Voluntary Retirement Scheme (VRS) Expenditure -
Accounting and Prudential Regulatory Treatment

BP.BC. 73 /21.04.018/2000-01

January 30, 2001

All Public Sector Banks

Dear Sir,

Voluntary Retirement Scheme (VRS) Expenditure -
Accounting and Prudential Regulatory Treatment

Consequent on introduction of VRS, public sector banks and IBA have approached us for issuing guidelines on the accounting treatment in respect of VRS related expenditure such as ex-gratia payment and other termination benefits. We have examined the accounting issues in consultation with the Institute of Chartered Accountant of India (ICAI) and the accounting treatment of VRS expenditure is given below.

2. The VRS related expenditure will comprise of:

i. Ex-gratia payment of a sum equal to 2 months pay for every year of service rendered or pay for the remaining period of service, whichever is less and

ii. Termination benefits like gratuity, pension / provident fund, commutation of pension, encashment of accumulated leave, cost of reimbursement of travel and transportation at the time of retirement, etc.

2.1 **Ex-gratia Payment**

The bank is required to recognise the liability in respect of VRS ex-gratia payment in the accounting year in which the decision to accept the VRS of an employee is taken and communicated to him / her. Unless expensed in the same period, the entire ex-gratia amount as a result of VRS, can be treated as an extra-ordinary item and as Deferred Revenue Expenditure.

2.2 **Termination Benefits**

As regards termination benefits in respect of VRS employees, banks should normally have made provision on actuarial basis. However, in view of the early retirement under the VRS, it is possible that the amount of termination benefits payable may be more than the provision made in this respect in the past for that employee. The excess of termination benefits payable over the provision held in this regard, unless expensed in the same year, can be treated as an extra-ordinary item and Deferred Revenue Expenditure.

2.3 **Period of Deferment**

The period of deferment would be restricted to a maximum of 5 years including the year of acceptance of VRS application by a bank.

2.4 **Leave Encashment Expenditure**

In respect of encashment of leave salary and similar other expenditure, most banks have not made the provision on an actuarial basis and have treated the same on a cash basis. In that event any payment made for encashment of leave salary for employees who have opted for VRS must be treated as an expenditure for the year and cannot be treated as Deferred Revenue Expenditure.

If any bank has provided for encashment of leave salary on an actuarial basis or chooses to provide for it on an actuarial basis, the excess of the payment over the actuarial liability provided can be treated as Deferred Revenue Expenditure and amortised over a period not exceeding five years.

2.5 **Allocation of Expenditure**

While allocating the Deferred Revenue Expenditure, it should be recognised that the tax benefits for the whole expenditure will arise in the first year itself. Therefore, the basis of allocation should be as under:

(i) for the first year the charge should be equal to the sum of the tax benefit obtained + 1/5th of the balance

(ii) in each of the other 4 years, the charge should be equal to 1/5th of the net amount i.e. the gross amount less the tax benefit obtained for the first year.

An illustrative example is given in the Annexure.

2.6 **Disclosure**

The Board of Directors of a bank must disclose the accounting policies followed in respect of VRS expenditure. If VRS applications were accepted subsequent to the closure of the accounting year, the Board of Directors would be required to make a disclosure in the Board Report of that fact and of the likely impact of the VRS.

3. **Regulatory Issues**

3.1 Banks have also approached us that the VRS related Deferred Revenue Expenditure may not be reduced from Tier I capital. We have examined the issue and advise that in view of the extra-ordinary nature of the event, VRS related Deferred Revenue Expenditure would not be reduced from Tier I capital. The position will stand regularized by the end of the accounting year in which the deferred expenses are totally wiped out.

3.2 Some banks have proposed to meet the VRS related expenditure partly on cash basis and the other part in the form of bonds and requested us to treat the bond as subordinated debt counting for Tier II capital. It is advised that the bonds to be issued to the VRS employees as compensation package, net of the unamortised Deferred Revenue Expenditure, could be treated as Tier II capital, subject to compliance with the terms and conditions stipulated in our circular No.DBOD.BP.BC.5 /21.01.002/98-99 dated 8 February 1999 for issue of such bonds.

Yours faithfully,

(***A. Ghosh***)
Chief General Manager-in-Charge

Annexure

Recognition of Tax Benefit for Allocation of Expenditure - Example

If the Deferred Revenue Expenditure is 100 and spread over five years, taking into account the tax savings, the amount to be charged off in each year should be as under:

Year	Gross charge	Tax saving	Net charge
2000-2001	38.5	38.5	--
	12.3	---	12.3
	50.8	38.5	12.3
2001-2002	12.3	--	12.3
2002-2003	12.3	--	12.3
2003-2004	12.3	--	12.3
2004-2005	12.3	--	12.3
	100.0	38.5	61.5

If a bank does not have adequate taxable income to fully absorb the deduction for VRS in the 1st year, the charge in the 1st year may be lower and in later years higher than in the above example. For example, if a bank's taxable income is 80, the charge for each year will be as under:

Year	Gross charge	Tax saving	Net charge
2000-2001	30.8	30.8	--
	12.3	--	12.3
	43.1	30.8	12.3
2001-2002	7.7	7.7	--
	12.3	--	12.3
	20.0	7.7	12.3
2002-2003	12.3	--	12.3
2003-2004	12.3	--	12.3
2004-2005	12.3	--	12.3
	100.0	38.5	61.5