Reporting of Defined Benefit Cost in the Sponsor's Books in an Unregulated Setting: Australia Compared to the United States and the United Kingdom

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Abstract

This paper compares the development of the reporting for pension commitments by the sponsoring employer in Australia to that in the United States and the United Kingdom. In Australia, there are no measurement rules concerning the calculation of the periodic cost to the defined benefit fund (DBF) provided by the sponsor. By contrast, in the United States and the United Kingdom, accounting standards on this topic were introduced in 1987, and an international accounting standard first promulgated in 1983. The flexibility of accounting treatment in Australia permits managerial discretion when determining the contribution expense to the DBF and permits an assessment of how the actuary and the sponsor interact in an unregulated environment.

1. Introduction

This paper describes the history of superannuation in Australia and compares the reporting of superannuation commitments by sponsoring employers in Australia to practice in the United States and the United Kingdom.[1] Unlike overseas, there are no measurement rules concerning the calculation of the periodic cost to the defined benefit fund (DBF) in the sponsor's profit and loss in Australia.[2] The pay-as-you-go method, prohibited in the United States 35 years ago, is still permitted in Australia. Consequently, the contribution holiday (that is, the reporting of a nil pension cost in the sponsor's profit and loss) is unique to Australia. There are no recognition requirements by the Australian sponsor to record the unfunded accrued benefit as a liability, nor any rules about how to account for surplus on the sponsor's balance sheet. [3] However, the sponsor is required to make disclosures of its interests in DBF according to AASB 1028, "Accounting for Employee Entitlements," effective June 1995.[4] Australia intends to adopt international financial reporting standards by Jan. 1, 2005.

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[1] The terms "superannuation" and "pensions" are used interchangeably to describe post-retirement benefits. Superannuation funds are generally referred to as pension funds in the United Kingdom and the United States.

[2] Periodic costs refer to the reporting of expenses in the same period as payment rather than the matching of expenses with revenues. Period matching is also known as indirect matching (Hendriksen 1970, p. 188).

[3] More recently, the Australian regulator, the Australian Securities and Investment Commission (ASIC) called for listed Australian companies to report their defined benefit funding shortfalls accurately (ASIC Media Release 03-263, Aug. 21,2003).

[4] Information about the DBF in the sponsor's accounts is disclosed in an AASB 1028 footnote under "Accounting for Employee Entitlements," (AASB 1994, par. 14 (e), (i) and (ii)). Items disclosed include the net present value of pension assets, accrued benefits, vested benefits, surplus/deficit and the amount recognized in the profit and loss.

The debate on pension accounting in the United States and the United Kingdom has a longer history than in Australia. In the United States, the first accounting standard on pension accounting, Accounting Research Bulletin (ARB) 36, "Pension Plans: Accounting for Annuity Costs Based on Past Services," was issued in November 1948 (FASB 1948).[5] The current U.S. pension standard, SFAS 87 "Employers' Accounting for Pensions" was issued in December 1985 and became effective in 1987 (FASB 1985).

In the United Kingdom, SSAP 24, "Accounting for Pension Costs," was issued May 1988, amended in 1992 (ASB 1988) and recently replaced by FRS 17 "Retirement Benefits," issued in November 2000 (ASB 2000). International accounting standard (IAS) 19 "Retirement Costs" was issued 1983, revised in 1995 and 1999 and renamed "Employee Benefits" (IASC 1983, 1999).

Currently, there is a lack of harmonization between U.S., U.K. and international accounting standards on pension accounting. Standard setters overseas address some of the complex accounting issues for accounting for DBFs, although compromises are made. For example, in the United States, SFAS 87 endorses the "corridor method" to deal with actuarial gains and losses to alleviate concerns about volatility in the sponsor's profit and loss. FRS 17 in the United Kingdom does not permit the corridor method.

Furthermore, varying country-specific pension regulations work against harmonization of accounting standards. For example, the Employee Retirement Income Security Act of 1974 (ERISA) in the United States prompted the FASB to issue "Interpretation No.3, Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974" to clarify the sponsor's obligations and the accounting for pension fund requirements. Consideration of the sponsor's obligation collapses the debate into the legal versus the economic substance viewpoint. Proponents of the economic substance viewpoint argue that the sponsor's obligation under a DBF should not be restricted by purely legal considerations but also embrace other "moral" liabilities as well.[6]

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[5] This was followed by ARB 47 "Accounting for Costs of Pension Plans" in 1956 and Opinion No.8 "Accounting for the Cost of Pension Plans" in 1966. These early standards focus on the profit and loss impact of pension accounting. With the passage of ERISA in 1974, the FASB added the pension topic to its agenda. As an interim measure and dealing only with disclosures, FASB issued SFAS 36 "Disclosure of Pension Information" in May 1980. SFAS 36 was prepared to be consistent with Statement No. 35 "Accounting and Reporting by Defined Benefit Plans" also issued in 1980. Focusing on the accounting for pensions by the employer, FASB issued "Preliminary views on Employers' Accounting for Pensions and Other Post-employment Benefits" in 1982 (FASB 1982). This met with stern opposition.

[6] The legal view considers the pension obligation discharged by funding the pension fund and does not consider the accrued benefits of the fund to be liabilities of the sponsor. This is because most trust deeds provide for the sponsor to terminate the plan and so there is no legally enforceable obligation. The economic substance viewpoint is that while the accrued benefits of the fund may not represent strict legal liabilities of the sponsor (according to the trust deed), they may be construed as "moral liabilities." In the

The plan of this paper is as follows. The history of superannuation and the accounting for pension costs by the sponsor in Australia is described briefly in the Section 2. In Section 3, the development of accounting standards for reporting interests in DBFs by employers in the United States and the United Kingdom is discussed. Section 4 discusses current practice by Australian sponsors. Finally, Section 5 concludes that the differences between SFAS 87, FRS 17 and IAS 19 need to be addressed if international harmonization of accounting standards is to proceed. The flexibility of accounting treatment for interests in DBF by Australian sponsors will disappear as Australia converges with IAS 19.

2. Background

2.1 Brief History of Pension Funds in Australia

For more than 100 years prior to award superannuation, pension schemes in Australia were generally DBFs. These early funds were established mostly by banks, insurance companies and financial institutions (Richards 1972, p. 6). At the same time, some public sector superannuation funds were established, for example, the Police Superannuation and Reward Fund in 1862 (Ward 1998, p.10). Superannuation was regarded as a managerial gratuity because members were predominantly managers and white-collar workers (Ward 1998).[7]

Selective vesting rules in Australia was common and restricted superannuation benefits to a select few. Early vesting did not "catch on" in Australia, unlike in the United States and the United Kingdom, where enhanced retirement benefits were used to quell industrial unrest (Francis 1977).

Superannuation coverage for the general work force was low (only 32 percent of employees were covered in 1974). In 1983, the Hawke Government's "Accord" encouraged union interest in superannuation. The 1986 National

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profit and loss, the legal perspective records the expense as the amount funded to meet promised employee benefits while the economic substance view relates the expense to the pension asset/liability already recognized. In the latter case, funding is merely a shift of resources within the broader economic entity. Unfunded vested benefits represent legal liabilities of the sponsor if the pension legislation mandates this; then, the excess of accrued over vested benefits represents the "moral" liability.

[7] By contrast, U.S. pension plan membership in 1945 includes unionized workers in noncontributory DBFs and covers approximately 20 percent of private wage earners. By 1970, this coverage increases to 43 percent and is predominantly DBFs. By 1996, participation in DBFs fell to 50 percent and is replaced by contributory DCFs (OECD 2000). The switch from DBF to DCF takes the plan outside PBGC's jurisdiction (Brigham, Gapenski and Daves 1999, p. 896).

Wage case delivered a 3 percent wage productivity increase through superannuation rather than direct wage increases. This encouraged the growth of defined contribution (DC) funds and immediate vesting of benefits. Prior to 1992, Australia was one of the very few developed nations that did not have a national employment-related retirement income plan (Bateman, Kingston and Piggott 2001, p.118). In 1992, the Australian Government exercised its taxation powers and imposed a nontax deductible levy on employers that did not abide by the "compulsory" superannuation contribution rates for employees. The Superannuation Guarantee Charge commenced July 1, 1992, starting at 3 percent of employee earnings (7 percent from July 1, 1998; 8 percent from July 1, 2000) and increasing to 9 percent by 2002. The upshot was to increase the coverage of superannuation for Australian workers to 92 percent.

Also, combination plans, now referred to as hybrid funds, emerged in Australia during the 1970s.[8] These plans had a dual benefit structure, with the employers' benefits placed in the DB section and the employees' contributions plus investment earnings in the DC section. In this way, the advantages of both fund designs could be obtained.

The total assets invested by superannuation funds grew substantially. In 1983, the total value of assets invested by Australian superannuation funds was $32 billion, in 1991 the total was $135 billion and, by 1999, this had grown to $409 billion (Bateman and Piggott 1996, p. 56).[9]As of September 2002, assets invested by superannuation funds totaled $505.7 billion. Excluding funds with less than five members and statutory funds, the assets invested by superannuation funds in September 2002 total $380.733 billion, divided as $219.761 billion for corporate DC and $61.337 billion for corporate DB and hybrid funds, with the remaining $99.635 billion representing public sector funds.

2.2 Reporting by Australian Pension Funds to Members

Despite the strong growth in superannuation, the reporting and accountability by pension funds to members was extremely limited. Hubbard (1982) notes that most Australian pension funds did not circulate individual or

[8] A third type of benefit structure for a superannuation fund is a hybrid fund. Hybrid funds for accounting purposes are technically DBFs and, to this extent, the accounting issues endemic to the DBF also attach to the hybrid fund.

[9] The authors cite 1983 and 1991 statistics from Australia—Census of Superannuation Funds, Australian Bureau of Statistics and the Insurance and Superannuation Commission unpublished data. Also cited is the proportion of fund assets as a percentage of gross domestic product, increasing from 19 percent in 1983 to 36 percent in 1991 and 49 percent in 1995. Figures for 1999 are in the Australian Prudential Regulatory Authority Superannuation Trends, June 1999.

fund accounts to members but prepared audited accounts per the trust deed, and these were available for member inspection upon request. In 1982, the Australian accounting profession published Discussion Paper No. 7, "Accounting and Reporting for Superannuation Plans" (Hubbard 1982). This was followed by the issue of two exposure drafts in 1986. Accounting standard AAS 25 "Financial Reporting by Superannuation Plans" was finally released in August 1990 and provided for the inclusion of accrued benefits as a liability of the fund.[10] AAS 25 met with strong, widespread opposition from the superannuation and life insurance industries as well as the actuarial profession (see Klumpes 1994).[11]

2.3 Accounting for Pension Costs by the Sponsor in Australia

Accounting standard setters in Australia turned to accounting for pension plans by the sponsoring employers. The first exposure draft on accounting for pension costs by the sponsor, ED 53: "Accounting for Employee Entitlements," was issued in 1991 (AARF 1991), shortly after AAS 25. ED 53 also endured strong opposition. It requires that the net position of the plan (that is, the surplus/deficit calculated as the difference between the present value of accrued benefits and the net market value of plan assets) be recognized in the employer's accounts as an asset/liability. The market valuation of plan assets was also endorsed by ED 53 but the "corridor" method of SFAS 87 was not. Concerns that the ED 53 proposals introduce volatility into the employer sponsors' books resulted in the more difficult issues of accounting for DBFs contained in ED 53 being set aside for future deliberation. Consequently, there are no recognition (only disclosure) requirements for the accounting for superannuation funds by the employer in Australia at present.

In the sponsor's *profit and loss* statement there is no requirement to allocate the pension cost on a consistent basis across those periods expected to benefit from the employees' services. The superannuation expense is based on the cash contributions to the fund and the amount funded is the same as the amount expensed. The "pay-as-you-go" method, still tolerated in Australia but outlawed in the United States 35 years ago, results in a mismatching of the economic event with the payment for superannuation and does not reveal the financial effect of the DBF on the sponsor firm. The result is considerable

[10] Prior to this, the actuarial profession issued a booklet "Reporting for Superannuation Plans in Australia" in 1975, but with a message from the President of the Institute of Chartered Accountants in Australia supporting it (IA 1976). This booklet was the outcome of a Joint Liaison Committee established by the Institute of Actuaries (IA) in Australia and New Zealand and the Institute of Chartered Accountants in Australia (ICAA) in 1975. It represented the first pension fund reporting requirements for Australia.

[11] In July 2001, a proposed revision to AAS 25 was issued for comment by the ICAA.

variability in reporting periodic pension costs in the sponsoring firms' profit and loss. Subject to actuarial approval, the sponsor may take a "contribution holiday." A contribution holiday permits the sponsoring employer to cease funding and reduce the contribution expense in the sponsor's profit and loss to zero.[12] Also, the size and disposition of the surplus may provide opportunity to take a contribution holiday. For example, the larger the surplus, all other things being equal, the more likely management are to take a contribution holiday.

In the sponsor's *balance sheet* the appropriate treatment of pension assets and pension liabilities is unresolved in Australia. AASB 1028 requires disclosure only of the pension surplus/deficit in the notes to the accounts of the sponsoring employer. The actuarial profession in Australia supports the legal view and argues that the accrued benefits and pension assets attach to the fund (that is, the trust) not the employer. On the other hand, standard setters in Australia (in ED 53) support the economic substance view and argue for the inclusion of the pension deficit/surplus as a liability/asset in the sponsor's balance sheet. However, the surplus of the DBF is not necessarily considered a prepayment of contributions by the employer to be used for the employer's benefit.[13] The "ownership" of surplus in Australia is uncertain with common law suggesting the surplus should be "shared" between the employer and the members of the fund.

3. Accounting for Pension Costs in the United States and the United Kingdom

At present, there is only partial harmonization between the pension standards in the United States and the United Kingdom. SFAS 87 in the United States endorses the "corridor" method to reduce the volatility of the pension cost caused by actuarial gains and losses. SFAS 87, par. 32, requires recognition of actuarial gains and losses outside a 10 percent corridor (if net cumulative unrecognized actuarial gains and losses exceed the greater of 10 percent of the projected benefit obligation or 10 percent of the fair value of plan assets).[14] FRS

[12] Most corporate DBF in Australia are governed by a trust deed and are employer specific. The employer normally retains the right to suspend contributions (subject to actuarial approval) and terminate the fund. The employer's access to the net assets of the DBF (for example, a contribution holiday) is determined, in the first instance, by reference to the fund's trust deed. The Superannuation Industry Supervision Act (SIS), effective July 1, 1993, and the SIS Regulations, effective July 1, 1994, do not disallow an employer taking a contribution holiday.

[13] In the United States, most DBFs are noncontributory so that the surplus of the fund is considered a prepayment of contributions by the sponsor to the fund. In Australia, DBFs may be both contributory and noncontributory.

[14] The minimum amount that an entity should recognize is the part that fell outside the corridor at the end of the previous reporting period, divided by the expected average remaining working lives of the

17 does not follow the "corridor approach" but requires that actuarial gains and losses be recognized immediately in the statement of total recognized gains and losses.[15] Relative to SFAS 87, income under FRS 17 would exhibit more volatility. IAS 19 (revised 1998) is also flexible because it tolerates all methods—that is, either the "corridor" approach, immediate recognition or some other systematic write-off of actuarial gains and losses provided the same basis is applied to gains and losses and it is applied consistently over time. Currently, the varying accounting treatment for actuarial gains and losses is an impediment to harmonization.

Another source of difference between SFAS 87 and FRS 17 is the treatment of the pension surplus in the sponsor's balance sheet.[16] FRS 17 endorses symmetry of treatment of the pension deficit/surplus in the sponsor's balance sheet but SFAS 87 does not. FRS 17 (par. 37) requires the recognition of the DBF surplus/deficit (calculated as the excess/shortfall of plan assets over the present value of plan liabilities) in the balance sheet. The upper limit on surplus recognition is the extent to which contributions may be reduced in the future or return of surplus effected. SFAS 87 requires recognition of a minimum liability (calculated as the excess of the accumulated benefit obligation, without salary projection, over the fair value of pension assets for each plan), but does not require recognition of an asset when the fair value of pension assets exceeds the accumulated benefit obligation.[17, 18]

Until recently, the variety of actuarial methods permitted also compromised international comparability of pension costs among sponsor companies. The accounting profession in the United States (and more recently the United Kingdom) and the IASC require use of the projected unit credit

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employees participating in that plan. The interval ± 10 percent acts as a corridor within which gains and losses are not recognized (Dufresne 1993, p.2).

[15] The U.K. Accounting Standards Board (ASB) is also working closely with the IASB on a joint project on the performance statement.

[16] Actuaries are not as concerned by an unfunded deficit because it is determined more by the contributions promised in the future than by past events. An unfunded deficit is not considered a liability by the actuarial profession because it is better described as "an anticipated shortfall in future normal contributions" (Ezra 1980, p.48).

[17] In the United States, insurance with the PBGC gives unfunded pension plans a lien of up to 30 percent of firm assets in the event of a shortfall between vested accrued benefits and pension assets.

[18] Unlike the pension cost in the profit and loss based on the projected unit credit method, the calculation of the additional minimum liability is based on the accumulated benefit obligation (that is, without taking account of future salaries) to lessen the change from current practice.

method (part of the accrued benefit family method.[19] Similar to the unit credit method, the projected unit credit method accrues the member's pension benefit each year as it arises thus ensuring the pension benefit is paid as it accrues, but uses future salary levels to do so. In the United Kingdom, SSAP 24 did not attempt to judge the accrued benefit or projected family methods as conceptually superior, but FRS 17, issued recently, requires use of the projected unit credit method. In Australia, an actuarial costing method is not mandated.

4. Current Practice for Accounting for Interests in DBF by Australian Sponsors

Prior to 2000, most DBFs in Australia were overfunded and sponsor-employers benefited by taking a contribution holiday.[20] Institutional arrangements in Australia defer prerogative rights to the employer so that the employer has discretion concerning the contribution holiday. The SIS Act gives the employer-sponsor control over the contributions to the fund. For example, for the DBF, changes to the rate of employer contributions (including discontinuance), changes to the admission of new members or classification of members, changes to the admission of new employers and terminating the plan do not need the ratification of the trustee.[21] This is subject to the actuarial valuation and the terms of the trust deed. Of 1,500 firm years (sampled as 300 firms for five years from the top 500 companies listed on the Australian Stock Exchange), there are 441 sponsor firm years and, of these, 189 firm years were on a contribution holiday for the period from 1995 to 1999. Not all companies clearly disclose if they are on a contribution holiday.

The incidence of the contribution holiday is subsiding with reports of the "superannuation black hole" in Australian superannuation funds caused by falling equity markets (*Australian Financial Review*, Dec. 13, 2002). Concerns over inadequate disclosures and dated actuarial reports makes assessment of the extent of DBF deficits difficult in Australia. Only a handful of companies disclose actuarial assumptions, and plan assets and accrued benefits are frequently measured at differing dates. The Australian Securities and Investment

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[19] Using this method, the contribution required in a year is composed of two parts: the normal cost (the present value of all future benefits accrued in the year) and an amount to cover any unfunded accrued liabilities (which is an allowance for actuarial assumptions deviating from actual past experience).

[20] Alternatively, the sponsor can recoup the DBF surplus as a lump sum. The SIS Act (s. 117) requires that the following conditions be met prior to a payment out of surplus to the employer: (a) equal employer and employee representation on the fund's board, (b) certification by the actuary that the fund will remain in a satisfactory position after the payment of surplus, (c) three months notice of the payment has been given to the members, d) the trust deed permits such a payment, and (e) that the trustees of the fund are satisfied that the payment represents a reasonable resolution of interests between the employer and the members.

[21] For other plans, the SIS Act requires the trustee's approval to change the trust deed.

Commission is encouraging sponsors to review their defined benefit arrangements and, if a legal obligation for any deficit exists, to report it.

5. Conclusion

This paper bridges the gap in the literature between the history of pension accounting in Australia and the related overseas experience. There is a lack of international harmonization of accounting standards on accounting for superannuation costs in the books of the sponsoring employer. The new standard FRS 17 in the United Kingdom is very different from SFAS 87 in the United States and IAS 19 (revised). SFAS 87 supports the "corridor" smoothing technique in the profit and loss, while FRS 17 supports immediate recognition of actuarial gains and losses. For the balance sheet, FRS 17 recognizes both the net pension asset and liability, while SFAS 87 recognizes only a "minimum" liability. These differences are substantial and need to be settled if international harmonization is to be achieved.

In the absence of an accounting standard on accounting for pension costs in the employers' books, the Australian Accounting Standards Board (AASB) intends to harmonize with IAS 19 (revised). The harmonization program has been delayed because AASB considers that IAS 19 (revised) contains too many options on the treatment of actuarial gains and losses. Stressing comparability, the AASB rejected IAS 19 (revised). By permitting alternative methods of amortization of actuarial gains and losses, compliance with this standard could result in two companies with identical superannuation commitments reporting divergent balance sheet and profit and loss amounts (AARF 1998). The unregulated setting in Australia permits testing of the determinants of the DBF cost to see if actuarial variables dominate the funding decision. This will inform how the actuary and the sponsor in Australia interact and the level of regulation required. For example, if the actuarial variables dominate the determination of the DBF cost, then it is likely that the actuarial profession is acting as intended.

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