Indian Accounting Standards

Employee benefits perspective

Implementation of Ind AS 19 and Ind AS 102

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NUMERICA

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ABOUT THIS DOCUMENT

THIS IS A WHITE PAPER

This document belongs to the 'white paper' series authored by Numerica. It provides concise and general direction on specified issues, without getting into too much technical details.

OBJECTIVE OF THIS PAPER

This paper is not a definitive guide for implementation of Ind AS framework. This paper does not constitute professional advice and is meant to provide guidance on general issues expected to be encountered by most Indian companies when implementing Ind AS. A thorough independent analysis is required to address issues specific to your company before adopting the Ind AS framework.

STRUCTURE OF THIS PAPER

This document consists of three distinct sections, each of which can be read more or less independently of the other sections.

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1 BACKGROUND

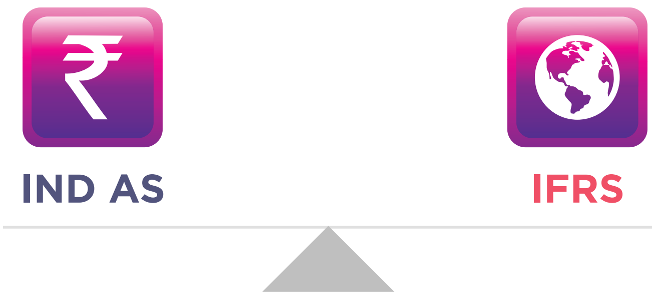
1.1 Why new accounting standards are being introduced?

Need for a consistent accounting framework

Accounting bodies around the world are working towards having a consistent framework for financial reporting. This purpose of developing such a framework is to enable users of this information, particularly analysts and investors, to compare the performance and relative attractiveness of companies operating in different countries. A 'like-to-like' comparison will enable the users to make informed decisions regarding where to invest their or their clients' capital. The International Financial Reporting Standards ('IFRS') framework developed by the International Accounting Standards Board ('IASB') is a step towards achieving that goal. A number of countries, particularly in Europe, have already adopted the IFRS framework.

Currently, differences in the local accounting standards between countries make identification of investment opportunities difficult. Therefore, analysts are increasingly relying on IFRS financial statements to reveal investment opportunities globally. Arguably, companies which do not follow an 'IFRS-like' framework are at a relative disadvantage as analysts tend to overlook otherwise attractive investment opportunities due to a lack of understanding of the local accounting standards. Indian companies are expected to benefit by aligning themselves with IFRS to increase their financial competitiveness in the eyes of global investors. In summary, adoption of IFRS is likely to increase investment in to the country.

Ind AS have been introduced by Ministry of Corporate Affairs for greater alignment with IFRS framework in order to make **Indian companies more attractive in the eyes of global investors.**



Indian Accounting Standards (Ind AS)

With this objective of aligning the Indian accounting framework with IFRS, the Ministry of Corporate Affairs ('MCA') released a set of 39 accounting standards, referred to as 'Indian Accounting Standards' ('Ind AS') in February 2015. An amendment to the original notification was issued in March 2016, which clarified that Ind AS will be applicable to banks, insurers and most Non-Banking Financial Companies ('NBFC's'), an issue that was not adequately addressed in the earlier notification.

Each of these Ind AS mirror an accounting standard of the IFRS framework, referred to as 'international standard' in this paper for ease of reference. Ind AS are not exact replicas of the international standards – the differences exist primarily because Ind AS restrict the choices available for accounting treatment compared to the corresponding international standard.

As explained in the next section, adoption of Ind AS will not be mandatory for all companies but voluntary adoption by companies is possible, unless prohibited. Chances are that solo entities with net worth of less than INR 250 crores will have a choice whether to report under the existing Accounting Standards promulgated by Institute of Chartered Accountants of India ('ICAI') or voluntarily adopt Ind AS.

250 crores

Solo entities with net worth less than Rs 250 crores will not come under the ambit of Ind AS, unless they choose to do so voluntarily.

1.2 When will the Ind AS come into effect?

MCA has notified a phased implementation of Ind AS as set out in the diagram below. Early adoption, voluntarily, is possible, unless it is explicitly prohibited.

Ind AS will become applicable to companies in a phased manner starting from FY2016-17 and not all companies will be required to adopt them.

For companies other than banks, insurers and NBFC's, Ind AS will be applicable as follows:

FROM 1 APRIL 2016 – will apply to any company with net worth of more than INR 500 crores as well as their subsidiaries, joint ventures, associates and holding companies.

FROM 1 APRIL 2017 – will apply to listed companies having net worth of less than INR 500 crores and unlisted companies of net worth more than INR 250 crores but less than INR 500 crores. Subsidiaries, joint ventures, associates and holding companies would also come under the ambit of Ind AS.

For banks, insurers and NBFC's:

FROM 1 APRIL 2018 – will apply to scheduled commercial banks (excluding Regional Rural Banks 'RRBs'), insurance companies and NBFC's having net worth of more than INR 500 crores. Subsidiaries, joint ventures, associates and holding companies would also come under the ambit of Ind AS.

FROM 1 APRIL 2019 – will apply to listed NBFC's having net worth of less than INR 500 crores and unlisted companies of net worth more than INR 250 crores but less than INR 500 crores. Subsidiaries, joint ventures, associates and holding companies would also come under the ambit of Ind AS.

Voluntary adoption

Banks, insurers and NBFC's cannot adopt Ind AS any sooner than the roadmap set out for them. However, other companies falling within the ambit of Ind AS can opt for an early adoption from FY2015-16 voluntarily. Companies for which Ind AS are not applicable, can also choose to follow them voluntarily.

If you are not mandatorily required to adopt Ind AS, a decision is required whether to voluntarily adopt. This is going to be a strategic decision that will depend on your business goals and unlikely to be driven by employee benefits-related concerns alone.

1.3 Ind AS for employee benefits

In this paper, we restrict ourselves to implications of Ind AS on employee benefits reporting. Plenty of literature is available on a wide range of topics related to Ind AS on Numerica website and elsewhere.

There are primarily two Ind AS that directly relate to accounting and disclosures of employee benefit plans:

Ind AS 19 and Ind AS 102 are the two major accounting standards that prescribe the treatment of employee benefits under Ind AS framework.

IND AS 19 EMPLOYEE BENEFITS:
for accounting of employee benefits other than share based benefits

IND AS 102 SHARE BASED PAYMENTS:
for accounting of share based benefits (e.g. ESOPs and SARs)

2 IND AS 19 EMPLOYEE BENEFITS

2.1 What is going to change

As per the current accounting framework, accounting for all employee benefits, except share based benefits, is done as per the Accounting Standard ('AS') 15. For companies reporting under Ind AS, AS 15 will be replaced by Ind AS 19. While Ind AS 19 is a reflection of the most up to date version of IAS 19, AS 15 is based on a slightly older, but quite different, version of IAS 19 that existed prior to the 2011 amendments.

The differences between AS 15 and Ind AS 19 are primarily of two types:

> Ind AS 19 will replace AS 15. Actuarial gains are recognised in OCI rather than the P&L statement. Sensitivities of DBO to key actuarial assumptions are now required.

1. AS 15 actuarial gains and losses are referred to as 'remeasurements' in Ind AS 19 and these no longer recognised in the P&L statement. Instead, they are recognised as 'Other Comprehensive Income' or OCI and charged to equity.

2. Disclosure requirements have increased with an intent to bring out the state of risk management affairs. Amongst other things, a key requirement is to disclose the sensitivities of the plan liabilities (i.e. Defined Benefit Obligation, or DBO) to significant actuarial assumptions.

2.2 How will Ind AS 19 affect you

In order to understand how your company will be affected, it will help to analyse the changes in a bit more detail. Illustrative disclosures for a hypothetical gratuity plan under Ind AS 19 and AS 15 are shown below to bring out the key differences:

TOPIC	AS15	INDAS19	EXPLANATION
Balance sheet	Defined Benefit Obligation 1,000 Value of assets 900 **Surplus/deficit (100)**	Defined Benefit Obligation 1,000 Value of assets 900 **Surplus/deficit (100)**	No change in the statement of financial position is expected.
Income statement	Service cost 150 Interest cost 50 Expected return on assets (40) Actuarial gains or losses 150 **Total expense 310**	Service cost 150 Finance cost 10 **Total expense 160**	P&L expense under AS15 will be split into that can be expensed through income statement and that will go through OCI.
Other Comprehensive Income	Not applicable	Remeasurements on DBO: 130 1-Impact of financial assumptions 50 2-Impact of demographic assumptions 20 3-Impact of plan experience 60 Remeasurements on plan assets 20 **Total OCI 150**	OCI charge would largely be same as actuarial gains under AS15, except for some minor variation for funded schemes. AS15 expense will be sum of IndAS19 expense and OCI.
Sensitivities	Not applicable	**Base DBO 1000** **Impact of: Impact** 1% decrease in discount rate +100 1% increase in salary escalation +95 10% increase in attrition rates -8 10% decrease in mortality rates +80	Sensitivities are a new set of disclosures required under IndAS19 with the purpose of bringing out important risks facing the plan.

To summarise, transition to Ind AS 19 will bring benefits and concerns for the reporting company.

Financial position will remain unchanged

> The balance sheet will remain unchanged for most companies as on the implementation date.

It is going to be all good news on the financials, primarily because of two reasons:

1. For most companies, the balance sheet will remain the same as under AS 15. As explained above, the methodology for setting assumptions or valuing the liabilities is broadly unchanged.

2. Since the actuarial gains and losses (now called remeasurements) are recognised outside the income statement, the expense in respect of benefit schemes is expected to remain quite stable each year. Earlier under AS 15, a slight change in discount rate could lead to a significant impact on income statement. Under Ind AS 19, impact of such changes will be recognised in OCI rather than the income statement.

New disclosures would require better risk management

The disclosure requirements, however, have increased significantly and the most important one being that related to sensitivities. There are other qualitative disclosures related to risk identification and management.

Comparison with global peers will demand a higher quality of disclosures

Another implication of reporting under Ind AS 19 would be that the disclosures will possibly undergo a higher level of scrutiny by the auditors, analysts and investors, who would expect the quality of reporting to match with other global companies. The responsibility for correct and complete reporting rests with the Board of Directors of the reporting enterprise and companies will need to get comfortable that the actuarial workings and disclosures suffice the requirements of Ind AS 19. This is a huge ask from non-actuarial personnel to assess and validate the work of professional actuaries by themselves, but a variety of methods are employed by companies around the world for achieving this. For example, using external auditors specialised in auditing actuarial reports, getting occasional second opinions from other actuaries and getting trained on spotting issues.

> A number of tools to support accountants and auditors involved in actuarial reporting have been developed by us and can be found on **Numerica website.**

2.3 What you need to do

If you do adopt Ind AS 19, either mandatorily or voluntarily, there isn't much more that you will need to do compared to what you are doing already for AS 15. The only additional exercise that you will need to get involved in would be to get the financials of the immediately preceding period, prior to adoption, restated under Ind AS 19 so that prior period comparatives can be reported for the first year of adoption. There are two possible scenarios here:

> The primary requirement would be to get the prior period comparatives. Higher level of scrutiny of employee benefits related disclosures can be expected in future.

1. If you are adopting Ind AS 19 for FY16-17, you will need to get the AS 15 numbers for FY15-16 restated as per Ind AS 19. It is advisable to get the restatement done ahead of time as all the information required to restate the numbers for FY15-16 should be already available with your actuary.

2. If you are adopting Ind AS 19 for FY17-18 or later, you will need to get two sets of actuarial reports from your actuary for FY16-17 or for the year preceding the adoption. Again, this shouldn't mean that you need to do anything extra or provide more information to your actuary as both sets of reports can be prepared using the same data that you already provide for AS 15.

If your company is listed in India or have been reporting employee benefits liabilities on a quarterly basis, you may have to get the prior period comparatives for each quarter of the prior year.

2.4 Implications for companies reporting under IAS 19

Many Indian companies, particularly those with parent entities headquartered in Europe, also account for their employee benefit schemes under IAS 19. This is in addition to the Indian GAAP reporting, which so far has been under AS 15. With the adoption of Ind AS 19, the Indian and international GAAP disclosures are expected to be better aligned.

The most important difference between Ind AS 19 and IAS 19 relates to the selection of discount rate for actuarial valuation. IAS 19 says that the discount rate could be based on the yields available on AA-rated corporate bonds and government bonds should be used if a deep liquid market for corporate bonds does not exist. Ind AS 19, on the other hand, specifically prescribes the use of Government of India bonds only in selection of the discount rate.

Most Indian companies reporting under IAS 19 have already been basing their discount rates on Government of India bonds as the corporate bonds market is not deemed to be very liquid in India. Therefore, a company could be able to use the results of Ind AS 19 valuation to report under IAS 19 too, and vice versa, as long as any differences in the period of reporting are allowed for.

3 IND AS 102 SHARE BASED PAYMENTS

3.1 What is Ind AS 102 all about

Ind AS 102 is based on IFRS 2. Broadly speaking, Ind AS 102 sets out the accounting treatment of transactions where a company has agreed to make a 'share based payment' in exchange for goods or services provided by another party. If a payment has been agreed in exchange for services with an employee, these payments are referred to as 'share based plans' or simply 'share plans'. A common share plan is to award stock options to its employees. These awards are better known as Employee Stock Option Plans, or ESOPs and are an important component of an employee's benefit package. Another less common way to remunerate employees is by awarding them Share Appreciation Rights, or SARs, which provide for a bonus to be given based on the share price at a future date.

Ind AS 102 prescribes financial reporting in respect of share based payments and is most relevant for companies remunerating their employees by shares based payments.

Note that Ind AS 102 also covers non-benefits transactions that are share based, but these are outside of the scope of this paper.

3.2 How are share plans treated in Ind AS 102

Before getting into more details about how Ind AS 102 might affect your financial reporting, it would be helpful to know how common types of share based plans work.

Employee Stock Option Plans, ESOPs

A generic structure of an ESOP is as follows: an employee will have an option to purchase 100 shares of the employer (i.e. own company) at the current market price in three years' time and will then have one year to purchase. The employee will have to continue to render service for three years (known as **'vesting period'**), starting from the date on which the option was given (known as **'grant date'**). After completing the vesting period, the employee will then have one year to decide whether to purchase the shares (known as **'exercise period'**) at the price specified in the option (known as **'strike or exercise price'**). In practice, a typical stock option plan is graded; i.e. options vest at different points in time in future. For example, 25 options could vest each year starting from three years from initial grant date.

The employee doesn't necessarily have to purchase the shares; if the share price is below the exercise price at all times during the exercise period, the employee would be better off by not exercising the option to purchase the shares. In such a situation, the option will become worthless and the company will not incur any loss. If the employee exercises the option when the purchase price is higher than the strike price, the company will need to bear the loss equal to the difference.

More details about Ind AS 102 are covered in a separate paper available on **Numerica website.**

Share Appreciation Rights, SARs

The structure is exactly the same for a SAR, with one exception – instead of receiving shares of the company when the option is exercised, the employee receives cash calculated as the difference between the share price on exercise date and the exercise price.

Accounting of share plans as per Ind AS 102

The accounting treatment under Ind AS 102 will vary depending on whether the share based transaction is settled in equity (e.g. ESOPs) or in cash (e.g. SARs) as described below:

For equity settled ESOPs, the fair value of the ESOPs are issued at the grant date and this cost is amortised over the life of the option and a corresponding entry is made to an equity account. It should be noted that the options are not revalued later. On the other hand, for cash settled transactions, the fair value of options is assessed at each reporting date and recorded as a liability. The increase in liability is recorded as an expense in the P&L statement.

To summarise, Ind AS 102 requires that:

- ✓ An expense is recognised in the P&L statement in respect of share based plans; the assessment of this expense will depend on how the share based transaction will be settled
- ✓ A corresponding entry be made to an equity account of the issuing company, in case of ESOPs
- ✓ A corresponding entry be made to a liability account of the issuing case, in case of SARs

3.3 What is going to change

It would be useful to understand the existing framework for financial reporting of share based plans in India. There is no specific accounting standard dealing in the reporting of such plans. ICAI issued Guidance Note 18 (GN18) in 2005 that prescribes a reporting framework, but the application is not mandatory. In addition, Securities and Exchange Board of India ('SEBI') has prescribed additional reporting requirements for listed companies that run share based plans; these guidelines are referred to as 'SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999'. It is worth noting that no framework exists for share based transactions that are not related to employee benefits.

Both ICAI and SEBI permit the use of 'intrinsic value' for valuing and reporting costs related to share based plans. Therefore, any company using the intrinsic value approach coming under the ambit of Ind AS 102 is likely to be affected. See the next section on more details about the impact this on your financials.

From an employee benefits perspective, companies that do not issue stock options or share schemes to their employees will not be affected by Ind AS 102. Companies that have unexpired (vested or unvested) share plans will need to closely analyse the applicability of Ind AS 102, but not all companies with unexpired plans will be affected.

> Companies using intrinsic value method and having unexpired stock options are likely to be affected the most.

Ind AS 101 First Time Adoption of Ind AS, provides an option for 'voluntary exemption' from certain provisions of Ind AS 102. If a voluntary exemption is applied, the company will not need to follow Ind AS 102 for any share plans that have vested before the transition date. Even if such plans are modified before the transition date, Ind AS 102 will not apply. However, for any plans that remain unvested as on the transition date, the cost will need to be reassessed and the unexpired cost will need to be amortised as per Ind AS 102.

3.4 How will Ind AS 102 affect you

Key differences between Ind AS 102 and the current accounting framework prescribed by ICAI and SEBI are summarised in the table below:

TOPIC	GN18	INDAS102	EXPLANATION
Basis of valuation	Fair value measurement recommended but intrinsic value is allowed. Most companies end up using intrinsic value approach. As per SEBI guidelines, the impact of using fair value needs to be disclosed in Directors' report.	Fair value measurement is mandatory. The fair value impact which was previously disclosed in the notes or Directors' report will actually be recognised in P&L.	Fair value of a stock option cannot be less than the intrinsic value. The amount by which fair value exceeds the intrinsic value (called 'time value') depends on a number of factors. Generally speaking, companies that are using intrinsic value method and have unvested options with the following characteristics will see an increase in P&L expense: • a long outstanding vesting period, or • strike price close to the share price at grant
Amortisation of costs	For graded stock option plans, the amortisation could be done for each tranche separately, or an aggregate schedule can be produced by combining all the tranches. A tranche consists of a set of options vesting as on particular date.	Costs in respect of graded plans will need to be amortised for each tranche separately.	The change in method of amortisation would affect the timing of when the cost is recognised in P&L and won't affect the total cost itself. On a like-for-like basis, this would mean that more cost will be recognised in the initial years under IndAS102. For existing grants that are already approaching vesting date, the P&L cost will increase immediately following the transition to IndAS to make up for the lower recognition in the previous years. The cost will drop significantly in subsequent years.

TOPIC	GN18	INDAS102	EXPLANATION
Disclosures	Certain disclosures, including the following are required: • Description of each type of share plan • Eligibility, vesting, term, settlement mechanism • Reconciliation between opening and closing number of stock options • Weighted average share price at the time of exercise • Weighted average exercise price of outstanding options However, companies that are not listed and not following GN 18 do not currently make these disclosures.	All these disclosures will usually be required. Note that these disclosures are in addition to other disclosures related to method, assumptions and financial impact of ESOPs on P&L and balance sheet for unvested plans.	Voluntary exemption provided by Ind AS 101 does not include exemption from disclosures even if the options vested prior to the transition date. Additional disclosure requirements will not directly affect the financial results. However, revelation of a significant unreported share based plan is likely to surprise the users of financial information.
Group sponsored share plans	No guidance provided on which entity should recognise the costs of share plans which are sponsored by another group entity.	The entity whose employees receive share based compensation needs to recognise the cost in its P&L. For equity-settled plans, the corresponding increase in equity needs to be treated as a contribution from the entity that sponsors the plan. For cash-settled plans, it has been made clear that the transactions need to be reflected in the solo financial statements of the entity receiving the services.	The share plans are quite often structured in a manner that another group entity becomes responsible for settlement. The lack of guidance meant that companies were able to avoid from recognising the costs on grounds that they didn't have any obligation to settle these transactions.
Consolidation of trust accounts	GN 18 does not require that the accounts of ESOP trusts be consolidated with the company. However, SEBI guidance requires listed companies to consolidate trust accounts with the company.	Trust accounts will be consolidated with the company's own accounts thereby eliminating any transactions between the two entities.	Any company choosing not to consolidate the trust accounts with its own accounts was able to take benefit of the transactions with the trust and avoid some of the costs associated with running the share plans. After implementing Ind AS 102, reporting of share plans will be done on a 'look-through' basis; i.e. the reporting will be done as if the benefits are directly awarded and managed by the company.

In summary, the introduction of Ind AS 102 is expected to streamline various market practices that are currently prevalent in the country. However, the requirements of compliance could be significant.

The expense recognised in P&L is likely to increase

This is because of the following reasons:

1. Companies that have not been reporting for costs of share based plans will need to mandatorily recognise this cost under Ind AS 102. This would mean a fresh new expense category hitting the P&L.

2. For companies already reporting for share based plans, the expenses are likely to increase in most cases, particularly those companies valuing the plans using intrinsic value, rather than fair value, will see the costs rise the most.

The costs of running share based plans are likely to rise under Ind AS 102 if fair value accounting is not being followed. Reporting requirements will also increase.

Comparison with global peers will demand a more accurate measurement

Ind AS 102 disclosures are expected to attract much attention from the investors and analysts who would be particularly interested in understanding the contingent nature of these benefits. Companies will be better off in designing the share plans with full understanding of how the costs will affect their financials.

3.5 What you need to do

Once a decision has been made on whether or not Ind AS would be applicable for your company, you will also need to decide whether to apply any of the voluntary exemptions provided by Ind AS 101. However, it is unlikely that voluntary exemptions will significantly reduce what you need to do to comply with Ind AS 102.

A thorough due diligence is required to classify the share based plans into various categories as required under Ind AS 102 to ascertain the correct accounting treatment for each type of share based plan. Trust and group arrangements will need to be understood before bringing them within the scope of Ind AS 102.

Fair value of any unvested awards need to be determined and P&L cost from the date of transition will need to reflect the amortisation of fair value. Fair valuation of unvested awards is going to be an extensive exercise and two aspects of estimating the fair value will be very important in ensuring that estimated fair value is appropriate:

> Due diligence, followed by estimating the fair value of any unvested share based awards should be top priority.

- The method of valuation will be an important consideration. Black Scholes, Binomial and Monte Carlo methods are all valid candidates for use with Ind AS 102 and the choice will depend primarily on the design of the awards.
- The assumptions to be used for valuation will be another important issue and in particular, the share price volatility. For listed companies, volatility can be calculated from historical share price information or from any traded options issued by the company. For unlisted companies, volatility assumption will most likely be derived from alternative sources with an overlay of expert judgement.

We suggest to undertake the process of due diligence followed by fair valuation of unvested awards in time before the transition date. The information required to complete these two tasks should already be available and no new information should be needed. Any deficiencies so revealed can then be addressed before transitioning to Ind AS.

ABOUT NUMERICA

Numerica is a group of consulting firms providing actuarial and consulting services to companies arounds the world. Our services include the areas of employee benefits and social security, insurance consulting and data science.

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