Query No. 17

Subject: ***Exempt Provident Fund - disclosure and valuation as per Accounting Standard (AS) 15, 'Employee Benefits.***[1]

A. Facts of the Case

1. A company (hereinafter referred to as 'the company') has an Exempt Provident Fund Trust (hereinafter referred to as 'the Trust') to manage the contributions of its members. Contributions are made to the Trust as per the rules and the Provident Fund Scheme. The Exempt Provident Fund Trust invests the contributions in securities as prescribed by the Employees Provident Fund Organisation. The Trust has not sold any of its security since inception. The querist has stated that the Trust is restricted by the Employees Provident Fund Organisation in general from selling its investments. All the investments of the Trust are, therefore, 'Held to Maturity' investments as per paragraph A40 of Accounting Standard (AS) 31, 'Financial Instruments: Presentation' (the reference seems to be to paragraph A40 of Accounting Standard (AS) 30, 'Financial Instruments: Recognition and Measurement'), and paragraph AG20 of Indian Accounting Standard (Ind AS) 39, 'Financial Instruments: Recognition and Measurement'.

2. The querist has stated that an Exempt Provident Fund Trust has the obligation to its members to declare the interest rate announced by the Employees' Provident Fund Organisation **(**EPFO). Hence, there is an interest rate guarantee for the interest given by such Exempt Provident Fund.

3. The Institute of Actuaries of India (IOAI) issued Guidance Note 29 (GN 29) on 'Valuation of Interest Rate Guarantees on Exempt Provident Funds under AS 15 (Revised)' in the year 2011, effective from 1st April, 2011.

[1] Opinion finalised by the Committee on 16.7.2013

4. The querist has stated that after the issuance of GN 29 by IOAI, the interest rate guarantee portion of the Exempt Provident Fund Trust takes the characteristic of a defined benefit. However, as per the querist, contributions made to the Exempt Provident Fund Trust continue to have the substance of a defined contribution plan.

5. As per the querist, Accounting Standard (AS) 15, 'Employee Benefits', does not have any specific guideline on how to value and disclose liability towards Exempt Provident Fund Trust where the interest portion is a defined benefit and the contribution made is having the characteristic of a defined contribution plan. Under AS 15, the disclosure and valuation requirements for defined benefit plans are significantly different from those of defined contribution plans.

6. The querist has also informed that post issuance of GN 29, and in the absence of any specific guidelines on valuation and disclosure of liability for Exempt Provident Fund, the company has been asked to follow the valuation and presentation guidelines similar to defined benefit plans. Accordingly, as per the querist, all the 'Held to Maturity' investments of the Exempt Provident Fund Trust are fair valued at their market price. Fair valuation of the 'Held to Maturity' investments leads to gain or loss. Such gain or loss is notional only since the Exempt Provident Fund Trust is restricted to sell its investments by the Employees' Provident Fund Organisation in general. Such notional gain/loss on the investments is passed through the statement of profit and loss of the company.

7. As per the querist, the company has been following the accounting policies consistently and these policies are in line with the Accounting Standards pronounced by the Institute of Chartered Accountants of India (ICAI). With regard to the employee benefits, AS 15 is followed by the company. Till the financial year 2010-11, provident fund was considered by the company as

defined contribution plan and interest rate guarantee valuation was followed as per the industry practice.

8. The company has disclosed the following in its notes forming part of its financial statements for the year 2011-12:

> "AS 15, 'Employee Benefits' requires fair valuation of the Planned Assets on the balance sheet date for all defined benefit plans. However, AS 15 does not specifically detail any prescriptive method for fair valuation of investments held by Exempted PF Trust which have a unique investment objective. The investments of Exempted Provident Fund are normally held to maturity as mandated by Employees Provident Fund and Miscellaneous Provisions Act, 1952. The Exempted Trust Fund is expressly prohibited from selling these securities except under exceptional conditions and only with specific permission of EPFO. Accordingly, market prices are not good reflectors of fair value for such held to maturity investments. The company has therefore followed the valuation principle envisaged in AS 30: Financial Instruments – Recognition and Measurement and Ind AS 39: Financial Instruments – Recognition and Measurement which specifically stipulate that for held to maturity investments face value must be used and market prices may not be a good indicator.
>
> The company, in compliance with AS 15 and further with AS 30 and/or Ind AS 39 has valued the investments at their fair value which is based on the face value of the investments. The exempted trust has demonstrated a positive intent to hold the security until maturity by not making any sales since inception of the trust and has further adhered to the PF rules which prohibit it from selling any such securities. The face value of the investments is higher than the liability by … on the balance sheet date and since such excess belongs to the Exempt Trust, the same is not recognised in the books of the company."

9. The statutory auditors of the company have drawn attention to the note referred above in their report to members stating that "…the valuation of plan assets of the provident fund administered by a Trust set up by the company (a defined benefit plan) at the face value instead of using the fair value, which in our view is not in compliance with Accounting Standard (AS) 15, Employee Benefits". Accordingly, they have qualified their opinion in this regard.

B. Query

10. The querist has sought the opinion of the Expert Advisory Committee as to whether an Exempt Provident Fund is to be disclosed as a defined benefit plan, defined contribution plan or both and whether the basis of valuation of the investments held by the Exempt Provident Fund Trust as 'Held To Maturity' should be at the market value or the face value.

C. Points considered by the Committee

11. The Committee restricts itself to the issues raised by the querist in paragraph 10 above regarding the nature and disclosure of 'Exempt' Provident Fund Scheme as defined benefit plan or defined contribution plan under AS 15 as well as the valuation of the investments held by Exempt Provident Fund Trust under the 'held to maturity' category, for the purpose of its presentation in the financial statements of the company. The Committee has, therefore, considered only these issues and has not touched upon any other issue that may arise from the Facts of the Case, such as, valuation of the investments in the financial statements of the Trust, accounting treatment followed by the company prior to the issuance of GN 29 by the IOAI, correctness of the company's accounting policy, etc.

12. 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 AS 15, reproduced as below:

> `“***7.5 <u>Defined contribution plans</u> 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.”***
>
> ***“<u>7.6 Defined benefit plans</u> are post-employment benefit plans other than defined contribution plans.”***

From the above, the Committee notes that a post-employment benefit plan has to be treated either as a defined contribution plan or as a defined benefit plan. AS 15 does not contemplate any other category of post-employment plan.

13. The Committee notes that section 17 of the Employees’ Provident Funds and Miscellaneous Provisions Act, 1952 (EPFMPA) empowers the Government to exempt any enterprise from the provisions of the EPFMPA provided the rules of the provident fund set up by the enterprise are not less favourable than those specified in section 6 of the EPFMPA 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 EPFMPA.

14. The Committee further notes that the Employees’ Provident Fund Scheme, 1952 issued under the EPFMPA requires in Appendix A (clause 7) to clause 27AA of the said Scheme that “Any deficiency in the interest declared by the Board of Trustees is to be made good by the employer to bring it up the statutory limit”. Therefore, such exempt provident funds carry an embedded interest rate guarantee.

15. The Committee notes from the definition of defined contribution plan given in paragraph 12 above 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. As stated in paragraph 14 above, in the case of an Exempt Provident Fund, 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 Government under clause 60 of the Employees' Provident Fund Scheme, 1952.

16. The Committee further notes that as per paragraph 26 of AS 15, "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 …". Hence, the obligation referred to in paragraph 16 above clearly falls within the definition given in paragraph 26(b) of AS 15. As per paragraph 27 of AS 15, "Under defined benefit plans: (a) the enterprise's obligation is to provide the agreed benefits to current and former employees …". Accordingly, the Exempt Provident Fund set up by the company is a defined benefit plan under AS 15. This has also been confirmed in paragraph 9 of 'ASB Guidance on Implementing AS 15, Employee Benefits (revised 2005)', issued by the Accounting Standards Board of the ICAI, which states that "…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". Further, since an exempt provident fund is a defined benefit obligation, the Committee is of the opinion that an enterprise is required to make the disclosures in terms of paragraph 120 of AS 15.

17. With regard to basis of valuation of the investments held by the Exempt Provident Fund Trust, as per paragraph 55 of AS 15, in determining the defined benefit liability, "(c) …the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly" has to be taken into account.

18. The Committee notes that AS 15 deals with the fair value of plan assets in paragraphs 100 – 102. Paragraph 100 of AS 15 provides as below:

> "100. The fair value of any plan assets is deducted in determining the amount recognised in the balance sheet under paragraph 55. When no market price is available, the fair value of plan assets is estimated; for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation)."

Therefore, the Committee is of the view that AS 15 explicitly requires all investments to be fair valued (irrespective of the period for which it is held) to determine the defined benefit liability after taking into account the factors mentioned in the above-reproduced paragraph. The Committee further notes from the Facts of the Case that the querist has stated that since AS 15 does not specially detail any prescriptive method for fair valuation of investments held by Trust, the company has followed the valuation principle as prescribed under AS 30 and Ind AS 39 for 'held to maturity' investment. In this regard, the Committee notes that paragraph 2 of AS 30, while stating the scope of the Standard, explicitly scopes out the financial instruments held by employer under AS 15 by stating as follows:

> ***"2. This Standard should be applied by all entities to all types of financial instruments except:***
>
> **…**

(c) employers' rights and obligations under employee benefit plans, to which AS 15, Employee Benefits, applies."

On the basis of the above, the Committee is of the view that while determining the defined benefit obligation, for valuation of the investments held by the Trusts, only the principles of AS 15 should be followed.

D. Opinion

19. On the basis of the above, the Committee is of the opinion that an Exempt Provident Fund Scheme is a defined benefit plan in terms of paragraph 7.6 of AS 15, the accounting for which has to be done on an actuarial basis. Since an exempt provident fund is a defined benefit obligation, the Committee is further of the opinion that an enterprise is required to make the disclosures in terms of paragraph 120 of AS 15. The plan assets held by the Trust should be valued at fair value as per the principles of AS 15, as discussed in paragraph 18 above.
