

## **Amendments to the Payment of Gratuity Act- An overview of accounting implications**

In India, the Payment of Gratuity Act, 1972 (Act) requires entities with ten or more employees to pay gratuity benefit to their employees at the time of termination of employment. The act also provides that if an entity is covered under the act because its number of employees exceeded ten on a particular day, it will continue to be covered under the act even if its number of employees fall below ten subsequently. However, no gratuity is payable to an employee, which terminates its services to the entity before completing five years of service, if such termination is not due to death or disablement. Further, the act does not apply to arrangements, which do not constitute an employer-employee relationship or to employees of the central/state governments governed by separate rules framed by the government.

According to the act, gratuity payable to an employee is calculated by using the formula given below:

$$\frac{\text{Last monthly salary x 15 days x completed years of service} \\ \text{plus part thereof exceeding six months}}{26 \text{ days}}$$

If gratuity computed as per the formula above exceeded Rs. 350,000, the entity had an option to limit maximum gratuity payable to each employee to Rs. 350,000. In practice, many entities have capped gratuity payable to their employees at the amount fixed under the act.

### **Recent developments**

The Government has notified the Payment of Gratuity (Amendment) Act 2010 in May 2010. This bill to this amendment was approved by the Cabinet before 31 March 2010. The amendment raises the ceiling on gratuity payable to employees from the existing Rs. 350,000 to Rs. 1,000,000.

### **Financial reporting impact**

The enactment of this amendment will require entities, which have fixed their maximum gratuity liability at the ceiling laid down in the act, to pay higher gratuity to their employees. We believe that the proposed amendment will give rise to the timing issue as to in which period the provision is required. Given below is our perspective on this issue.

**Should the proposed change in the limit be considered in determining gratuity liability as at 31 March 2010?**

Gratuity liability is covered under scope of AS 15 Employee Benefits and is treated as a defined benefit plan. According to AS 15, the provision for a defined benefit plan is calculated using the projected unit credit method (PUCM) of actuarial valuation. The application of PUCM requires an entity to make various financial assumptions such as future salary increases and changes in benefit levels. Consequently, the proposed change in the gratuity limit should also be considered for determining defined benefit liability as at 31 March 2010. It does not matter if the bill was an act at the reporting period date, as long as there is reasonable certainty that the law would be passed.

Appropriate disclosures should be made with regards to the above in the notes to the financial statements