May 25, 2004

ACCOUNTING FOR IMPLICIT PENSION LIABILITIES

PROPOSALS FROM NATIONAL ACCOUNTANTS FOR A CHANGE OF SNA 1993/ESA 1995

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Reasons for the review of the current SNA/ESA

1. The *1993 SNA* recognizes retirement pension obligations as liabilities only for employer schemes and only when they are "funded", i.e., when they maintain "segregated reserves" (widely interpreted as segregated assets).

2. Such a position creates an unhealthy situation where mere differences in financing arrangements lead to noticeable differences in recording, with substantial associated risks of biasing against reform, notably of civil servants pensions. It also leads to numerous accounting anomalies, notably at time of transfers of pension rights from one scheme to another, including at time of liquidation or assumption of entire schemes (France Telecom or Belgacom cases).

3. At a more conceptual level, the current criteria laid down in the *1993 SNA* for pension liability recognition deviates from the fundamental asset recognition criteria otherwise followed in the *1993 SNA* (and from most business accounting frameworks, see IAS[1] recommendations below), which rely on whether a promise or obligation is enforceable and whether future economic benefits will flow from it. This creates an unhealthy situation where households' SNA net worth depends on the financial arrangement of the scheme, instead of the solidity (legal as well as economic) of the claim, which would appear more logical. The measure of households saving is also distorted in so far as the economic behavior of households depends on their perception of the solidity of their pension claims.

4. The *1993 SNA* pension recording rules seem neither to follow an accrual principle (actual contribution measurement) nor the market valuation principle (residual obligation of the employer to the fund).

   a. The *1993 SNA* measure of cost of labor is noticeably distorted and deviates from GAAP[2]: (1) it includes actual pension contributions of funded schemes, so that contribution holidays or supercontributions impact the cost of labor [3] (despite the fact that they often originate from overperformance or underperformance of fund's assets); (2) the *1993 SNA* allows accounting for

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[1] International Accounting Standards (IASs) from the International Accounting Standards Board (IASB).

[2] Generally Agreed Accounting Principles, i.e. business accounting principles. As an example, in IAS 19, the cost of employment is decomposed in a *current service cost*, which captures the actuarial value of new entitlement rights accrued by staff employed during the period, a *past service cost*, the *interest cost* (interest on pension obligations), the *expected return on (net) assets* minus/plus the *amortization of the cumulated unrecognized actuarial gains/losses*. The expected return on assets is currently reported in income and the difference between the expected return and the actual return is treated as an "actuarial gain and loss", the recognition of which is currently allowed to be deferred. Hence, IAS 19 currently allows enterprises to delay the recognition of *net plan assets* on their balance sheet and therefore the impact on their operating statements, by way of imputing an *expected return on plan assets* (IAS 19 Para 105–107) and defining a *cumulated unrecognized actuarial gains/loss* to be amortized gradually over time (outside of a corridor of +/-10 percent).

[3] See Enrica Detragiache's EDG contribution and her IMF Working Paper WP/03/222 dated November 2003, *Company Pension Plans, Stock Market Returns, and Labor Demand* (at: http://www.imf.org/external/pubs/ft/wp/2003/wp03222.pdf).

the cost of labor of unfunded schemes using the amount of pension benefits provided, a poor proxy. In contrast, the GAAP cost of labor focuses on the actuarial value of additional promised benefits. Such a SNA labor cost valuation distorts the measure of GDP (when the employer is nonmarket) or the gross operating surplus (when it is market).

b. Recent falls in the price of companies' shares originating from adverse news related to the underfunded position of their pension funds have triggered a further rethinking on how to account for pension promises. This has inspired a trend amongst accountants favoring immediate recognition of employer pension liabilities and abandoning the deferment option (see IASB project on IAS 19 revision).

5. Leading business accounting standards — such as FAS 87 (US) or as IAS 19, which will be enforceable in 2005 for all listed companies in the EU and is applied in some other OECD countries — require the recording of a pension liability even for unfunded employer schemes, although they allow delayed recognition of liabilities arising from actuarial profits/losses. It is worth noting that the UK standard, FRS 17, has already dropped such a deferment option and instead prescribes immediate recognition (starting 2005), with actuarial gains/losses being entered directly against equity (and only gradually transiting thereafter through the profit and loss account).

6. The new IMF sponsored *Government Finance Statistics Manual 2001* (*GFSM 2001*), which otherwise closely aligns with the *1993 SNA*, recognizes unfunded pension obligations as liabilities. The IFAC PSC[4], producer of the International Public Sector Accounting Standards (IPSAS), recognizes IAS 19 as appropriate in relation to employer pensions (i.e., civil servant schemes) and has established a project on public pensions (Steering Committee on Social Policy Obligations[5]). The current SNA puts national accountants in a strange position: their system would not recognize a liability that is nonetheless recognized by the economic agents themselves in their own accounts. Such a contradiction already led countries (Australia, Canada) to not strictly follow the *1993 SNA,* thus decreasing international comparability.

7. At a time when aging of population is of matter of great concern and having in mind a renewed interest for international comparability as well as for proper accountability by government of their commitments, the statistical community examines again – at the occasion of the on-going review of the *1993 SNA* – how the unsatisfactory existing SNA pension treatment can be reviewed. Discussion is being conducted via an Electronic Discussion Group (EDG), accessible at: http://www.imf.org/external/np/sta/ueps/index.htm.

<u>EDG propositions currently examined</u>

8. The EDG proposes (1) abandoning the funded/unfunded delineation; (2) using actuarial valuations for both stocks and flows; and (3) allocating the funds' net assets to employers. Propositions center on defined benefit schemes (no proposition of change concerns defined contribution schemes[6]).

9. As a first step, the EDG proposal is restricted to employer schemes, because the benefit provided is clearly of a nature of a deferred compensation (in contrast to other pension schemes, such as those by

[4] International Federation of Accountants – Public Sector Committee.
[5] See exposure draft at: http://www.ifac.org/Guidance/EXD-Details.php?EDID=0031
[6] While in need of clarification, the recording of defined contribution schemes is satisfactory in the *1993 SNA*: a liability is systematically recognized, equal to the (market value of) fund's assets.

social security), and because the *1993 SNA* already treats employer schemes differently. Some accountants consider that accrual accounting does not encompass social security obligations. However, recent classification difficulties linked to new cases (e.g., Polish case) have led some to believe that a more wide-ranging rethinking of *1993 SNA* may be warranted to ensure better international comparability; in addition, they note that the observed anomalies linked to the treatment of transfers of pension entitlements between schemes probably cannot be fully clarified if the extension to public pensions was not made.

10. The proposal applies to all employer schemes: private employers as well as government, because, in the *1993 SNA*, institutional sector considerations are generally not an appropriate justification for differences in recording. The most visible impact for users of national accounts data will be on general government accounts.

Liability recognition

11. The EDG proposes recognizing a scheme's pension liability (an asset for the households) when there is a legal obligation or when the obligation is such that it would be a "constructive obligation" under GAAP. Constructive obligations are (according to the IASB) "obligations that derive from an enterprise's actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the enterprise has created a valid expectation on the part of those other parties that it will discharge those responsibilities". Liability recognition would not depend on whether the scheme is funded or not, i.e., **unfunded schemes would be treated as if funded.**

12. The recognized liability is to be limited to the rights accrued to date, i.e., originating from work done in the past. Since those additional pension promises originating from future work are not recognized as schemes' liabilities, by the same token, expected future contributions are not recognized as schemes' assets.

13. Recognizing a liability for unfunded schemes changes substantially the pension mathematics, with the important consequence of increasing employers' expenses, owing to the fact that the liability now generates a property income payable (its increase over time, as the discount factor unwinds).

Actuarial valuation

14. The EDG proposes following business accounting for the **valuation of compensation of employees** (as well as for property income attributable to property holder), taking the present value of additional rights accrued (actuarially estimated) due to the work service delivered during the period.

15. The proposition merely extends throughout the whole sequence of flows the *1993 SNA* reference to actuarial valuation, in a way that reduces inconsistencies. The *1993 SNA* refers to actuarial valuation of unfunded schemes' social contributions and requires actuarial valuation for stocks of pension liabilities.[7]

16. In this context, actual contributions become merely financial transactions, without impact on the cost of labor. Changes in stocks of pension liabilities originating from changes in discount rate and in other actuarial assumptions would be recorded not as transactions but as revaluations or in a special account called "other changes in volume", with the consequence of avoiding any impact on the main

[7] Respectively: SNA 7.45, ESA 4.99 and SNA 13.76, SNA 13.78, ESA 5.101, ESA 7.59.

balancing items (income, saving or net lending borrowing) of the revenue and expense accounts. Hence, the EDG proposition will not increase the volatility of income and instead has the potential of reducing it.

17. **Unfunded schemes**. From the point of view of the employer, the recognized expense associated to an unfunded pension would considerably increase: while the net impact of a change in treatment on the cost of labor may be positive or negative (it is a function of the maturity of the scheme and of the expected growth rate / discount rate differential), a new property income on the pension liability appears as a new expense. Supposing unchanged actuarial assumptions, the degradation in net lending/net borrowing corresponds to the trend increase in scheme liabilities; under a steady state regime involving a 20% of GDP pension debt and 6% nominal GDP growth rate, the published deficit increases by 1.2 points of GDP. The appendix illustrates the impact of the change for an unfunded general government employer scheme.

Allocation of the fund's net assets to the sponsor

18. The EDG proposes **allocating the fund net assets to the employer/sponsor**: when it is underfunded, the employer has a liability; when it is overfunded, the employer has (generally) an asset. It more correctly represents the extent of the employer obligations. The net worth of the sponsor does not depend on whether the scheme is consolidated or not with its accounts, avoiding the impact of obscure debates on the classification of schemes. This allocation is also the logical consequence of the fact that contributions are now measured when accrued and that further employer obligations originate from other changes too (e.g., performance of assets, change in actuarial assumptions).

Implementation issues

19. The switchover to actuarial valuation for flows and the recognition of unfunded flows in national accounts will require that national accountants familiarize with pension recording and actuarial questions but also use new source data.

20. In relation to schemes/funds organized by **private enterprises**, the relevant information exists, both in the accounts of the enterprise and in that of the scheme/fund. On the other hand, (unfunded) **civil servants** schemes may not yet produce reports with the necessary information. This situation is unsustainable and governments need to appoint actuaries to inform them about the extent of the obligations towards the pensioners (civil servants). Flexibility may be advisable for a transition period: when no information is available for unfunded schemes, a liability may be estimated using same-scheme ratios; and a property income would then be calculated using domestic interest rates.

21. On the conceptual side, one issue is the choice of the appropriate discount rate and the income volatility in the accounts it may impart. Such a choice should be consistent with built-in actuarial inflation assumptions. Some prefer using a nominal discount rate instead of a real discount rate (the rate of government inflation-indexed bonds), others prefer using a fixed rate instead of a market rate. Another issue is the exact basis for compiling projected benefits. Finally, some issues relate to the recording of changes in benefit structure (to expense or not?), as well as some other actuarial changes. The EDG report (available as room document) describes those issues in further detail.

Appendix: Simulation of the impact of the proposed change on an unfunded general government employer scheme

1/ Current SNA: The government imputes 14 of social contributions (D122) to its employees (households) as part of compensation of employees. In principle, the *1993 SNA* recommends that this represents the present value of future benefits to be paid that have been gained by employees during the accounting period (actuarial calculations). We will suppose here that this principle is implemented[8]. The government receives 1.5 of employee contributions (D6112) and 14 of employer contributions (which is equal to the 14 paid as part of compensation of employees: see footnote 8). It pays 11 in pensions (D62). The net lending/borrowing (surplus/deficit) is 9.5, which corresponds to the net disbursement in cash (F2).

General government unfunded employee scheme: current SNA recording

	Imputed flows are in italics	**General government**	
		uses	Resources
D122	*Imputed employer contributions*	*14*	
D6112	Employee contribution		1.5
D612	*Employer contribution*		*14*
D62	Pensions	11	
B9A	**Net lending/ net borrowing**	**-9.5**	
	Financial accounts	*ΔAssets*	*ΔLiabilities*
AF2	Cash	-9.5	
B9B	**Net lending/ net borrowing**		**-9.5**

8 In fact, the *1993 SNA* allows this amount to be equal in practice to benefits paid (11 in our example). This gap between theory and practice is not important in the context of these accounts, as the convention is to record this (imputed) payment (D122) to employees but at the same time to record an equal (imputed) payment (D612) from the employees to the employer. Thus the two flows compensate each other, and whatever the amount, it will not affect the deficit.

2/ Proposed change: The essential difference with the previous account originates from the fact that we now record flows as if the arrangement was a saving scheme[9], with the recognition of a debt / liability. In particular, contributions are considered to increase the debt, payments of pensions decrease the debt.

Let us describe all the lines. First, the same amount of imputed social contributions is recorded as part of compensation of employees. However, the big difference with the previous accounting system is that there is no more a corresponding resource/receipt of imputed contributions; instead, employer contributions received are recorded as an increase in debt, and appear in the financial transactions (below the line of net lending/borrowing). As a result, the actuarial social contributions fully impact the deficit, which is therefore increased by this amount compared to the previous situation. Second, the pension payments disappear as a use/expense above the line and are recorded below the line, as a decrease of the pension debt. Third, an imputed charge of property income (interest) of 6 (D44) appears in relation with the recognition of the liability (also called "contribution supplement"). Fourth, employee contributions are also recorded under the line. Overall, the deficit is thus increased by 10.5 (14 – 11 + 6 +1.5), reaching 20.

In the financial accounts, a change of 10.5 in debt in "net equity of households on pension funds" appears. It corresponds to an increase of the liability corresponding to all contributions (1.5 + 6 + 14) minus payments of pension benefits (11).

General government unfunded employee scheme: new SNA recording

	Imputed flows are in italics	General government	
		Uses	Resources
D122	*Imputed employer contributions*	*14*	
D44	*Imputed property income*	*6*	
B9A	**Net lending/ net borrowing**	**-20**	
	Financial accounts	*ΔAssets*	*ΔLiabilities*
AF2	Cash	-9.5	
AF612	Net equity of households in pension funds		10.5 (1.5+*6*+*14* – 11)
B9B	**Net lending/ net borrowing**		**-20**

It is important to understand that this new account rightly reflects the impact of the new commitments that the employer made during the period. In the long-term, and taking into account a whole cycle of pension debt creation *and extinction*, the cumulated deficit of the previous account and of this one are equal. The timing is however different, the last one giving a better picture in terms of structural deficit.

[9] An exhaustive presentation would have shown additional lines of employer contributions (D.612) and pensions (D.62), plus an adjustment, called "adjustment for net equity of households" (D.8), just before the line B.9A. The sum of these additional entries is equal to zero. They have therefore no impact on the balancing item under review and are less essential in the context of this presentation. They have been omitted here, as they could confuse readers.