Opinion

Adjustment of the effect of first recognition of group gratuity liability against opening balance of reserves and surplus as an appropriation in the current financial year

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 company (hereinafter referred to as the 'company') is a limited company established by the Government of Tamil Nadu in the year 1978 with an object to secure suitable overseas placements for the Indian professionals, skilled workers and others, who are desirous of securing jobs abroad. The company also holds a valid registration certificate issued by the Government of India, Ministry of Labour, as required under the Emigration Act, 1983, to perform the functions of a recruiting agency.
2. The querist has stated that in the current financial year 2014-15, the company has made the following appropriation from the opening balance of reserves and surplus:

   The company provides post-employment benefits to its employees in the form of gratuity. With regard to the same, the company has gratuity fund with the Life Insurance Corporation of India (LIC). In the F.Y. 2014-15, the company adjusted ₹24.76 lacs being the *actuarial liability for the earlier years towards group gratuity payable to employees* against the accumulated surplus as an appropriation from the reserves and surplus by invoking the transitional provision as per paragraphs 144 and 145 of Accounting Standard (AS) 15, 'Employee Benefits' (Revised 2005).

   Since the net liability as per AS 15 Report provided by the LIC is recognised for the first time by the company in the F.Y. 2014-15, the transitional provisions as per paragraphs 144 and 145 of the Standard are applicable. According to the querist, paragraph 145 provides that the net liability should be adjusted against the opening balance of revenue reserves and surplus.
3. The querist has separately informed that the company has not applied AS 15 in the true sense, since inception. All employee benefits were accounted for only on cash basis. No provision for any benefit had been made till 31st March, 2015. Although a LIC policy was taken to cover the employees for gratuity, no provision was ever made for actuarial liability.

B. Query

4. On the basis of the above, the querist is seeking opinion of the Expert Advisory Committee on the following issues:
   (i) Whether provision for gratuity for the prior period based on actuarial valuation can be adjusted against the opening balance of revenue reserve and surplus of the current financial year 2014-15.
   (ii) If the answer to (i) is no, what is the correct accounting treatment?

C. Points considered by the Committee

5. The Committee notes that the basic issue raised in the query relates to first time recognition of gratuity liability for the prior periods in respect of employees of the company in the financial year 2014-15. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, correctness of determination of the company's liability for gratuity benefit for its employees as per the requirements of AS 15, etc.
6. The Committee notes that while recognising the gratuity liability for the first time in its financial statements for the financial year 2014-15, the querist has referred to paragraphs 144 and 145 of

AS 15, notified under the Companies (Accounting Standards) Rules, 2006, which provide as follows:

> ***"144. On first adopting this Standard, an enterprise should determine its transitional liability for defined benefit plans at that date as:***
>
> ***(a) the present value of the obligation (see paragraph 65) at the date of adoption;***
>
> ***(b) minus the fair value, at the date of adoption, of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 100-102);***
>
> ***(c) minus any past service cost that, under paragraph 94, should be recognised in later periods.***
>
> ***145. If the transitional liability is more than the liability that would have been recognised at the same date as per the pre-revised AS 15, the enterprise should make an irrevocable choice to recognise that increase as part of its defined benefit liability under paragraph 55:***
>
> ***(a) immediately as an adjustment against the opening balance of revenue reserves and surplus (as adjusted by any related tax expense), or***
>
> ***(b) as an expense on a straight-line basis over up to five years from the date of adoption.***
>
> ***…"***

From the above, the Committee notes that as per the above transitional provisions, the company had the option to adjust the difference between the transitional liability as per AS 15 (revised) and the liability that would have been recognised as per AS 15 (pre-revised) as on the date of transition, net of any related tax expense (saving) against the opening balance of revenue reserves and surplus on the date of transition. However, the Committee is of the view that the transitional provisions are provided with a view to facilitate a smooth switch-over to new accounting requirements from the date the new Standard (AS 15 (revised 2005) in the extant case) comes into force. In other words, the benefit of the transitional provisions was available only at the beginning of the first year of the application of AS 15. With regard to applicability of AS 15 (revised 2005), the Committee further notes the Announcement of the Institute on 'Deferrment of Applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005)', published in March 2007 issue of the Journal, which states as follows:

> "The Council of the Institute of Chartered Accountants of India (ICAI), at its 265th meeting held on February 3-4, 2007, decided to defer the date of applicability of Accounting Standard (AS) 15, Employee Benefits (revised 2005), issued by the ICAI, keeping in view the practical difficulties and general hardship being faced by industry. As per the decision, AS 15 comes into effect in respect of accounting periods commencing on or after December 7, 2006 (instead of April 1, 2006, as stated in the said Standard) and is mandatory in nature from that date. Earlier application of the Standard is encouraged."

From the above, the Committee notes that AS 15 (revised) was encouraged to be followed from April 1, 2006 and was mandatorily applicable in respect of accounting periods commencing on or after December 7, 2006, viz., financial year 2007-08 and accordingly, the transitional provisions were applicable for the financial 2006-07 (in case the company opts to follow AS 15 (revised) voluntarily) or 2007-08, as the case may be and not for a subsequent financial year. Therefore, the question of applicability of transitional provisions in the financial year 2014-15, as being applied by the company in the extant case does not arise.

7. The Committee further notes that since in the extant case, the requirements of AS 15 (revised) are not followed after it is applicable mandatorily from the financial year 2007-08 (as the company has accounted for all employee benefits on cash basis), the same would be an accounting error of those periods and therefore, should be treated as a 'prior period item' within the meaning of Accounting Standard (AS) 5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', notified under the Companies (Accounting Standards) Rules, 2006 and should be rectified by a charge to the statement of profit and loss in the current reporting period. In this regard, the

Committee also notes the following paragraphs of AS 5:

> ***"4.3 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."***

D. Opinion

8. On the basis of the above, the Committee is of the following opinion on the issues raised in paragraph 4 above:

(i) and (ii) The provision for gratuity for the prior period based on actuarial valuation as per the requirements of AS 15, which is recognised for the first time in the financial year 2014-2015 cannot be adjusted against the opening balance of revenue reserve and surplus, as proposed by the querist. The same should rather be treated as 'prior period item' as a charge to the statement of profit and loss in accordance with the requirements of AS 5, as discussed in paragraphs 6 and 7 above.

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 Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on July 21, 2016. 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 thirty four volumes. A CD of Compendium of Opinions containing thirty four volume 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 eac@icai.in.