UNUSUAL PENSIONS ISSUES

INTERNATIONAL MERGERS AND ACQUISITIONS CAN INVOLVE COSTLY OR TIME-CONSUMING PENSIONS ISSUES IF NOT SPOTTED IN TIME. **CHRISTINE SOANES** OF LANE CLARK & PEACOCK EXAMINES SOME OF THESE ISSUES AROUND THE WORLD.

During the 1990s, the value of crossborder mergers and acquisitions (M&As) rose by roughly 700%, with Western European nations at the forefront of the trend. This growth is expected to continue. Over the same period there has also been an increasing awareness of the financial significance of pensions as key elements within these transactions.

Every country is obviously different and each has its own wide range of issues that must be borne in mind. So what might one come across in an international pensions due diligence? Unfortunately, the answer is, be prepared for virtually anything. Here are a few brief examples I have come across:

- liabilities for pensions and termination indemnities reported in French accounts, but not included in the balance sheet (that is, included only as an 'off balance sheet note');
- when taking on pensioner liabilities in Germany, typically financed internally through book reserves, the tax framework did not make it easy to 'buy out' these liabilities with an insurance company, leaving the purchaser continuing to have to book reserve and pay pensioners directly;
- a liability under US GAAP for post-retirement healthcare in South Africa, where just 19 individuals had a liability of £1m, none of which had been picked up when the target company had previously acquired the firm that had made that commitment; and
- no pensions being provided in Thailand by the target despite new legislation only a couple of years away which would require a plan to be established, and hence allowance for such costs needed to be made in profit forecast.

No checklist could pick up all of these. Careful due diligence and a lot of lateral thinking are essential if you are to avoid inconvenient or costly oversights.

The following case studies illustrate in more detail some of the pensions issues that have been picked up during the due diligence process. All three examples raise very different problems, but they represent the wide range of lurking traps of which the due diligence review should be aware.

JAPAN: ARE INSURED PLANS REALLY FULLY FUNDED? A common problem encountered with international due diligence is understanding what is meant by the term 'fully funded'. Many countries' local standards require funding at a level below that of what would be considered in the UK to be fully funded. Japan is no exception.

However, Japan has an additional issue at present. It is easy to assume that defined benefits provided under an insurance company arrangement are fully covered if they report reserves at least equal to the liabilities. But that assumes the value of those reserves is realistic. In the current economic climate in Japan, the assets are usually woefully inadequate, which can lead to substantial unforeseen future contribution requirements.

CASE STUDY. The target company operated a company-sponsored defined benefit retirement plan. The target financed the majority of the ¥100m liability internally through book reserves, although ¥20m of this was financed through insurance.

The purchaser accounted for pensions under the international standard, IAS19. It was not clear what assumptions and method had been used to determine the Japanese liabilities, but if they were on the local statutory basis, as seemed likely, moving to IAS at that time (1999) could have increased the liability three-fold, resulting in a shortfall equivalent to ¥160m (£1m).

Furthermore, the ¥20m insured reserve would not have been worth the full amount, possibly well below half this, due to falling investment values. This particular deal fell through, but had it proceeded the purchaser was going to push for a purchase price adjustment in respect of the pensions issue.

US: STATUTORY FUNDING LIMITS. One of the key features of defined benefit plans is that employer contributions can vary, and at any one time may be increased to fund a shortfall or reduced (possibly even to nil) if there is a reported surplus. However, if an employer is paying low or no contributions, it is not always safe to assume that a fund is financially strong. The following example shows that it is important to look deeper than just the cash contributions.

‘SO WHAT MIGHT ONE COME ACROSS IN AN INTERNATIONAL DUE DILIGENCE? THE ANSWER IS, VIRTUALLY ANYTHING’

CASE STUDY. The target operated an old defined benefit pension plan. The most recent actuarial valuation revealed a deficit on a basis which made no allowance for future salary increases but which assumed a somewhat pessimistic investment return. Approximate calculations showed that a liability calculated on US GAAP-type assumptions would have been similar (that is, also revealing a deficit).

Under US tax laws, contributions to pension arrangements receive tax relief only if they are within certain limits, which depend upon statutory assumptions. Even though the plan had a shortfall under the two assessments above, the maximum level of contributions that would receive tax relief for that year was zero.

The target had intended winding up the plan, based on the assumption that it was currently in surplus, and planned that the wind-up would occur once the surplus was exhausted. However, having been alerted to the difference between a ‘surplus’ on the tax basis and one on a realistic basis, the purchaser was able to make proper allowance in their projections for the need to contribute to the plan in future.

SWEDEN: PICKING UP PAST LIABILITIES. Sweden currently accounts under a nominal yield approach, although it will soon be adopting a standard similar to the International Accounting Standard for pensions (IAS19), which is market-related, for group accounts. These are very different standards and IAS19 could result in an increase or decrease in liability depending on market conditions and the particular membership.

More significantly, there can be extra liability on the new employer picking up salary increases on service with former employers.

CASE STUDY. This transaction involved hiving off several subsidiaries from a large group. Historically, there had been many changes within the group so that employees typically had service periods built up with different subsidiaries.

In Sweden there is a standard structure for white-collar private sector pensions called the ITP. The group provided pensions to its employees in accordance with this structure. The cost of benefits is largely met by each employer, although various cost limiting mechanisms exist within ITP, for example, excessive increases for one company are shared among all participating companies.

Local accounting rules and IAS19 assess the cost of the liabilities in the ITP differently, one of the key differences being that, under IAS19, the value will depend upon market conditions.

For employees who had been with a subsidiary throughout their career, this resulted in a 30% higher liability under IAS19 in 1999, or 10% lower liability in 2000, the difference being due to changes in bond yields.

However, for employees who had been employed by one of the subsidiaries remaining in the group, or by another employer, there was a potentially significant extra liability. This relates to a particular feature of the ITP system, whereby an employee’s total pension in the system is related to their final few years’ salary at retirement, regardless of whether they had changed employer.

A former employer would be liable for a pension based on the employee’s salary at the date they leave that employer, generally with revaluation. Hence, the new employer picks up the liability for salary increases (in excess of revaluation) on the pension accrued with previous employers, as well as for the pension they are accruing with the new employer.

Under local calculation methods, this will be picked up only as and when salary increases are awarded. Under IAS19, this has to be fully reflected in the allowance for future expected salary increases. In a stable environment, with as many employees joining as leaving, this could increase IAS19 liabilities by about 15%. But for a new employer, solely taking on employees at the beginning, the effect would be far more dramatic (although mitigated partially by ITP’s cost limitation measures).

The effect varied between subsidiaries, but for some this increased IAS19 liabilities by about 25% and, for new employers taking on experienced employees, could be even higher.

Because IAS19 was new in Sweden, most people locally had not thought through the implications of future salary increases, and there was strong resistance from the providers to accepting that there was an issue.

The above case studies highlight the variety and complexity of the issues that often tend to arise with pensions and related benefits during an international due diligence exercise. It is not possible to predict in advance what issues may arise, although there are of course standard problems that one comes to recognise in particular countries. Hence, as every transaction is different, sound local knowledge must be combined with an enquiring mind.

Pension liabilities can often be significant relative to the overall value of a business – I worked on one transaction for a South African purchaser where just the extra pensions liability identified in the due diligence process was several times the value of the target business! Therefore, it is important that actuaries are involved at the beginning of the due diligence process to avoid late discovery of deal-breaking or costly benefits issues.

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