On 25 <sup>th</sup> June		On 25 <sup>th</sup> Dec.	
		EEL	NEL	EEL	NEL
Upto 5 years	22	8	3	8	3
Above 5, upto 10 years	24	9	3	9	3

Above 10, upto 15 years	26	10	3	10	3
Above 15, upto 20 years	28	11	3	11	3
Above 20 years	30	11	4	11	4

3. The querist has stated that the accumulation limit of earned leave is 300 days, beyond which, it shall automatically lapse. The advance credit of encashable portion of earned leave will, however, not be taken into account for determining the accumulation limit. Encashable earned leave can be encashed or availed at any time subject to an accumulation limit of 300 days and NEL is encashable at the time of retirement only, but it can be availed at any time during the service period. There is no restriction on an employee in availing the earned leave (whether encashable or non-encashable) in the same year in which it has fallen due. It is an employees' discretion to avail/encash or accumulate the leave at any time. In a nutshell, the employee has an option either to avail the leave without any restriction or encash once in a year or accumulate subject to the ceiling limit of 300 days.
4. The querist has also explained the rules of the company relating to Half Pay Leave (HPL) as below:
  - (i) All employees are entitled to 20 days of half pay leave in a year.
  - (ii) Advance credit is allowed on 25<sup>th</sup> June/25<sup>th</sup> December each year at the rate of 10 days each time.
  - (iii) There is no limit for accumulation of half pay leave. However, it is encashable only at the time of superannuation subject to a maximum of 480 half days, i.e., 240 days.
  - (iv) Half pay leave can be availed at any time but encashable only at the time of superannuation.
  - (v) Half pay leave can also be commuted and availed, as 'sick leave', i.e., 2 half days will be counted as 'one sick leave'.
5. A summary of the above rules has been provided by the querist as under:

	EEL	NEL	HPL
Accrued during the year (days)	16 to 22	6 to 8	20

Maximum accumulation limit (days)	300 days both for EEL & NEL put together		No limit
Encashable during the service	Yes- once in a year without any restriction	No	No
Encashable limit on superannuation (days)	300 days EEL & NEL both put together		480 half days. (240 full days).
Availment restriction at any time during service	No	No	No

6. The querist has stated that prior to the introduction of Accounting Standard (AS) 15 (revised 2005), 'Employee Benefits', issued by the Institute of Chartered Accountants of India (ICAI), the leave liability was being accounted for on actuarial basis. However, pursuant to the introduction of AS 15 (revised 2005) from 01.04.2006, the company is accounting for the leave liability on accrual basis based on the opinion taken from a renowned consultant, which as per the querist, is in line with the requirements of AS 15 (revised 2005).

7. The accounting policy of the company relating to employee benefits is as below:

"Earned leave, half pay leave, provident fund and employees' family pension scheme contributions are accounted for on accrual basis. Liability for gratuity, travel claims on retirement and post-retirement medical benefits are accounted for in accordance with actuarial valuation. The actuarial liability is determined with reference to employees at the beginning of each calendar year. Compensation under voluntary retirement scheme is charged-off in the year of incurrence on a pro-rata monthly basis."

8. The accounting practice of the company in respect of leave liability from 1.4.2006 is stated by the querist as below:

Liability for encashable earned leave (EEL), non-encashable earned leave (NEL) and half pay leave (HPL) is provided for in the books on accrual basis for the value of leave outstanding at the end of the year. According to the querist, provision for half pay leave is made for the total leave balance at the year end without restricting it to 480 half days (240 full days) per employee in line with the requirements of AS 15 (revised).

9. During the audit of annual accounts for the financial year 2009-10, the Government audit has raised a query stating that the past pattern indicates that the employees are unlikely to avail/encash the entire carried forward leave during the next twelve months and hence, the benefit would not be short-term. Accordingly, they are of the view that keeping in view the behavioral pattern of the employees, the leave benefit should be considered as long-term benefit and the provision should be made based on actuarial valuation.

10. The company has expressed its views as below: Paragraph 8 (b) of AS 15 (revised 2005), issued by the ICAI states as follows:

"8. Short-term employee benefits include items such as:

b) short-term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service;"

Paragraph 10 of AS 15 (revised 2005), issued by the ICAI states as follows:

**"10. When an employee has rendered service to an enterprise during an accounting period, the enterprise should recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service..."**

In the case of the company, leave is accrued when the employee renders his service and there is no restriction on an employee in availing /encashing in the same year in which it has fallen due. The accumulation or encashment is entirely an individual's discretion and the employee can avail/encash the entire accumulated leave balance in one financial year itself.

The point raised by Government audit for treating the leave benefit as long-term benefit is stated to be based on behavioral pattern of the employees on availing /encashing the leave based on the ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005), issued by the Institute of Chartered Accountants of India (ICAI). Since there is no provision in AS 15 (revised 2005), issued by the ICAI on treatment of benefits based on behavioral pattern, the treatment has to be in line with AS 15 and not based on the said Guidance which clearly states that it is not a part of standard.

11. The querist has enclosed the trend of leave accrued, leave availed/encashed during the period 2008-09 and 2009-10 at Annexure A for reference. The querist has pointed out that it may be seen from the Annexure that approximately 96% of EEL and 82% of NEL accrued during the year were availed/encashed by the employees in the year 2009-10. Further, there is no clear trend that on an average how many employee will encash/avail or carry forward the leave. It may also be observed that in the financial year 2009-10, there is a substantial increase in leave encashment/availment as compared to year 2008-09. Therefore, as per the querist, when there is a full obligation of the company towards leave liability, it should be treated as short-term and accounted for on accrual basis.
12. According to the querist, in view of above and based on opinion given by the consultant when AS 15 (revised 2005) was introduced, leave liability is accounted on accrual basis and being continuously followed from the financial year 2006-07 onwards.

### B. Query

13. Based on the above facts, the querist has sought the opinion of the Expert Advisory Committee on the following issues:
- (i) Whether treatment of leave liability as short-term employee benefit and accounting on accrual basis by the company is correct and is in line with AS 15 (revised 2005) or not.
  - (ii) In case it is not, then how to account for the change during the year 2010-11, i.e., through profit and loss account or through retained earnings (balance sheet approach).

### C. Points considered by the Committee

14. The Committee, while answering this query, has restricted itself to the issues raised in paragraph 13 above and has not touched upon any other issue arising from the Facts of the Case, such as, accounting policy of the company in general and particularly for provident fund, gratuity, pension, travel claims on retirement, post-retirement medical benefits and compensation under voluntary retirement scheme, etc. and the basis of actuarial valuation etc.
15. The Committee notes the definitions of the terms 'short-term employee benefits' and 'other long-term employee benefits' as contained in paragraphs 7.2 and 7.8 of AS 15, notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter

referred to as 'the Rules') which are reproduced below:

***"7.2 Short-term employee benefits are employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service."***

***"7.8 Other long-term employee benefits are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within twelve months after the end of the period in which the employees render the related service."***

16. The Committee also notes that paragraph 8 of AS 15 notified under the Rules provides as below:

"8. Short-term employee benefits include items such as:

...

- (b) short-term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service;

..."

The Committee also notes that although ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005) does not form part of the Standard, by virtue of this Guidance, the Accounting Standards Board has clarified in the context of short-term and long-term employee benefits, vide Issue 3 thereof, which, inter alia, provides as below:

"Paragraph 7.2 of the Standard uses ***"falls due"*** as the basis, paragraph 8(b) of the Standard uses ***"expected to occur"*** as the basis to illustrate classification of short-term compensated absences. A reading of paragraph 8(b) together with paragraph 7.2 would imply that the classification of short-term compensated absences should be only when absences have ***"fallen due"*** and are also ***"expected to occur"***. In other words, where employees are entitled to earned leave which can be carried forward to future periods the benefit would be a 'short-term benefit' provided the employee is ***entitled*** to either encash/utilise the benefit during the twelve months after the end of the period when he became entitled to the leave and is also ***expected to do so***. Where there are restrictions on encashment/availment, clearly the compensated absence has not fallen due and the benefit of compensated absences is more

likely to be a long term benefit. For example, where an employee has 100 days of earned leave which he is entitled to an unlimited carry forward but the rules of the enterprise allow him to encash/utilise only 30 days during the next twelve months, the benefit would be considered as a 'long-term' benefit. In some situations where there is no restriction but the absence is not expected to wholly occur in the next twelve months, the benefit should be considered as 'long-term'. For example, where an employee has 400 days carry forward earned leave and the past pattern indicates that the employees are unlikely to avail/encash the entire carry forward during the next twelve months, the benefit would not be 'short-term'. Whilst it is necessary to consider the earned leave which **"falls due"**, the pattern of actual utilisation/encashment by employees, although reflective of the behavioural pattern of employees, does determine the status of the benefit, i.e., whether 'short-term' or 'long term'. The value of short-term benefits should be determined without discounting and if the benefit is determined as long-term, it would be recognised and measured as "Other long-term benefits" in accordance with paragraph 129 of the Standard. The categorisation in 'short-term' or 'long-term' employee benefits should be done on the basis of the overall behavioural pattern of all the employees of the enterprise and not on individual basis."

17. On the basis of the above, the Committee is of the view that short-term employee benefits include only those compensated absences which accrue to the employees and are expected to be availed (or encashed, as the case may be) within twelve months after the end of the period in which the employees render the related service. In other words, where it is expected that the employees will avail/encash the *whole* of the benefit accruing to them on account of earned leave (EEL and NEL) and half-pay leave within the twelve months after the end of the period in which the employees render the related service, the same would fall within the category of 'short-term employee benefits'. However, the Committee notes from the Facts of the Case that both the leave entitlements of the employees of the company can be carried forward for more than twelve months after the end of the period in which employees render the related service. Further, the Committee notes from the Annexure provided by the querist that both the types of leaves, which were accrued during the year 2008-09 and 2009-10, have been accumulated and carried forward by the employees. Therefore, the Committee is of the view that the benefit on account of both types of leaves does not fall within the category of 'short-term employee benefits'. Rather,

the entire benefit on account of these leaves should be treated as 'other long-term employee benefits'.

18. With respect to the recognition and measurement of other long-term employee benefits, the Committee notes that AS 15 (revised 2005) provides that the same should be measured on actuarial basis using the Projected Unit Credit Method. The Standard contains detailed requirements in this regard in paragraphs 129 and 130.

19. As regards accounting for the change in the accounting treatment of these types of leaves, the Committee notes the definition of the term 'Prior period items' and paragraphs 15 and 19 from Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the Rules, which provide as follows:

***"Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods."***

***"15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived."***

***"19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss."***

From the above, the Committee is of the view that since earned leaves and half pay leaves are to be accounted for as 'other long-term employee benefits' instead of 'short-term employee benefits', as being done by the company, same is an error and accordingly, it should be treated as 'Prior period item', the nature and amount of which should be included and disclosed separately in the profit and loss account of the period in which such error is revealed.

20. The Committee also notes from the Facts of the Case and the wordings of the accounting policy of the company as reproduced by the querist in paragraph 7 above, that the company has made a distinction between the terms 'accrual' and 'actuarial

valuation'. The Committee wishes to clarify that the actuarial valuation is also based on 'accrual basis of accounting'. Accordingly, the Committee is of the view that the wording of accounting policy of the company should also be changed in this respect.

**D. Opinion**

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

(i) No, the treatment of leave liability as 'short-term

employee benefit' by the company is not correct. Such treatment is not in line with the requirements of AS 15 (revised 2005). Refer to paragraphs 17 and 20 above.

(ii) The change in the accounting treatment of leave liability, in the extant case, from 'short-term employee benefits' to 'other long-term employee benefits' should be treated as 'prior period item'. Accordingly, the nature and amount thereof should be included and disclosed in the profit and loss account for the period in which such error is revealed as discussed in paragraph 19 above.

**Annexure A**

**DETAIL OF LEAVE BALANCES – THE COMPANY**

**NO. OF EMPLOYEES - 46274 as on 31.03.2010**

**(In No. of days)**

DESCRIPTION	NATURE OF LEAVES	F.Y. 2009 – 10			F.Y. 2008 – 09		
		RETIRED EMPLOYEES	OTHER EMPLOYEES	TOTAL	RETIRED EMPLOYEES	OTHER EMPLOYEES	TOTAL
OPENING BALANCE (No. of days)	EL	332774	3084518	3417292	269548	3069913	3339461
	NEL	151459	1525442	1676901	127268	1473474	1600742
	HPL	524933	5797895	6322828	478722	5775591	6254313
Total number of Leaves accrued during the year (No. of days)	EL	33216	876446	909662	26714	879407	906121
	NEL	10973	299107	310080	8299	293219	301518
	HPL	27679	884884	912563	23032	859770	882802
Total number of Leaves availed/ encashed by the employees during the year (No. of days)	EL	365990	839457	1205447	296262	548713	844975
	NEL	162432	246112	408544	135567	168568	304135
	HPL	552612	289287	841899	501754	338280	840034
CLOSING BALANCE (No. of days)	EL		3121507	3121507		3400607	3400607
	NEL		1578437	1578437		1598125	1598125
	HPL		6393492	6393492		6297081	6297081
Leave avail/encash as %age to leave accrued	EL		95.78%			62.40%	
	NEL		82.28%			57.49%	
	HPL		32.69%			39.35%	

1	The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.	Compendium of Opinions containing twenty eight volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.  4 Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.  5 Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to <a href="mailto:eac@icai.org">eac@icai.org</a> .
2	The Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on 03.05.2011. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.	
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty eight volumes. A CD of	