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ACCOUNTING VS FUNDING

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INTRODUCTION

Periodic actuarial valuations are carried out for employer-sponsored benefit schemes in India, such as gratuity, pension etc. Independent actuaries carry out accounting valuations to help companies account for the costs of these schemes in the books of the company. Valuations for funded schemes are also prepared by insurers, with whom employers invest funds pertaining to the employee benefit scheme. The results of these valuations often vary from each other due to the different objectives of each type of valuation.

Funding valuations help to plan the financing of the benefit over time and to pace the funding based on the objectives of the enterprise / trustees

Accounting valuations help uniformly recognize the cost of providing the benefit in the books of accounts during the service lifetime of the employee

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COMPARISON

Whilst the actuarial principles and models used to carry out either of these valuations are generally the same, there are certain fundamental differences between both.

Accounting Valuation		Funding Valuation
Statutory requirement	Requirement	Need-based
Auditors, Regulatory Authorities & Shareholders	Key stakeholders	Management, Trustees, Employees & Beneficiaries
At least annually at end of each financial year	Frequency	As per the requirement of management / trustees
Prescriptive – Need to be carried out as per codifications of the relevant accounting standard	Level of Freedom	Freedom to choose basis of valuation and methodology
Realistic set of assumptions to accurately compute costs and liability	Basis of valuation	Chosen as per the funding strategy and targeted funding levels
Projected Unit Method as prescribed in the accounting standard	Valuation Method	Method should be chosen based on salient features of the scheme
Derived based on stipulations in the accounting standard	Discount Rate	Derived based on future expected return on assets
Best Estimate and realistic	Other Assumptions	Freedom to choose based on purpose of valuation
As codified in the accounting standards	Disclosure Requirements	Based on the exact purpose and requirements

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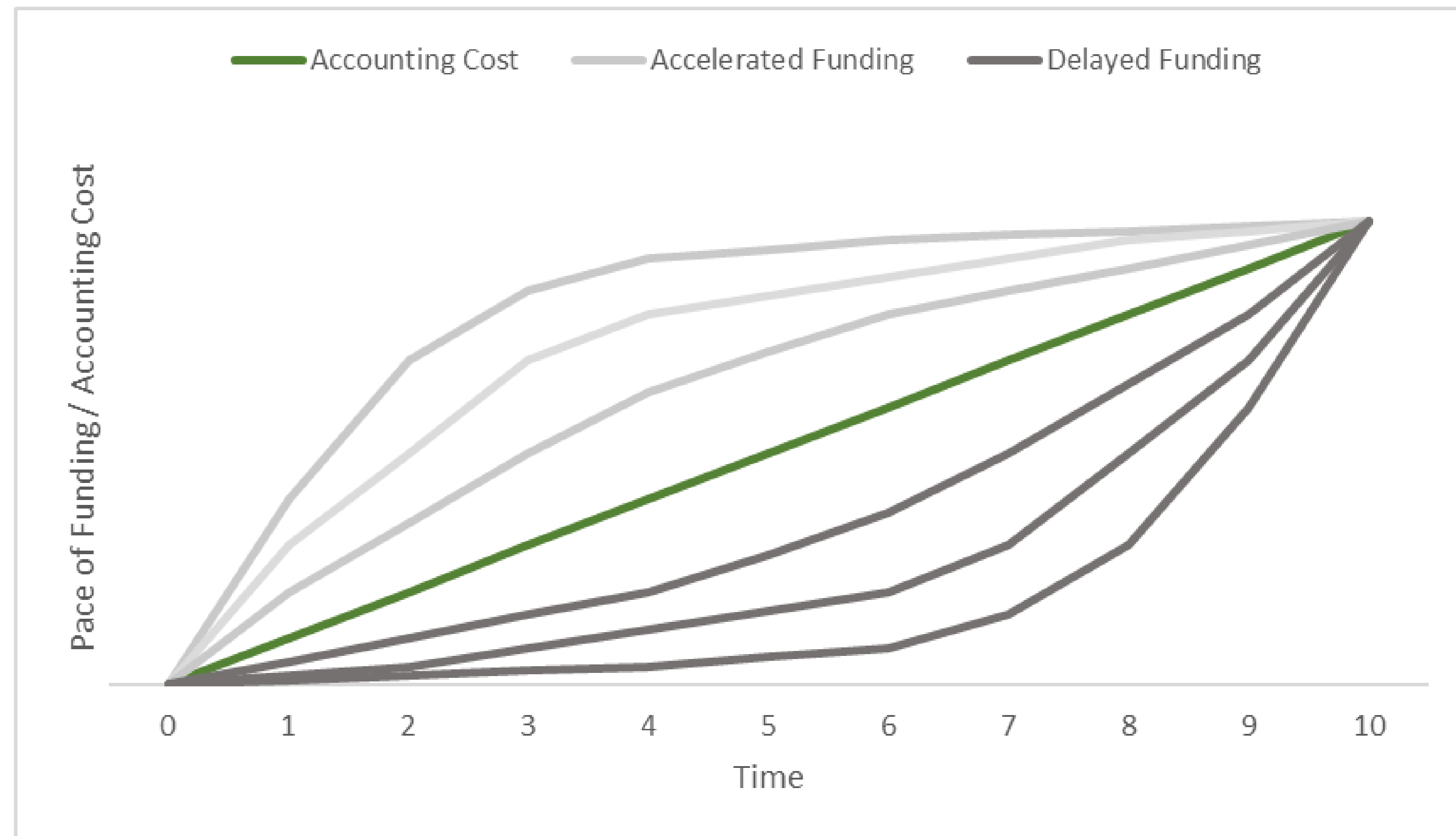
PACE OF ACCOUNTING/FUNDING

Actuaries use various actuarial methods while carrying out a valuation. Furthermore, since liabilities are based on the net present value of future cash flows, a set of financial and demographic assumptions are used along with the chosen method to arrive at the liability. The choice of actuarial methodology and assumptions critically dictate the pace at which liabilities get accounted or funded.

A conservative choice of method and assumptions would result in a faster pace of accounting/funding in earlier years and lesser in future whilst a less conservative choice of method and assumptions would achieve exactly the opposite result.

Accounting standards require costs to be recognized as uniformly and realistically as possible over the service lifetime of the employee. To ensure this, almost all accounting standards prescribe the use of an actuarial method called Projected Unit Credit method along with a realistic set of assumptions. In the graph depicted below, the accounting valuation represents the line in the center which results in the most uniform and systematic recognition of costs over a period of time.



On the other hand, funding objectives can vary and hence there is far more flexibility in choosing the actuarial method and assumptions, thereby offering multiple approaches to the enterprise to build funds and eventually reach the required corpus to finance the liabilities.

Accelerated funding is an approach where the employer opts to prefund the liabilities by contributing more funds in earlier years as compared to later years. This can be done by using a conservative method and assumptions basis which will overstate the liability initially and lead to true-ups closer to the termination. It is graphically represented by various paths available in the area above the accounting cost .

Delayed funding involves a more gradual approach to funding where higher contributions are made closer to retirement to cover up the lower level of funding in earlier years. Such a strategy can be achieved by using less conservative method and assumptions during the funding valuations and is represented by various paths available in the area below the accounting cost.

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REASONS FOR ADOPTION OF DIFFERENT FUNDING STRATEGIES

Accelerated Funding	Delayed Funding
Insistence of trustees / govt. authorities	Funds required for operational purposes
To utilize tax advantages to the extent possible	Better returns available with other investments
To prioritize security of employees' benefits	Ties in with larger cashflow plan of company

VALUATIONS IN THE INDIAN CONTEXT

The adoption of accounting standards on employee benefits such as AS15 (revised 2005) and IndAS 19 is mandatory for all enterprises in India. These standards are prescriptive and leave little flexibility in the hands of actuaries in choice of funding methods or assumptions.

On the other hand, defined benefit plans in India do not require to be funded nor do they have any minimum funding requirements. Employers often make benefit payments directly to employees from their own funds. Even for employers who have assets earmarked for their employee benefit schemes, decisions to contribute funds are taken based on liquidity, excess capital availability and any opportunities to maximize tax advantages.

Trust funds for employee benefits are predominantly set up with an insurance company who manages these assets and provides funding advice based on their assumptions and models. Assumptions used are generic in nature and do not take into account specific features of how the employer's actual experience in the future might be. The models used to calculate the funding levels might also not be aligned with the relevant accounting standard. As a result, the assumptions and model differ from what would be used for an accounting valuation, which leads to different results between an actuary's report and the insurer's report.

In some instances we find companies use an accounting valuation for funding purposes and funding valuation for accounting purposes. This however, would not necessarily be the correct approach to adopt unless the chosen funding objectives are fully in sync with the requirements of the accounting standards.

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CONTACT US

For any questions or requirements pertaining to accounting / funding valuations, please feel free to get in touch

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