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Corona and pension liabilities in your financial statements

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Introduction

For many companies, COVID-19 (hereafter Corona) has direct visible consequences on cash, revenue and net earnings. However, some consequences are not directly visible. Especially, the effects on the provisions will only become visible once the company starts preparing its accounting statements. Possibly this will not be until the end of the year. Many companies, particularly listed companies, will have to act earlier: when preparing their quarterly or semiannual reports.

This article explains the impact of the Corona crisis on the provisions for deferred employee benefits in the accounts of listed companies. More specifically: the impact, under IAS19, on companies with defined benefit plans (DB plans). Similar observations can be made for companies using American accounting rules (ASC715).

IAS19: Pension provisions are long-term provisions

The long-term character of DB plans means that a significant number of assumptions is required to determine the liabilities. The most important assumption is the discount rate, but other assumptions are important as well. They include the (long-term) inflation expectation, expected indexation and long-term expectations for wage increases. It is also important to understand which demographic assumptions will be affected by Corona. How will Corona affect the expected mortality or the expected employee turnover? Will Corona lead to a reorganisation or to an adjustment in the pension plan? Most plans in the Netherlands are backed up by an insurance contract or by resources in a pension fund. What does this mean? And what would be the effect of postponed payment of premiums?

We will consider the different aspects that affect the liability on a company's balance sheet. We will also explain whether an increase or decrease of the liability will first appear in the profit and loss statement or will go directly to equity.

IMPACT OF THE DISCOUNT RATE ON THE PENSION OBLIGATION

The relevant discount rate for IAS19 is the interest rate on high-quality corporate bonds. In general, we assume the use of corporate bonds with AA ratings. The market shows that the rates on corporate bonds increased significantly since the beginning of the crisis. This is advantageous for companies: a higher rate means lower pension obligations. This is different from what we see in Dutch pension funds. The interest rate used by these funds decreased, hence resulting in higher reported pension obligations. The rate on corporate bonds decreased between the end of March and the end of May, whereas the rate used by pension funds hardly changed during this period.

With IAS19 interest rates, which are currently substantially higher than at the end of 2019, significantly lower pension liabilities are expected. Some caution with the corporate rating should be exercised when determining the interest rate of corporate bonds. It is possible that the risks of a corporate bond or a company (whether or not as a result of Corona) have reached such a level that it loses its AA rating. With the lower rating, it would no longer be justified to include the bond in the mix of bonds that is used to determine an IAS19 discount rate. A company or bond losing its AA rating should be spotted on time and should be excluded from the mix.

A decrease in the pension liability due to an increase in the discount rate is not accounted for in the profit and loss statement but directly in equity.

IMPACT OF THE DISCOUNT RATE ON THE INVESTED FUNDS

Companies are required to place their pension plan assets outside of the company, for example with an insurer or with a pension fund. Therefore, there will always be assets outside of the company covering the pension liabilities. These assets may contain stocks and bonds, but could also be insurance contracts. The company's balance sheet shows the surplus or deficit of assets over liabilities.

Some companies have their pension plans with a company pension fund. We have seen that, because of Corona, pension funds suffered significant losses on their investments in stocks. Following the strong rise in credit spreads, corporate bonds also showed a decrease in value. For government bonds, this decrease was milder. On the other hand, several pension funds reported increases in the fair value of assets due to interest rate hedging. Such increases (partly) offset the aforementioned losses on stocks and bonds. The total losses on the invested assets would then be much less than expected, based solely on the losses on stocks and bonds. This could lead to significantly lower reported pension liabilities for the company. On the one hand this is due to the lower value of the pension benefits, on the other hand it is due to the moderate loss (potentially even gain) in the value of the assets.

Companies that fund their pension plans with an insurer must determine the value of the assets by the value of the insurance contract. For this purpose IAS19 prescribes the IAS19 discount rate. The asset value of this contract will decrease with an increase of this discount rate. The value thus moves along with the value of the IAS19 pension obligations, leading to a relatively limited decrease in the pension liability on the company's balance sheet.

IMPACT ON THE EXPECTED INDEXATION UNDER IAS19

Most Dutch pension plans have a conditional indexation, where the available assets (in the fund, in the contract) and the returns on these assets, will entirely be used for pension benefits. If the value of the assets remains the same, then a decline in liabilities due to higher discount rates might be compensated by an increase in liabilities due to higher indexation expectations. The net effect on the balance sheet would then be limited. Points of attention are:

- Companies with their own pension funds, where the fund hedges the interest rate risk. The fund will use its own (risk-free) discount rate to do so. This rate is currently lower than at year-end 2019. This means that the interest rate hedge could have led to higher asset values. Consideration should then be given to the impact of these higher asset values on the indexation parameter.
- Companies with an insured plan, where the nature of the plan, the nature of the profit sharing or the nature of cost calculation result in DB classification under IAS19. In general, insured policies should be valued with the same assumptions (especially discount rate and mortality) as the liabilities. The value of the policies thus moves along with the value of liabilities. The impact of higher interest rates, if applicable, will probably be limited.

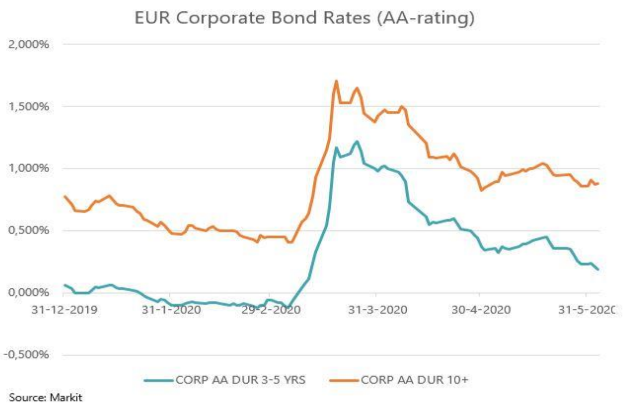
Companies with unconditional indexation (such as unconditional price compensation or unconditionally following the indexation by an industry-wide pension fund) will have to determine what Corona means for the expected inflation or for the expected indexation by the industry-wide pension fund.

A change in the balance sheet liability, due to an adjustment in the expected indexation, is not recognised in the profit and loss.

HOW DOES CORONA AFFECT THE EXPECTED WAGE INCREASES?

The impact of Corona on the expected wage increases will strongly depend on the sector and on how much room collective labour agreements contain for wage revisions. Sectors that are heavily affected by Corona are likely to show limited wage increases in the short run, perhaps even (temporary) decreases. However, IAS19 focuses on the long run. This could mean that, due to Corona, a company should apply lower wage increase assumptions for the next two or three years and that the regular long-run assumptions are applied again after those two to three years. The lower wage increase assumption reduces the pension liability on the balance sheet.

A change in the balance sheet liability following a change in the expected wage increases is not recognised in the profit and loss.



HOW DOES CORONA AFFECT MORTALITY EXPECTATIONS?

So far, the market (both pension funds and companies) does not deem it necessary to adjust the assumptions used at year-end 2019. In September 2020, the Royal Dutch Actuarial Association is expected to give an update on its mortality tables. Pension funds and companies are expected to use these updated tables, once they are available. Currently, it is unknown whether this will lead to higher or lower pension liabilities.

A change in the balance sheet liability following an adjustment of the expected mortality is not recognised in the profit and loss.

HOW DOES CORONA AFFECT EXPECTED EMPLOYEE WITHDRAWALS?

For pension plans, the expected impact of the withdrawal probabilities in the Netherlands (with DB plans based on average pay) is limited. The impact is not recognised in the profit and loss.

For jubilee plans and other “non-activity” plans, a higher employee turnover is likely to lead to benefits for fewer people. A higher assumed withdrawal rate could then lead to significantly lower balance sheet liabilities. For these plans, this decline is fully recognised in the profit and loss statement.

HOW DOES CORONA AFFECT THE COMPANY? WHAT WOULD BE THE IMPACT OF A REORGANISATION?

It is possible that Corona leads to a reorganisation within the company, resulting in fewer people covered by the plan. Past service pension liabilities, resulting from expected future benefit increases, will lapse and the company’s balance sheet liability will decrease. Under IAS19, this decrease should entirely be recognised in the profit and loss. Under the American accounting standards (ASC715), the recognition depends on other factors as well and it cannot be said in advance whether this decrease in liabilities will impact the profit and loss and, if so, by how much.

It is recommended to discuss a reorganisation plan with your auditor and actuary to ensure it can properly be taken into account in the company’s interim report. According to IAS19, a company must incorporate the impact of a reorganisation when agreement is reached between the employer and the employees. As from the time of the agreement, the company should determine its pension cost with the assumptions at that time. As a result, there will potentially be a lower pension cost for the remaining part of the year, not only due to lower participation but also because of the higher discount rate.

HOW DOES CORONA AFFECT THE CONTENT OF THE PENSION PLAN? WILL IT BE ADJUSTED?

Corona might result in companies adjusting their pension plans, such as with a temporary suspension of the pension accrual or with other cutbacks in the plan. The company must recognise plan adjustments, when agreement is reached between the employer and the employees. The resulting gain should be recognised in the profit and loss.

In this case as well, it is recommended to discuss the plan adjustments with your auditor and actuary to ensure these factors are properly taken into account in the company’s interim reports. Also, according to IAS19, the pension cost for the remaining part of the year should be based on the assumptions at the time of the plan adjustment.

HOW DO DELAYED CONTRIBUTIONS AFFECT THE COMPANY?

A delay in pension contributions does not affect the IAS19 or ASC715 pension cost and pension liability, provided that it also remains without consequences for the pension benefit. Assuming that the delay does not affect the pension benefit, the later payment merely increases the pension liability with the amount of the delayed payment.

Conclusions

Due to the Corona crisis, the assumptions that are used to determine the pension liability on the company's balance sheet could change significantly. A revision in these assumptions is likely to lead to (potentially much) lower pension liabilities. This decrease should be recognised directly in the company's equity, not via the profit and loss.

A change in the assumptions will, most likely, also lead to lower liabilities for of other deferred employee benefits. This reduction should enter equity via the profit and loss.

The situation with the company may be such that agreement with its employers (works council) will be needed on a reorganisation or a plan adjustment. Should this be the case, then the company must recognise the impact on its liabilities in the profit and loss.

Corona has led to strongly changed market circumstances and this could significantly affect the company's balance sheet liabilities for deferred employee benefits. Companies that publish quarterly or semiannual results will have to show the impact in their intermediate reports, most likely with help from their accountants and actuaries. Waiting until the end of the year is no longer an option.

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