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कर्मचारी भविष्य निधि संगठन
EMPLOYEES' PROVIDENT FUND ORGANISATION
(श्रम एवं रोजगार मंत्रालय,भारत सरकार)
(Ministry of Labour & Employment, Govt. of India)
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No.HO/IMC/198/APFETF/2015 19966

Date : 31 DEC 2015

To,

All Exempted Provident Fund

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Subject: Accounting Policy and method of accounting for equity and related investment

As you may be aware that a New Pattern of Investment has been notified by Ministry of Labour & Employment both for EPFO and Exempted Provident Funds vide notification dated 23.04.2015 and 29.05.2015 separately. As per the New Pattern of Investment the Trusts have to invest minimum of 5% of the total investment in equity and related investments. Since equity as an asset class is different from fixed income securities their treatment for accounting purpose was a cause of concern among many of the exempt Provident Fund.

2. In order to arrive at a most prudent accounting policy and method of accounting for equity and related investment a draft accounting policy and method of accounting for equity and related investment was also circulated for comments from various stakeholders. Based on the suggestions received a draft policy on the same was taken to the 122nd meeting of Finance Investment & Audit Committee (FIAC) held on 09.12.2015 for its approval. The Committee after deliberation approved the policy. The same is circulated as *Annexure-'**A**' for* information at your end.

Yours faithfully,

Encl: as above.

(K.L. Goyal)
Addl. Central P.F. Commissioner –I (IMC)

Accounting policy and method of Accounting for equity & related Investment

1. The Central Board of Trustees (CBT), EPF in its 207th Meeting decided to investment 05% of its corpus in Exchange Traded Fund (ETF) under the category (iv) i.e. Equities and related investments of pattern of Investment notified by Ministry of Labour & Employment vide notification no. 1071 (E) dated 23rd April, 2015. This is the first time, EPFO has decided to invest in equity and related instruments in financial year 2015-16.

2. To provide method of accounting and accounting policy for equity and related investments, EPFO would require to frame accounting policy for equity and related investment. So far the investment in EPFO is only in such fixed income securities which pays interest either quarterly, half year or yearly. The assets have been held till maturity. The interest received has been treated as profit as per the cash system of accounting being followed by EPFO. Profit so calculated has been distributed among the beneficiary as per the provisions of para 60 of Employees' Provident Fund Scheme. Since the fixed income assets have been valued at cost of acquisition in the closing stock, capital gain or loss due to change in valuation have not been accounted for in these assets.

3. As against the above characteristics of fixed income assets where the income is actually derived from interest, which is revenue in nature, the profit in the equity will mostly be capital in nature and will be represented by its current market value as compared to its cost of acquisition. However, the dividend received on underlying shares of ETF, will be revenue in nature having characteristic similar to interest income.

4. Secondly, EPFO being a Pension Fund is likely to have long term investment in equity. It will not be prudent to sale the asset at the end of the year in order to realise profit in cash for its distribution among the beneficiaries. This will unnecessarily introduce the concept of repeated transaction cost during the sale for booking the profit and purchase in subsequent month from the fresh receipts.

5. The accounting complexity in EPFO is also due to the nature of scheme itself. At the end of the year, EPFO has to credit the interest to individual account and also has to declare the rate of interest. The declaration of rate of interest defines uniqueness of EPFO and distinguishes EPFO as a mode of saving from the other instruments for old age saving available in the market such as NPS, mutual fund etc. Declared rate of interest is also easy to comprehend for majority of the beneficiary of EPFO who are financially illiterate or not very well versed with the complicated instruments where profit has to be derived on the basis of certain set of data.

6. This characteristic makes Provident Fund a hybrid scheme which though is defined contribution on yearly basis becomes defined benefit scheme at the end of the year.

7. In the above operational context of the provident fund the decision to invest in equity and related instrument, while has the objective to maximise the profit on investment the objective of accounting policy should be to ensure that:-

i) the declared rate of interest is smooth over a long period of time despite making investment in equity and related instrument to the extent possible.

ii) The capital invested in equity is protected to the extent possible.

iii) To avoid generation shift in distribution of profit from investment in equity and related investment as far as possible.

8. In view of above, the following accounting policy for equity & related investments are proposed as under:

A. <u>Calculation of Profit/loss</u>:

I. Valuation of the Asset investment in equity will be as per **mark to the market basis (MTM).**

II. The opening stock of the first year will be nil (zero).

III. The purchases shall be calculated on the basis of the cost of purchase + brokerage and other direct cost paid for the purchase.

IV. The closing stock of the investment relating to equity and related instruments will be valued at market price**(mark to market basis).**

V. The closing stock of the previous year shall become the opening stock of the subsequent year.

VI. The dividend will be considered as receipt on accrual basis. In other words, the dividends declared by 31st March on any of the equity held as investment shall be treated as income of the year.

VII. The profit or loss every year in equity and related investments will be difference of the closing stock + dividend received + sale price (sale if there is any)as reduced by the value of opening stock + purchase during the year.

B. <u>Creation of Equity Income Stabilisation Reserve</u> :

I. It is expected that over period of next 7-10 years, the compound annual growth rate of equity will be 12% though this target may be achieved in long term. There may be year to year volatility in the same.

II. In order to declare a smooth rate of return, certain portion of profit from the investment in equity shall be declared as distributable profit for the year under para 60 of EPF Scheme. Remaining portion of profit shall be transferred in reserve, which may be called Equity Incomestabilisation reserve(EISR).

III. The profit from investment in equity shall be bench marked to the average G-sec rate. For calculation of average G-sec rate,average closing price of current series of 10 year G-sec. for last day of each month of pervious year will be considered. If there are more than one current series in the previous year, the relevant series will be considered for the months in which it was current. In month of April every year EPFO will calculate and make available the working of the average g-sec rate on it’s website.

(iv) The profit from equity and related investment will be considered for distribution in the following manner.

Percentage (profit on cost of investment)	Distributable profit in percentage	
Above average G sec rate Upto 15%	200 bp above Average G.Sec. rate	A.
From 16% to 20%	A + 40% of the profit in excess of 15%	B
From 21% to 30%	B+ 50% of profit in excess of 21%	C
Above 30%	C+ 60% of profit in excess of 31%	

(v) The excess of the profit from the investment in equity and related instrument over and above distributable profit as calculated in the paragraph 4 above shall be transferred to ESIR.

(vi) The excess of profit from fixed income assets as against the amount of interest payable to individual beneficiary calculated on the basis of declared rate of interest for that year shall also be credited to this EISR.

(vii) The Equity Income stabilisation reserve will hold maximum upto 10% of the value of AUM.

(viii) If the interest stabilisation reserve become more than 10% of AUM, there will be no further credit to this accountand any amount which otherwise would have been creditable to the reserve will be available for distribution of the profit.

C. <u>Use of Funds in EISR :</u>

(i) The EISR can be used for smoothen out the rate of interest declared by EPFO from year to year.

(ii) In case the profit from investment in share and related instrument is between the “Average G.Sec. Rate” and 200 basis point above averageG.Sec. Rate, no drawal from interest stabilisation reserve will be made to distribute or declared the interest for the year.

(iii) If the profit from the share and related instruments for a particular year is below the average of G.sec. Rate, the Board may at his discretion decide to draw from the reserve to declare the rate of interest for the year.

(iv) If during any year, there is income from equity below the average G.Sec. rate and there is no balance in EISR, the actual income calculated alone shall be distributed.

(v) If during any year, there is loss on investment in equity and there is no balance in EISR, the loss out of investment in equity shall be added to income out of investment in other asset and the resultant income shall be distributed as interest for that particular year.