Impact of Salary Reduction on Actuarial Valuation

Case Study 5

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Case Study

Information Ltd. has decided to reduce salary of employee from 15% to 50% based on category of employees effective from 1 April 2020

Whether reduction in compensation to employees will have any implication to retirement benefit plan such gratuity and leave encashment for the year ended 31 March 2020.

AS-15 Employee Benefits

Employee benefits divided into 4 parts (Para 4 of AS 15):

- ✓ **Short-term employee benefit-** are employee benefits (other than termination benefits) which fall due wholly within 12months after the end of the period in which the employees render the related service.
  - E.g. Wages, salaries, bonus, paid leaves, allowances, etc (if payable within 12 months)

- ✓ **Post-employment benefits-** Are employee benefits (other than termination benefits) which are payable after the completion of employment.
  - E.g. Gratuity, pension, other retirement benefits, post-employment life insurance, post-employment medical care, etc.

- ✓ **Other long-term employee benefits-** Are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within 12 months after the end of the period in which the employees render the related service
  - E.g. long-service leave or sabbatical leave, bonuses, any compensation or any other long-service benefits

- ✓ **Termination benefits-** Payable due to an enterprise's decision to terminate an employee or employee's decision for voluntary retirement

Post Employment Benefits

- The Post employment benefits include, Retirement Benefits (E.g. Gratuity and Pension) and Other benefits (E.g. post-employment life insurance and postemployment medical care)
- As per Para 25 These are further divided as follows:

Defined Contribution Plan

- are the post-employment benefits in which an enterprise pays fixed contributions into a separate fund and will have no obligations to pay any amount in future.
- Under this plan, the actuarial and investment risk falls upon the employee as there might be a chance that the benefits will be less than expected or the assets will be insufficient to meet expected benefits.

Defined Benefits Plan

- are the post-employment benefits which are not covered by the defined contribution plans.
- Under this plan, the actuarial and investment risk falls upon the employer and a very detailed actuarial calculation is performed to determine the charge
- Gratuity and Leave encashment are included under defined benefits plan.

Actuarial Assumptions and Treatment

- Actuarial assumptions should be unbiased and mutually compatible. The actuarial assumptions must be treated as an enterprise's best estimate of the post-employment benefits. The calculation should be prudent and not too conservative.

- Para 74, States that the following actuarial assumptions should form part:

  A. Demographic assumptions about the future of the current and former employees who are eligible for benefits. Such matters are:

    i. Employee Turnover Rate
    ii. Plan Members with dependents
    iii. Claim rates under the plan
    iv. Mortality

  ii. Financial assumptions such as the

    i. discount rate,
    ii. future salary, and benefits,
    iii. expected rate of return on assets,
    iv. medical benefits costs.

- It should be based on the market rate as on the date of the balance sheet.

Actuarial Valuation Method

- As per para 65:
  - An enterprise should use the Projected Unit Credit Method (PUC) to determine the present value of its defined benefit obligations.
  - PUC- Valuation method that sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation.
- Since present value need to be determined i.e. obligation needs to be discounted, Para 78 states:
  - The rate used to discount post-employment benefit obligations (both funded and unfunded) should be determined by reference to market yields at the balance sheet date on government bonds.

Actuarial Gain/Loss

- Actuarial gain or loss refers to an increase or decrease to a company's estimate of the Present Value of Obligation or the Fair Value of Plan Assets as a result of ***change in assumptions.***

- As per Para 92:

  Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense.

Recognition in statement of Profit & Loss

- Para 61 of AS 15/Ind AS 19: An enterprise should recognize the net total of the following amounts in P&L account:
  a) Current service cost
  b) Interest cost
  c) The expected return on any plan assets and on any reimbursement rights
  d) Actuarial gains and losses
  e) Past service cost
  f) The effect of any curtailments or settlements.

- Ind AS 19 requires recognition of actuarial gains and losses in Other comprehensive income, both for post-employment defined benefit plans and other long-term employment benefit plans.

Recognition of Defined Benefit Liability

- Para 55 of AS 15/ Para 54 of Ind AS 19: The amount to be recognised as a defined benefit liability should be the net total of the following amounts:
  a) The present value of the defined benefit obligation at the balance sheet date
  b) Minus any past service cost not yet recognised
  c) Minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly

- Present value of the defined benefit obligation will include the interest cost of the current year.

Actuarial Assumptions

Particulars	March 31, 2020	March 31, 2019	March 31, 2018
Salary Growth Rate	**Reduction in salary will have an impact here.**	8%	8%
Discount Rate		6.4% p.a.	6.2% p.a.
Expected Rate of return on assets		6.2% p.a.	7.36% p.a.
Attrition rate		3%	3%
<u>Withdrawal Rate</u> Up to age 35 years Above age 35 years		70% p.a. 40% p.a.	70% p.a. 40% p.a.
Mortality Rate		IALM 2012-14 (Ultimate)	IALM 2006-08 (Ultimate)
Expected weighted average remaining working lives of employees		19 year	18 year

Conclusion

- **Considering AS 15 and Ind AS 19**

✓Reduction in salary of employees of Infosys Ltd. will have a major impact on the retirement benefit plan such gratuity and leave encashment for the year ended 31 March 2020.

✓The future obligation will have to be re-estimated considering the reduction in salaries and the gain (difference between the obligation recognised till current period and the obligation after re-estimation) will be recorded wholly in Profit or Loss account or in OCI(if the company prepares financials as per Ind AS)

Thank You