Pension Services Ltd

Newsletter
March 2016

Pension liabilities according to international accounting standards for companies affiliated to a *collective foundation*

Reporting in IFRS or US GAAP

Many companies keep their balance sheet in line with an international accounting standard, e.g., IFRS or US GAAP. In most cases they are obliged to do so either because they are listed on the stock exchange, because they are a subsidiary of a parent company which uses such a standard, or because potential investors demand it. A company may also choose to adopt such a standard voluntarily, for example in order to possibly gain easier access to international capital markets.

IFRS or US GAAP reporting requires the inclusion of pension liabilities on the company balance sheet, regardless of the fact that, in Switzerland, occupational provisions are managed by separate legal entities to the company itself. The methods of calculating and reporting pension liabilities are outlined in IAS 19 (IFRS) and ASC 715-30 (US GAAP) respectively (hereinafter the "Standard").

Defined benefits and defined contributions

The Standard distinguishes between defined contribution and defined benefit pension plans. It is not the same as the distinction between contribution-based and benefit-based plans in the usual Swiss technical terminology. According to the Standard, a plan qualifies as defined contribution if the employer only has to pay its share of contributions and then incurs no further risk, for example if the pension plan assets prove insufficient to cover the agreed level of benefits. It is similar to having a Pillar 3a account with a bank, where the insured must choose between several investment funds and then bears the investment risk him/herself.

It has long been evident that Swiss pension plans were defined benefit plans due to the minimal guarantees, such as the BVG interest rate or minimum conversion rate. The only exception was for plans reinsured in full with an insurance company ("full insurance"), the classification of which was controversial. Until 2007, the argument that such a plan involved no risk for either the pension fund or the employer was occasionally accepted by auditors. The major auditing companies then jointly decided that all these plans were to come under the defined benefit category for the following reasons: if the insurer terminates the contract, there is no guarantee that another insurer would offer similar conditions; moreover, in the event of repeated loss events the risk premium can increase substantially[1]. Both possibilities pose a risk for the employer in terms of extra payments in the future.

Fully insured pension plans thus qualify as defined benefit plans. Consequently, the pension liabilities are to be calculated according to the Standard and the results need to be included in the company's balance sheet and income statement. The calculation differs significantly from the one according to the Swiss standard used by pension funds; it tends to be complicated and costly, which can prove problematic for SMEs. In addition, the calculations are based on many parameters, among which an interest rate used to discount future pension liabilities. This discount rate is currently very low so pension liabilities calculated using the Standard are a lot higher than those disclosed by pension funds themselves. As a result, full insurance solutions, 100 % covered according to Swiss standards, are systematically heavily underfunded (20 % to 40 %) according to the Standard. It is normal for a company to recognise an amount between CHF 50 000 and CHF 80 000 per insured person on its balance sheet, even if there will definitely be no restructuring measures during the term of the insurance contract.

[1] *Matthias Jeger and Martin Welser, "Vollversicherte BVG-Pläne unter IAS 19: Leistungs- oder beitragsorientiert?", (Fully insured BVG plans under IAS 19: Defined benefit or defined contribution?) Der Schweizer Treuhänder, Nr. 10/2007*

Particularities in a collective foundation
We now present some particular features that apply in the case of affiliation of a company to a collective foundation. Recall that within a collective foundation, each company constitutes a "pension scheme".

1 Plan assets
The plan assets do not consist of securities or real estate as the pension scheme does not make any investments itself[2]. It has entrusted its assets to the collective foundation. The plan assets consist essentially of entitlements vis-à-vis the foundation and amount to the retirement savings and the surrender value of current pensions, as this is the amount that would be paid were the affiliation contract to be terminated. If the collective foundation's regulations stipulate that a "partial liquidation" takes place at termination of the affiliation contract, one adds the contract's share of the collective foundation's fluctuation reserve and of its non-committed funds as well as certain technical provisions; in case of insufficient coverage (according to the Swiss standard), the retirement savings are reduced proportionally[3].

2 Current and future pensions
Many affiliation contracts stipulate that the collective foundation retains the beneficiaries of retirement and survivors' pensions if the contract is terminated. For this reason, the actuary may omit the corresponding pensions in the calculation, which reduces the balance sheet. Reversionary pensions for active insured members, on the other hand, may not be omitted as the contract could be terminated before the insured event occurs.

3 Determination of the calculation parameters
The calculation of pension liabilities using the Standard is based on a number of parameters. The pension solution chosen affects the estimate of the future interest rate on retirement assets and the estimate of future pension increases, but not the other parameters; in particular, it does not affect the two parameters with the largest impact on the pension liabilities, i. e., the discount rate and the long-term estimate of the salary increase.

4 Estimated return on plan assets
The estimated return on plan assets is an additional parameter of ASC 715-30 (since the revision of IAS 19 in 2013, it does not play any more role in that Standard). It does not influence the calculation of pension liabilities but the pension costs in the company's income statement.

Given – as we have seen – that the assets consist of entitlements vis-à-vis the collective foundation, the return on plan assets will equate to the interest rate on retirement savings if there are no ongoing pension payments to account for. On the other hand, if pensions in force are to be considered, one will also take into account the technical interest rate used to determine their surrender value, and then weight both interest rates according to the respective proportion of the retirement savings and of the surrender values in the plan assets.

Example
Take the example below: Affiliation to a collective foundation, no pensioners, CHF 40 million in retirement savings, employer contribution reserves of CHF 2 million. We compare the results of a full insurance and of a banking solution. We assume that in the latter, the target of the fluctuation reserve is 10% and that there are no technical provisions.

When a partial liquidation is not due at the termination of the affiliation contract, it can happen that the better the financial situation of the collective foundation, the larger the net liability to be disclosed by the company. This paradoxical result is due to the fact that the Standard takes future benefit improvements into account whereas the Swiss standard does not. On the contrary, if a partial liquidation is due, the collective foundation's financial situation is reflected in the liability to be disclosed by the company.

[2] The special case in which the pension scheme or even the single insured person can choose their own investment strategies is not treated here.
[3] In practice the provisions of the partial liquidation regulations need to be taken into account.

Swiss Life Pension Services AG assists you in dealing with IAS 19 or ASC 715-30, in particular in:
- the choice of the calculation parameters
- calculating the pension obligations
- the disclosure and the reporting
- special situations such as pension plan amendments or mergers and acquisitions.

Roland Schmid, Managing Director
29th February 2016

Type of collective foundation	**Full insurance**	**Banking solution**			
Basic data (CHF m.)					
Retirement savings	40				40
Employer contribution reserve	2				2
Calculation according to Swiss standard (RPC 26) (CHF m.)					
Pension liabilities	40	40	40	40	40
Coverage ratio of the collective foundation	100 %	115 %	110 %	100 %	90 %
Pension assets	40	46	44	40	36
Coverage surplus/deficit	0	6	4	0	–4
Calculations according to the Standard (CHF m.)					
Pension liabilities	58	59[4]	58	58	56[4]
With partial liquidation in case of contract termination					
Plan assets	42	48	46	42	38
retirement savings	*40*	*40*	*40*	*40*	*36[6]*
employer's contribution reserve	*2*	*2*	*2*	*2*	*2*
share of the collective foundation's fluctuation reserve	*0[5]*	*4*	*4*	*0*	*0*
share of the collective foundation's non-committed funds	*0*	*2*	*0*	*0*	*0*
On company balance sheet	–16	–11	–12	–16	–18
Without partial liquidation in case of contract termination					
Plan assets	42	42	42	42	42
retirement savings	*40*	*40*	*40*	*40*	*40*
employer's contribution reserve	*2*	*2*	*2*	*2*	*2*
On company balance sheet	–16	–17	–16	–16	–14

[4] Difference due to the higher or lower estimate of the future interest rate on retirement savings than in the other two scenarios.
[5] The fully insured collective foundation does not need fluctuation reserves.
[6] Proportional to the coverage ratio because the retirement savings are cut in case of partial liquidation.

Pension Services – Swiss Life's advisory company

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The future starts here.