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# Pensions threaten to tip the balance sheet

The combination of mature industries, declining equity markets and increased longevity is proving unfortunate for many companies around the world.

Accounting standards have allowed companies in the US and Europe to manage this situation for financial reporting purposes by allowing flexibility in the setting of assumptions and by spreading gains and losses. The problem for investors with this approach, however, is that the level of profit a company declares might vary depending on the stock exchange on which the company is listed and in particular the accounting standard which it uses to determine its pension cost.

Convergence of accounting standards in 2005 might mean that companies in continental Europe – and possibly also the US – will come more closely into line with UK practice under UK accounting standard FRS 17, helping to ensure consistency of reporting, but potentially revealing greater volatility in funding positions.

## Warning bells

Mature industries such as engineering, shipping and utility companies are likely to be the most severely affected by the change. The size of the retirement obligations in these sectors is likely to be significant relative to the size of the sponsoring business, because the obligations to retirees and vested members far exceed those for active employees.

These sectors, along with every other, have also been adversely affected by declining equity markets which have fallen over the last three years by around 50 percent. At the same time, the reduction in interest rates has increased the obligation on sponsoring employers.

Companies are also facing increasing obligations as a result both of improved longevity and greater employee protection, such as tighter vesting requirements in Germany or the requirement to provide pension increases in the UK.

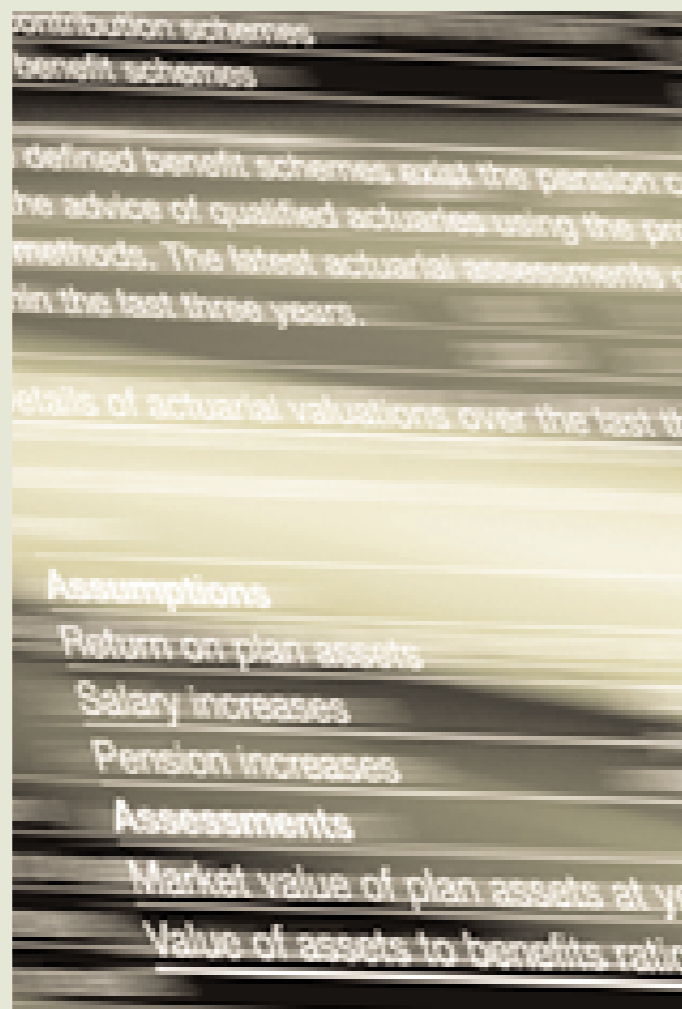
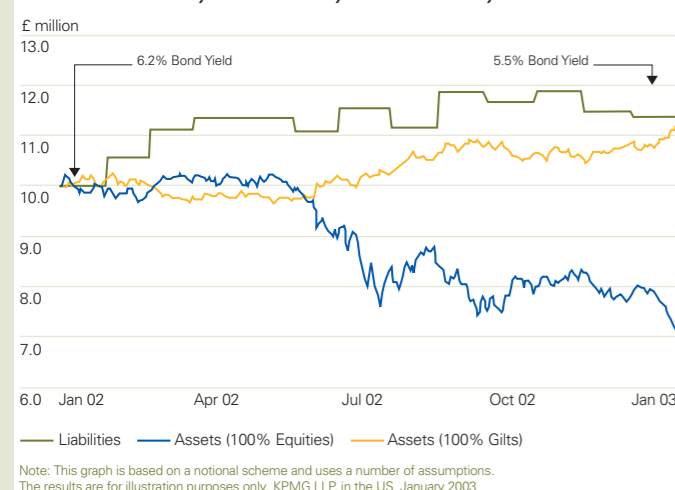
## CEO discussion points

- What steps are we taking to ensure that pension liabilities are contained at a level which is sustainable for the business?
- Are we aware of the impact which a harmonized standard similar in nature to the UK's FRS 17 would have made on our reporting over the past three years?
- In order to prepare for the change in reporting requirements, companies will need to consider the structure of their pension liabilities and assets and assess the potential impact on profitability. What changes might we consider to our investment approach in anticipation of declining profits and falling investor confidence?

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**Figure 4 The volatility of FRS 17**  
Balance sheet entry from January 2002 – January 2003



The result of these changes is that pension obligations might very well exceed the market capitalization of the sponsoring employer, which is somewhat ironic, since retirement funds such as those found in the US, UK, the Netherlands and Switzerland were established to provide a degree of financial security to employees should the sponsoring employer become insolvent.

#### Investor concerns

Key to the investor is the impact that the retirement obligation towards current and past employees has on the level of profitability and balance sheet of the company. Currently, the same company can show different levels of profitability and different levels of financial strength depending on the accounting standard under which it chooses to report its retirement obligations.

There are probably three influential accounting standards relating to pensions – the US standard FAS 87, the international accounting standard IAS 19 and the UK standard FRS 17 which is due to replace SSAP 24.

Greater consistency in the determination of pension costs is clearly desirable and indeed listed companies are likely to move closer to a common standard in 2005 through the

adoption of a new harmonized standard, an updated IAS 19. Although the US standard and the international standard are probably the most widely used, the UK standard is significant because it may signpost the direction that the updated IAS 19 is likely to follow. FRS 17 differs most significantly from the US and existing international accounting standard in that it does not permit the spreading of gains or losses arising over a year.

In terms of disclosing the balance sheet position, if IAS 19 follows FRS 17, the assets will be measured at market value and liabilities will be measured by using the discount rate underlying AA bond rates, and the net balance recognized in full. Where assets are predominantly equity based, this can give rise to significant volatility in the solvency position. In particular, the level of markets at the point when the solvency position needs to be disclosed becomes significant (see figure 4).

This is illustrated by the change in the value of assets and liabilities of a typical pension fund over the last two years. At times, assets and liabilities are in balance. At others, significant deficits arise.

#### Market volatility affects UK reporting

In general, the pensions charge on the profit and loss account is a combination of a current service cost (the cost of accruing another year's pension) and a financing cost. Under FRS 17, the finance cost is equal to the expected return on assets, less the interest on the pension obligation. While the interest cost on the pension obligation is driven by the yield underlying AA bond rates, the expected return on the assets is set by the sponsoring employer.

The International Accounting Standards Board has become alarmed at the apparent optimism struck by some employers against the backdrop of negative investment returns for the last three years and is likely to require the actual rate of return over the year to be used in preference to the employer's expected return. If the current economic climate were to persist, this would lead to significantly higher pension costs being recognized in the profit and loss account and consequently lower apparent profitability. Although FRS 17 has not yet been widely adopted by companies as their primary basis for reporting pension costs (merely used for mandatory supplementary disclosures), the impact of FRS 17 can already be felt in the UK in the following areas:

- Share price adjustments as the market appreciates the level of obligation that certain sponsoring employers have in respect of their retirement obligations.
- Review of credit ratings by credit rating agencies.
- Restrictions on dividend payments where distributable reserves are expected to be reduced by pension deficits.

This is not surprising when the deficits for leading UK companies were thought to be approaching UK£100 billion at the end of 2002.

#### Significant impact anticipated in US and Europe

Moving to a common international accounting standard similar to the UK's FRS 17 would have a significant impact in the US and continental Europe.

For continental countries such as Germany, abandoning the spreading of gains or losses would mean a step back to the traditional way of pension accounting, with the balance sheet reflecting immediate recognition of gains and losses.

In Germany, an interest rate of around 6 percent has generally been used irrespective of current market rates and is still used for domestic and tax accounting purposes. This fixed interest rate minimized the need for spreading gains or losses, a practice which only began in 1998 when standard life expectancy tables were altered.

Since German pension funds traditionally invest their monies conservatively, asset losses have not been disastrous, though more adventurous businesses which have adopted

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the contractual trust arrangements (CTAs) have invested mostly in shares and so face asset losses akin to their UK and US counterparts.

The current slide in interest rates is less disastrous for liabilities in the Euro zone than it is for Swiss or Japanese liabilities with the extremely low interest rates in these currencies.

In those countries where pension funds typically follow a less equity based investment strategy, moving to a standard similar to FRS 17 is likely to be less significant. However, the change in accounting practice is likely to cause greater reported volatility than investors have been used to. Share price adjustments and credit agency rating reviews and restrictions on dividend payments could be expected to dog the US market as they have the UK.

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