

## **Requirement of Accounting & Funding Arrangement for Gratuity Benefits**

***This article is an attempt to give clarity about requirement of Accounting and Funding Arrangement for Gratuity Benefits.***

### **1. An Overview Gratuity Benefits**

Gratuity benefits are governed by “The **Payment of Gratuity Act 1972**” and paid by the Company to an employee in addition to his salary on exit from the company. Gratuity shall be payable to an employee on the termination of his employment after he has rendered continuous service for not less than five years, –

**(a) on his superannuation, or**

**(b) on his retirement or resignation, or**

**(c) on his death or disablement due to accident or disease:**

***Provided that the completion of continuous service of 5 years shall not be necessary where the termination of the employment of any employee is due to death or disablement:***

### **2. Calculation of Gratuity Benefits**

Gratuity is a statutory right of employee whoever completes 5 years in the same organization and is a terminal benefit. It means, Gratuity amount will be determined when monthly terminal wages of the employee are known to the company. The terminal wages will include Basic & Dearness allowance only. The Gratuity Benefits are calculated using the following formulae:-

**(15/26) multiplied by (No of Completed Years on Exit) multiplied by (Terminal Wages)**

### **3. Factors affecting Quantum of Gratuity Benefits**

Gratuity Benefits changes with the change in the following:-

(a) Past Service of Employee in the Company,

(b) Increase in wages of Employee in the Company,

(c) Change in Benefit Formulae of the Gratuity Benefit due to the amendment in the Act,

(d) Change in Ceiling Limit on Gratuity Benefits due to the amendment in the Act,

(e) Change in Vesting Condition for eligibility of Gratuity Benefits due to the amendment in the Act,

***The impact of the above Factors on Gratuity Benefits can be understood by the following Examples :***

**(a) Change Past Service of Employee in the Company.**

Mr. A Joins the Company with a Basic Pay of Rs. 2,60,000/- per month and there is no change in basic salary, only his Past Service Change then Gratuity Payments for the next 5 years will be:-

On Completion of 1 Yr –  $(15/26) * 2,60,000 * 1 = 1,50,000/-$

On Completion of 2 Yrs –  $(15/26) * 2,60,000 * 2 = 3,00,000/-$

On Completion of 3 Yrs –  $(15/26) * 2,60,000 * 3 = 4,50,000/-$

On Completion of 4 Yrs –  $(15/26) * 2,60,000 * 4 = 6,00,000/-$

On Completion of 5 Yrs –  $(15/26) * 2,60,000 * 5 = 7,50,000/-$

The above amounts are subject to Ceiling Limits on Gratuity Benefits applicable.

**(b) Increase in wages of Employee in the Company.**

Mr. A Joins the Company with a Basic Pay of Rs. 2,60,000/- per month and there is the change in wages @10%, then Gratuity Payments for the next 5 years will be:-

On Completion of 1 Yr –  $(15/26) * 2,86,000 * 1 = 1,65,000/-$

On Completion of 2 Yrs –  $(15/26) * 3,14,600 * 2 = 3,63,000/-$

On Completion of 3 Yrs –  $(15/26) * 3,46,060 * 3 = 5,98,950/-$

On Completion of 4 Yrs –  $(15/26) * 3,80,670 * 4 = 8,78,460/-$

On Completion of 5 Yrs –  $(15/26) * 4,18,730 * 5 = 12,00,788/-$

The above amounts are subject to Ceiling Limits on Gratuity Benefits applicable.

**(c) Change in Benefit Formulae of the Gratuity Benefit due to the amendment in the Act.**

Mr. A Joins the Company with a Basic Pay of Rs. 2,60,000/- per month, His increment in wages @10%, and due to changes in the Gratuity Factor as 1/1 from 15/26 then Gratuity Payments for next 5 years will be:-

On Completion of 1 Yr –  $(1/1) * 2,86,000 * 1 = 2,86,000/-$

On Completion of 2 Yrs –  $(1/1) * 3,14,600 * 2 = 6,29,200/-$

On Completion of 3 Yrs –  $(1/1) * 3,46,060 * 3 = 10,38,180/-$

On Completion of 4 Yrs –  $(1/1) * 3,80,670 * 4 = 15,22,660/-$

On Completion of 5 Yrs –  $(1/1) * 4,18,730 * 5 = 20,93,660/-$

The above amounts are subject to Ceiling Limits on Gratuity Benefits applicable.

**(d) Change in Ceiling Limit on Gratuity Benefits due to the amendment in the Act.**

Mr. A Joins the Company with a Basic Pay of Rs. 5,00,000/- per month, His increment in wages @10%, and due to changes in Ceiling Limit from 10 Lakhs to 20 Lakhs then Gratuity Payments for the next 5 years will be:-

**Case 1 – When Gratuity Ceiling is 10,00,000/-**

On Completion of 1 Yr –  $(15/26) * 5,50,000 * 1 = 3,17,308/-$

On Completion of 2 Yrs –  $(15/26) * 6,05,000 * 2 = 6,98,077/-$

On Completion of 3 Yrs –  $(15/26) * 6,65,500 * 3 = 11,51,827/-$  Company liable to pay 10,00,000/-

On Completion of 4 Yrs –  $(15/26) * 7,32,050 * 4 = 16,89,346/-$  Company liable to pay 10,00,000/-

On Completion of 5 Yrs –  $(15/26) * 8,05,255 * 5 = 23,22,851/-$  Company liable to pay 10,00,000/-

**Case 2 – When Gratuity Ceiling is 20,00,000/-**

On Completion of 1 Yr –  $(15/26) * 5,50,000 * 1 = 3,17,308/-$

On Completion of 2 Yrs –  $(15/26) * 6,05,000 * 2 = 6,98,077/-$

On Completion of 3 Yrs –  $(15/26) * 6,65,500 * 3 = 11,51,827/-$

On Completion of 4 Yrs –  $(15/26) * 7,32,050 * 4 = 16,89,346/-$

On Completion of 5 Yrs –  $(15/26) * 8,05,255 * 5 = 23,22,851/-$  Company liable to pay 20,00,000/-

**Case 3 – When Gratuity Ceiling is 30,00,000/-**

On Completion of 1 Yr –  $(15/26) * 5,50,000 * 1 = 3,17,308/-$

On Completion of 2 Yrs –  $(15/26) * 6,05,000 * 2 = 6,98,077/-$

On Completion of 3 Yrs –  $(15/26) * 6,65,500 * 3 = 11,51,827/-$

On Completion of 4 Yrs –  $(15/26) * 7,32,050 * 4 = 16,89,346/-$

On Completion of 5 Yrs –  $(15/26) * 8,05,255 * 5 = 23,22,851/-$

**(e) Change in Vesting Condition for eligibility of Gratuity Benefits due to the amendment in the Act.**

In the above examples for (a) to (d), If an employee leaves the company before completion of 5 years then “Nil” gratuity benefit is payable in the following events :

(a) on his superannuation, or

(b) on his retirement or resignation.

**Case 1 – When Vesting Condition for eligibility is 3 years,** Company will be liable to pay gratuity benefit on completion of 3 years in event of his superannuation, on his retirement or resignation.

**Case 2 – When Vesting Condition for eligibility is 2 years,** Company will be liable to pay gratuity benefit on completion of 2 years in event of his superannuation, on his retirement or resignation.

**Case 3 – When Vesting Condition for eligibility is 1 year, Company will be liable to pay gratuity benefit on completion of 1 year in event of his superannuation, on his retirement or resignation.**

**Gratuity Benefits are long term benefits and are subject to the above changes, so it becomes mandatory for Companies to make proper Accounting/Funding arrangement for Gratuity Benefits.**

#### **4. Provisions for Employer under Payment of Gratuity Act 1972 (Amended)**

Section 7 of the Act has kept the obligation for payment of gratuity act on the shoulders of the employer, few provisions of this section act are listed below:-

1. As soon as Gratuity becomes payable, it employers responsibility to determine the amount of gratuity and inform it to an employee in writing (Refer subsection 2 of Section 7 of the Act).
2. The employer shall arrange to pay the amount of gratuity within 30 days from the date when it becomes mandatory. (Refer Sub-section 3 of Section 7 of the Act).
3. If the amount of gratuity is not paid within 30 days then the amount of gratuity and simple interest will be paid by the employer to the employee for the duration when the payment is not made to the employee. (Refer Sub-section 4 of Section 7 of the Act).

#### **5. Accounting/Funding Options for Gratuity Benefits**

Gratuity Liability increase exponentially with the increase in wages of employee and service period of the employee. Also, it is employers responsibility to pay the gratuity to the employee in any case. Companies have generally 2 options for discharging the Gratuity Liability: –

**1. Pay as go options** – In this option, the Companies makes provision of Gratuity Liability by taking an Actuarial Valuation Report/Certificate from **Actuary** to Comply with the requirements of following Accounting Standards issued by the Regulators :-

**a. AS 15 (Revised 2005)**

**b. IndAS 19**

**c. IAS 19 (Revised 2011)-IFRS**

**In Indian context, Companies falls in following three categories based on the basis of compliance criteria mentioned in Accounting Standards :-**

(i) SME – In this case, company needs to disclose details as required for Clause (I) of Para 120 of AS 15 (Revised 2005)

(ii) Non – SME – In this case, company needs to disclose details as required for Para 120 of AS 15 (Revised 2005)

(iii) Companies with Net-worth more 250 cr. – In this case, companies and their subsidiaries has to give disclosure of in compliance of IndAS 19 with comparative numbers of previous 2 years.

**2. Funding Option** –In this option, Management of Company make decision based on the Gratuity Liability Computed and Certified by An Actuary to creates an **Irrevocable Trust**. There are 2 major benefits to the company by creating an **Irrevocable Trust**:-

**(i) Contribution into Approved Trust is allowed as deductible Expense :** – Provision of Gratuity Liability shown in the Balance Sheet is not allowed as deduction whilst computing net Income for Income Tax ((Refer Section 47A (7) of Income Tax Act 1961) whereas Initial and Annual Ordinary Contribution made by company into an **Approved Gratuity Trust** (Subject to condition specified in Income Tax Rules 103 & 104) is **allowed as deductible expense** under **Section 36 (1) (v)**.

**(ii) Interest received from Investment of an Approved Gratuity Trust is also exempted as Income Tax :-** Interest received from Investment of an Approved Trust is also exempted as Income under **Section 10 (25) (iv)** of the Income Tax Act, 1961.

**In Indian Context, Companies have 2 options based on the Management of Fund of an Approved Gratuity Trust for making the Funding Arrangement for Gratuity Liability Management.**

**A. Privately Managed**

**B. Insurance Company Managed**

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