



A Comprehensive Analysis Of India's New Labour Codes And Their Impact On Financial Statements

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India's new **Labour Codes**, effective November 2025, introduce a standardized "Wages" definition that fundamentally alters corporate liabilities. If excluded allowances exceed 50% of an employee's Cost to Company, the excess is legally deemed "Wages," drastically increasing the calculation base for statutory benefits like **gratuity and provident fund**. Furthermore, **fixed-term employees** now qualify for pro-rata gratuity after just one year. Under Ind AS 19, these structural changes constitute a "**Plan Amendment**". Consequently, companies must immediately recognize the heightened obligations as a Past Service Cost in their Profit & Loss statements, directly reducing net profit, earnings per share, and net worth.

The enactment of the 4 new Labour Codes, the Code on Wages, 2019, the Code on Social Security, 2020, the Industrial Relations Code, 2020, and the Occupational Safety, Health and Working Conditions (OSH) Code, 2020 represents the most significant structural reform in India's employment history. These codes came into effect from November 21, 2025, which will consolidate and simplify 29 central labour laws into a unified framework. However, for the financial community specifically Chief Financial Officers (CFOs), auditors, actuaries, and institutional investors, the implications extend far beyond mere regulatory compliance. These reforms will necessitate a fundamental restructuring of employee benefit obligations that will materially impact financial statements prepared under Ind AS 19 – Employee Benefits and AS 15 Employee Benefits (revised 2005).

The most disruptive element of this legislative overhaul is the standardized definition of "Wages," which mandates that aggregate of specified exclusions from total CTC must not exceed 50% of the total Cost to Company (CTC) for the calculation of statutory benefits like

gratuity and provident fund. For decades, Indian corporate compensation structures have been "allowance-heavy," often keeping basic pay at 30-35% of CTC to minimize long-term liabilities and increase immediate take-home pay. By artificially uplifting the "wage" base to minimum of 50% of remuneration (CTC) through this deeming fiction, the Present Value of Defined Benefit Obligations (PVDBO) for gratuity and leave encashment is projected to rise by 25% to 50% for many entities, particularly in the service sectors.

This article provides a detailed technical analysis of these changes. It dissects the interplay between the legislative text and accounting standards, explores the actuarial complexities of the transition and considers the importance of disclosures in financial statements.

PART 1: THE LEGISLATIVE AND REGULATORY LANDSCAPE:

Rooted in the industrial era of the mid-20th century, the legacy framework comprised over 40 central laws and 100 state laws, creating a compliance labyrinth that stifled formal employment while failing to provide universal social security. The genesis of the current reforms lies in the report of the Second National Commission on Labour (2002), which recommended consolidating these laws into broad functional groups to ensure uniformity and ease of compliance. The objective is to balance worker welfare (through universal social security and minimum wages) with industrial flexibility (through fixed-term employment and simplified dispute resolution).

The consolidation has resulted in four pillars:

1. Code on Wages, 2019:

Subsumes the Payment of Wages Act, 1936; Minimum Wages Act, 1948; Payment of Bonus Act, 1965; and Equal Remuneration Act, 1976. Its primary financial impact stems from the unified, non-negotiable definition of wages.

2. Code on Social Security, 2020:

Subsumes nine laws, including the Employees' Provident Funds (EPF) Act, 1952; Employees' State Insurance (ESI) Act, 1948; and Payment of Gratuity Act, 1972. It extends social security coverage to gig and platform workers and alters eligibility criteria for gratuity enabling eligibility employees engaged under fixed-term contracts of more than one year.

3. Industrial Relations Code, 2020:

Streamlines regulations regarding trade unions, strikes, and lockouts, and introduces statutory recognition for Fixed Term Employment, allowing employers flexibility in hiring while mandating pro-rata benefits.

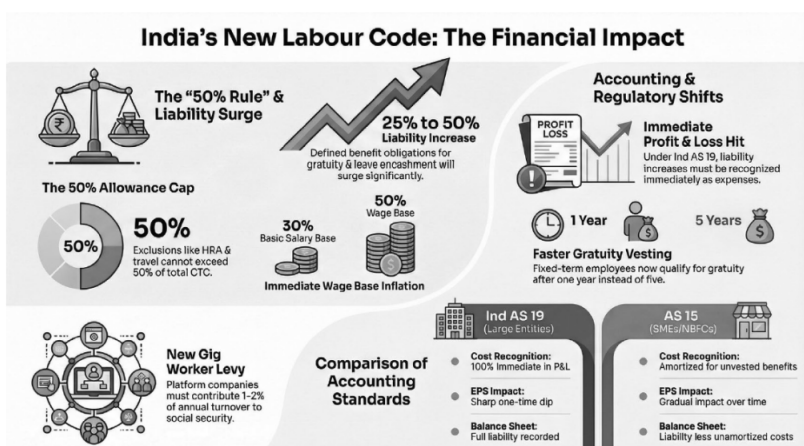
4. Occupational Safety, Health and Working Conditions (OSH) Code, 2020:

Consolidates safety regulations and significantly impacts leave encashment policies by standardizing leave entitlement and accumulation rules.

THE UNIFIED DEFINITION OF WAGES: THE 50% RULE:

The cornerstone of the financial impact across all four Codes is the new, uniform definition of "Wages" provided in Section 2(y) of the Code on Wages, 2019, which is adopted by reference in the other three codes. This definition is the mathematical engine that drives the increase in employee benefit liabilities.

The definition is structured in 3 distinct parts:



- **The Inclusions:** The core components that always constitute wages: Basic pay, Dearness Allowance (DA), and Retaining Allowance.
- **The Exclusions:** A specific list of components that are not wages, provided they do not exceed the cap. These include House Rent Allowance (HRA), conveyance allowance, overtime allowance, commission, house accommodation value, statutory bonus, and employer contributions to PF/Pension.
- **The Proviso (The 50% Cap):** This is the critical "deeming fiction" introduced by the legislation. The Code explicitly states that if the aggregate of the specified excluded components exceeds 50% (or such other percentage notified by the Central

Government) of the total remuneration calculated, the excess amount shall be deemed as "Wages" and added back to the inclusions for the purpose of calculating benefits. However, if the aggregate of exclusions exceeds the prescribed limit, the excess amount is deemed to be "Wages" and added back for the purpose of computing statutory benefits.

Now, this prevents employers from engineering compensation structures where the majority of the payout is disguised as allowances (e.g., "Special Allowance," "Flexi-Pay") to suppress the base for Provident Fund (PF) and Gratuity contributions.

ILLUSTRATION

Consider a typical service sector employee (e.g., a Software Engineer or Consultant) with a Cost to Company (CTC) of ₹1,000,000.

Component	Pre-Code Structure (Typical)	Post-Code Statutory Base Calculation
Basic Salary	₹ 300,000 (30%)	₹ 300,000
HRA	₹ 150,000	Excluded
LTA & Conveyance	₹ 50,000	Excluded
Special/Flexi Allowances	₹ 450,000	Excluded
Employer PF	₹ 36,000	Excluded
Gratuity Allocation	₹ 14,000	Excluded
Total Remuneration	₹ 1,000,000	₹ 1,000,000
Total Exclusions	₹ 700,000 (70%)	
Permissible Exclusion Limit		₹ 500,000 (50% of Total)
Excess Exclusion		₹ 700,000 - ₹500,000 = ₹ 200,000
Deemed Wages		₹ 200,000

Component	Pre-Code Structure (Typical)	Post-Code Statutory Base Calculation
Final Wage Base for Benefits	₹ 300,000	₹ 300,000 + ₹ 200,000 = ? 500,000

In this scenario, the liability base for Gratuity and PF increases from ₹300,000 to ₹500,000, a 66.6% increase. This increase is not a function of salary increment or inflation; it is a purely legislative adjustment that creates an immediate financial obligation.

Now, consider another scenario, continuing above illustration,

Component	Pre-Code Structure (Typical)	Post-Code Statutory Base Calculation
Basic Salary	₹ 600,000 (60%)	₹ 600,000
HRA	₹ 50,000	Excluded
LTA & Conveyance	₹ 25,000	Excluded
Special/Flexi Allowances	₹ 225,000	Excluded
Employer PF	₹ 72,000	Excluded
Gratuity Allocation	₹ 28,000	Excluded
Total Remuneration	? 1,000,000	? 1,000,000
Total Exclusions	? 400,000 (40%)	
Permissible Exclusion Limit		₹ 500,000 (50% of Total)
Excess/(Shortfall) Exclusion		₹ 400,000 - ₹ 500,000 = (? 100,000) <i>Negative and hence, shortfall will be ignored for deemed wage calculation</i>
Deemed Wages		? 0

Component	Pre-Code Structure (Typical)	Post-Code Statutory Base Calculation
Final Wage Base for Benefits	? 600,000	? 600,000

Here, exclusions i.e., 60% exceed the limit i.e., 50%, the surplus is mandatorily reclassified as "Wages" and included for benefit computation and hence Gratuity has been computed on ₹ 600,000 and not on deeming fiction of 50% i.e., ₹ 500,000.

THE FIXED-TERM EMPLOYMENT (FTE) PARADIGM SHIFT

The Code on Social Security, 2020 and the Industrial Relations Code, 2020 formalise the concept of "Fixed Term Employment." Historically, fixed-term contracts were often utilised by industries to maintain workforce flexibility and, crucially, to avoid long-term vesting liabilities. Under the Payment of Gratuity Act, 1972, an employee was required to render five years of continuous service to be eligible for gratuity.

Under Section 53 of the Code on Social Security, 2020, this regime is dismantled. The Code mandates that fixed-term employees are entitled to gratuity on a pro-rata basis if they render service for one year or more. The five-year vesting cliff is removed only for this category of workers.

Now, the financial impact

Pre-Code	Post-Code
An entity hiring 1,000 contract workers for a 3 year project had zero gratuity liability on its balance sheet for these workers, assuming they would leave before 5 years.	The entity must accrue gratuity liability for all 1,000 workers from Year 1. This moves a significant portion of the workforce from a "defined contribution" (or no benefit) mindset to a "defined benefit" classification.

The probability of vesting for FTEs jumps from near 0% (under the 5-year rule) to 100% (under the 1-year rule).

THE GIG AND PLATFORM ECONOMY

The Code on Social Security, 2020 is pioneering in its recognition of gig and platform workers (e.g., drivers for ride-hailing apps, delivery partners). Section 113 and Section 114 mandate social security schemes for these workers, funded by contributions from aggregators. Aggregators may be required to contribute 1-2% of their annual turnover (capped at 5% of the amount paid to such workers) to a designated Social Security Fund.

While this is not "gratuity" in the traditional defined-benefit sense, it represents a new statutory levy on revenue for platform companies, impacting unit economics and EBITDA margins directly. For financial reporting, this will likely be treated as a statutory levy like PF, recognized as an expense as the service is rendered.

PART 2: ACCOUNTING IMPLICATIONS (IND AS 19 & AS 15)

The primary standards in focus are Ind AS 19 (Employee Benefits) for listed and large unlisted companies following Ind AS, and AS 15 for those reporting under Indian GAAP. The treatment of the sudden, legislatively induced increase in liability is the subject of intense debate, which has been recently clarified by the Institute of Chartered Accountants of India (ICAI).

THE CLASSIFICATION DILEMMA:

The central accounting question triggered by the Labour Codes is: Is the increase in liability due to the new wage definition a change in actuarial assumption or a plan amendment?

- **Actuarial Assumption Change:** These typically relate to changes in estimates (e.g., discount rate fluctuations, mortality table updates, changes in future salary growth expectations). Under Ind AS 19, the financial impact of such changes is recognized in Other Comprehensive Income (OCI). Crucially, items in OCI are not reclassified to profit or loss; they bypass the income statement, shielding the Earnings Per Share (EPS).
- **Plan Amendment (Past Service Cost):** This arises when the terms of the plan are introduced, withdrawn, or changed (by deed or regulation), resulting in a change in the benefit payable for past service. Under Ind AS 19, Past Service Cost is recognized immediately in the statement of Profit and Loss (P&L). Where such amounts are material, entities may present or disclose them separately, including within line items described as exceptional, to enhance transparency in line with presentation principles

under Ind AS 1.

The ICAI Accounting Standards Board (ASB), in its guidance and FAQs on the Labour Codes, has clarified that the changes triggered by the new Codes constitute a Plan Amendment. The reasoning is jurisprudential: the benefit formula itself has effectively been changed by the force of law. The law has structurally redefined the input variable ('Wages') upon which the benefit is computed. It is not merely a change in the estimation of the variable, but a redefinition of the variable itself. Therefore, the increase in the Present Value of Defined Benefit Obligation (PVDBO) is a Past Service Cost.

ACCOUNTING UNDER IND AS 19:

For entities complying with Ind AS, the impact is immediate, transparent, and may be potentially severe for the reporting period.

Paragraph 103 of Ind AS 19 requires an entity to recognize past service cost as an expense at the earlier of:

1. When the plan amendment or curtailment occurs; and
2. When the entity recognizes related restructuring costs or termination benefits.

Since the Labour Codes became effective on November 21, 2025, the "amendment" is deemed to have occurred on that date. Ind AS 19 does not allow for the deferral or amortization of past service costs, regardless of whether the benefits are vested or unvested. ***The concept of "vesting" is irrelevant for recognition under Ind AS 19; once the liability exists, it must be booked.***

The Impact on the Financial Statements:

Upon the effective date, the entity must re-measure its DBO using the new wage definition.

- **Hypothetical Scenario:**

□ **DBO (Old Rules):** ₹ 100 Crores.

? **DBO (New Rules):** ₹ 140 Crores (due to wage base increase + FTE inclusion).

? **Increase (Past Service Cost):** ₹ 40 Crores.

- **Journal Entry:**

? *Debit:* Employee Benefit Expense (Past Service Cost) - **Profit & Loss A/c:** ? 40 Crores.

? *Credit:* Net Defined Benefit Liability - **Balance Sheet:** ? 40 Crores.

FINANCIAL CONSEQUENCES:

1. **Profitability:** The ₹ 40 Crore charge reduces Profit Before Tax (PBT) immediately in the reporting period (Q3 FY 2025-26). It is not routed through OCI, meaning it directly reduces Net Profit.
2. **EPS:** Earnings Per Share will take a sharp, one-time dip in the transition quarter.
3. **Net Worth:** The charge flows into Retained Earnings, permanently reducing the Net Worth of the company.
4. **Deferred Tax:** Since the expense is booked but not paid, a Deferred Tax Asset (DTA) should theoretically be created (subject to probability of future taxable profits), which might partially offset the Net Loss impact, although the cash tax outflow remains unchanged until actual payment.

Companies might attempt to restructure salaries to mitigate the impact (e.g., shifting allowances to basic pay voluntarily). The ICAI guidance notes that if a company increases basic pay disproportionately to comply with the code (e.g., attributing the entire increment to basic pay to reach the 50% threshold), this change in structure is also treated as a Plan Amendment, not an actuarial change. The rationale is that the change is driven by the statutory amendment, even if executed through an internal policy change.

ACCOUNTING UNDER AS 15:

For companies following Indian GAAP (SMEs, certain unlisted entities, and NBFCs not yet covered by Ind AS), AS 15 offers a slightly different treatment, though the liability must still be recognized.

Unlike Ind AS 19, AS 15 maintains a distinction between vested and unvested past service costs:

- **Vested Benefits:** The past service cost relating to benefits that are already vested must be recognized immediately in the P&L.
- **Unvested Benefits:** The past service cost relating to unvested benefits can be recognized on a straight-line basis over the average period until the benefits become vested. Application to Labour Codes
- **For employees with >5 years of service (already vested for gratuity),** the impact of the wage increase is immediate and fully expensed.
- **For employees with <5 years (unvested),** the increase in liability due to the new wage definition can be amortized over the remaining vesting period.
- **Crucial Exception:** For Fixed-Term Employees who now vest at 1 year, the "unvested" period is significantly shortened. If an FTE has completed 9 months, the amortization period is only 3 months. Thus, the relief offered by AS 15 amortization is practically very limited.

COMPARATIVE ANALYSIS OF IND AS AND AS:

Feature	Ind AS 19	AS 15
Event Classification	Plan Amendment (Past Service Cost)	Plan Amendment (Past Service Cost)
Recognition of Cost	Immediate in P&L (100%)	Immediate for Vested; Amortized for Unvested
Balance Sheet Impact	Full Liability recognized immediately	Liability recognized (less unamortized cost)
Impact on EBITDA	Significant One-time Hit	Significant Hit (Vested portion)

LEAVE ENCASHMENT: THE OSH CODE NUANCE

While Gratuity is the headline post-employment benefit, Leave Encashment liabilities also face pressure. The OSH Code standardizes leave rules, entitlement to encashment, and carry-forward limits, linking them strictly to the new "Wages" definition.

ACCOUNTING TREATMENT:

- Under Ind AS 19/AS 15, leave encashment is typically classified as an "Other Long-Term Employee Benefit" (OLTB) rather than a post-employment benefit (unless it is

strictly payable only on separation).

- **Remeasurement:** For OLTB, all components of the change in liability, including past service cost and actuarial gains/losses are recognized immediately in P&L. There is no OCI option for leave encashment.
- **Implication:** This compounds the volatility in the P&L. The "50% wage rule" applies here too, meaning the value of each accrued leave day increases. Since companies cannot route any part of the leave liability change through OCI, the P&L hit for leave encashment is often more severe relative to the size of the liability than gratuity.

PART 3: ACTUARIAL VALUATION

The financial statements are merely the reflection of the underlying actuarial models. The Labour Codes necessitate a recalibration of the Projected Unit Credit (PUC) method, the standard actuarial method mandated by Ind AS 19.

THE PROJECTED UNIT CREDIT (PUC) METHOD UNDER THE NEW LABOUR CODE

The PUC method views each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation.

Previously, the model projected Basic Salary + DA. Now, the model must project Maximum of (CTC – Exclusions (Maximum of 50% of CTC)).

The actuary cannot simply project the basic salary using a standard escalation rate. They must project the entire CTC and the individual components to check the 50% threshold at every time.

For the transition valuation (March 31, 2026), companies must provide two distinct sets of data to their actuaries:

1. **Current/Old Salary Structure:** To calculate the opening DBO and verify the "pre-amendment" status.
2. **New Salary Structure:** Reflecting the 50% adjustments and FTE inclusions to calculate the closing DBO and derive the Past Service Cost.

IMPACT ON SALARY ESCALATION RATE (SER) DYNAMICS:

The Salary Escalation Rate is a critical actuarial assumption representing the expected long-term growth in the salary base used for benefits. Due to these reforms,

- **The Inflationary Pressure:** To maintain "take-home" pay (which drops due to higher PF deductions), employers might be forced to increase gross pay, suggesting a higher short-term SER.
- **The Structural Dampener:** If the basic pay is forcibly increased to 50% today (a structural jump), future increments might be suppressed or directed into allowances (up to the limit) to manage costs. Management might argue for a lower future SER on the higher base.
- **ICAI & Actuarial View:** The SER must reflect the best estimate of future growth. A one-time structural jump is a "Plan Amendment," not an "Escalation." However, the future rate of growth on this higher base must be consistent with the company's long-term business plan and inflation expectations.

ATTRITION AND MORTALITY IN THE FTE ERA

Attrition (Withdrawal Rate) Assumptions must be overhauled for the FTE population.

- **Old Regime:** High attrition in years 1-4 was beneficial for gratuity liabilities because employees leaving before 5 years forfeited the benefit. The actuary would apply a high withdrawal rate, reducing the Net Present Value (NPV).
- **New Labour Code:** With 1-year vesting for FTEs, attrition in years 1-4 no longer extinguishes the liability; it only crystallizes it earlier.
- **Actuarial Impact:** The valuation model must now assume that almost every FTE who survives one year will vest. This effectively increases the DBO.

PART 4: TRANSITION AND DISCLOSURE:

Major Transition Impact:

A critical area of concern is Section 142 of the Code on Social Security, 2020. While it provides for the validation of acts done under the repealed enactments, it does not explicitly "grandfather" the gratuity calculation for past service at the old salary rates.

- **The Legal Position:** Gratuity is a terminal benefit calculated on the "last drawn wage."
- **The Consequence:** If an employee retires in Dec 2025, their "last drawn wage" is the new (higher) wage defined by the Code.

There is effectively no grandfathering of the liability calculation. The entire past service liability gets re-valued at the new, higher wage rate. This lack of grandfathering is the primary source of the massive "Past Service Cost" hit.

RECOMMENDED DISCLOSURES:

To maintain transparency and investor confidence, the following disclosures are recommended in the financial statements for the year ending March 31, 2026:

1. **Quantitative Impact:** Clearly quantify the "Past Service Cost" derived from the legislative change separate from routine current service cost.
2. **Narrative Disclosure:**

A Following Note to the Financial Statements:

"Effective November 21, 2025, the Code on Social Security, 2020 and Code on Wages, 2019 was notified. The Codes mandate a revised definition of 'Wages' for the calculation of Gratuity and expand eligibility to Fixed Term Employees. The Company has assessed the impact of these changes as a Plan Amendment under Ind AS 19 'Employee Benefits'. Consequently, the Defined Benefit Obligation was remeasured using the revised wage definition, resulting in an increase of ? [Amount] million. This amount has been recognized as Past Service Cost in the Statement of Profit and Loss. This is a non-recurring item resulting from a change in law.

As the detailed rules under the Codes are currently in draft form and subject to final notification, the assessment is based on the Company's interpretation of the notified provisions and available guidance. Any subsequent changes arising from finalisation of the rules may require reassessment of the impact in future periods."

Given the non-recurring nature of the adjustment arising from a legislative change, entities may, where material, present or disclose the impact separately, including within items described as exceptional, to enhance transparency in financial reporting.

3. Sensitivity Analysis: Show the sensitivity of the DBO to the wage definition assumption (e.g., impact if the interpretation of "Special Allowance" changes).

4. Exceptional Item: Argue for presenting the Past Service Cost as an exceptional item to normalize "Adjusted EBITDA" for analyst presentations

CONCLUSION:

The implementation of the New Labour Codes is not merely a legal compliance tick-box; it is a significant financial event that reshapes the cost structure of India Inc. **For the Auditor**, the focus must be on ensuring that the "Deemed Wage" calculation strictly

follows the Section 2(y) proviso and that the financial impact is transparently disclosed as a Past Service Cost, preventing entities from burying the impact in OCI.

The scope for "salary engineering" to avoid the gratuity liability is severely restricted by the "Deeming Fiction" in the Code. The strategy must shift from "avoidance" to "optimization" of the residual 50% allowances to ensure they deliver maximum perceived value to the employee (e.g., through NPS) rather than just being cash allowances that get capped.

Ultimately, while the short-term financial pain is acute, the Codes promise a more transparent, equitable, and legally robust employment framework.