# The current situation and issues of Japanese accounting standards for retirement benefits

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Outline :
This paper introduces topics relating to Japanese accounting standards for retirement benefits, and some of the following topics: the problems of the old standards, the impact of applying the new standards and the comparison between other standards.

Keyword:
Japanese accounting standards, retirement benefits

# 1. SUMMARY OF JAPANESE ACCOUNTING STANDARDS FOR RETIREMENT BENEFITS

## I. Introduction

In Japan, Retirement Allowance Plans (RAPs), which pay benefits in lump-sum from internal reserves, have been the prevailing retirement benefit plans for a long period of time. The characteristic of the benefits paid from RAPs is that the benefits are reward-oriented, and depend on the level of contribution each employee has made to the company during their service. The external funding pension plans (or corporate pension plans) in Japan have been mainly comprised of Tax Qualified Pension Plan (TQPP), enacted in 1962, and Employee Pension Fund (EPF), enacted in 1966. The contributions paid by the plan sponsors to these plans are tax deductible as expenses. Both plans have been very popular, especially among large companies. In most of the Japanese retirement plans, retirement benefit formulas often increase significantly when an employee's service years exceed a certain threshold. The formulas generally have remuneration characteristics based on long-term service rather than performance.

## II. Accepted accounting procedures, prior to the application of the new standards in 2000

Prior to the application of the new accounting standards for retirement benefits in 2000, accounting for retirement benefit plans in Japan differed between the internal reserve plans (e.g. RAPs) and the external funding plans (e.g. TQPPs and EPFs).

A. Accounting for internal reserve plans

- An allowance of retirement benefits was recorded on B/S.
- Only a limited portion of the retirement allowance could be included in expenses.
- Criterion for recording an allowance varied from one company to another.

B. Accounting for external funding plans

- Most companies recorded the amount of contribution as expenses, which is similar to the tax deductible amount.

## III. Summary of the new accounting standards for retirement benefits

A. Background to introduction of the new standards

In recent years, the deterioration of the financial condition of corporate pension plans, caused by poor investment performance and unrealized losses of plan assets, has been regarded as a crucial problem. As this deterioration had a significant impact on companies by increasing future expenses, the disclosure of the financial condition of corporate pension plans became important in terms of investment and corporate management. Based on such conditions, the Accounting Standards Board of Japan reconsidered the previous accounting standards for retirement benefits, and introduced the new standards of accounting and disclosure that would be acceptable by international standards. (Fig3) The new standards came into effect from the fiscal year starting after April 1st 2000.

B. Contents of the new accounting standards for retirement benefits

a. Definition of retirement benefits

The scope of the benefits covered by the new standards is the benefits based on each employees'service for a certain period and paid after their withdrawal. That is, a retirement benefit is basically regarded as a deferred compensation under the new standards, and assumed to accrue gradually according to an extension of service period.

According to the above definition, the accounting standards for retirement benefits, which varied previously based on payment methods (e.g. pension or lump-sum) and funding policies (e.g. internal reserve or external funding), have been unified. In addition, the scope of the benefits is only the benefits under the defined benefit plans. Therefore, the benefits of the defined contribution plans, under which the sponsors have no obligation to pay further contributions for employees' past service, are out of the scope, and the amount of the contribution of defined contribution plans will be recorded as expenses.

In addition, the retirement benefits for directors are out of the scope, because those benefits cannot be regarded as compensation for their service.

b. Summary of the accounting procedures

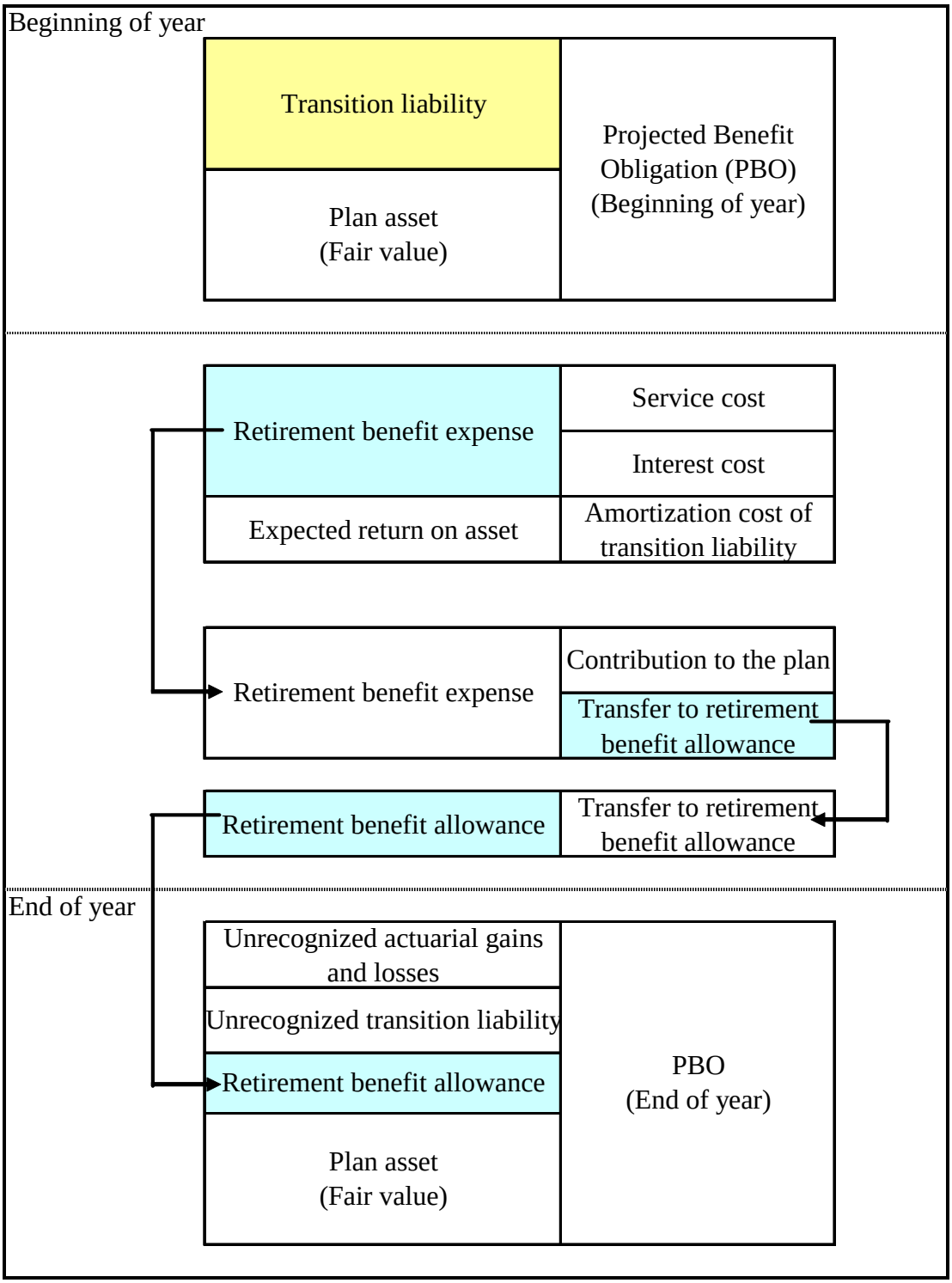
The amount attributed to the current period from the future retirement benefit will be transferred to the retirement benefit allowance as a current expense, and the amount of the whole allowance will be recorded in the liability section.

The amount of the plan assets will be deducted from the obligation, and also the expected return on assets will be deducted from the retirement benefit expenses.

Furthermore, the past service costs and the actuarial gains and losses, which arise from

amendments to the benefit level and changes of actuarial assumptions, are deducted from the obligation in principle, and recognized regularly over a certain period.

Fig 1. Accounting procedures for transition year




c. Projected benefit obligation

The projected benefit obligation (PBO) is a present value of expected future retirement

benefits evaluated by a certain discount rate which can be regarded to be accrued as of the date of measurement. At the evaluation time of expected future retirement benefits, a salary that is certain to increase should be taken into consideration. For actuarial evaluation of the PBO, the projected credit unit method, a kind of accrued benefit evaluation method, should be used.

Also, in Japan, the straight-line basis of years-of-service is generally used to attribute the benefits to each period.

d. Plan assets

Plan assets are the funded assets of the corporate pension plans to be devoted only to the retirement benefits, and the amount is measured at fair value at the balance sheet date. Plan assets of multi-employer plans are divided by the following ratios:

- Ratio based on PBOs.
- Ratio based on actuarial reserve subtracted by unamortized past service cost, both of the amounts are evaluated in terms of the pension plan management.
- Ratio based on actuarial reserve evaluated in terms of the pension plan management.

e. Retirement benefit expense

The retirement benefit expense is described by the following formula:

Retirement benefit expense = Service cost + Interest cost − Expected return on asset + Amortization cost of transition liability +/- Past service cost +/- Net actuarial gains and losses recognized

Fig2. Items of the retirement benefit cost

<table>
<tr><td rowspan="2">Retirement benefit expense</td><td>Service cost</td></tr>
<tr><td>Interest cost</td></tr>
<tr><td rowspan="3">Expected return on asset</td><td>Amortization cost of transition liability</td></tr>
<tr><td>Past service cost</td></tr>
<tr><td>Net actuarial gains and losses recognized</td></tr>
</table>

*Service cost*

Service cost is a present value of expected future retirement benefits which can be regarded to be accrued at the current period. The present value of the expected retirement benefits is evaluated using a certain discount rate and employees' remaining service period.

*Interest cost*

Interest cost is the implicit interest accrued from the PBO determined at the start of the period according to the elapse of time from the start to the end of the period, and evaluated by multiplying the discount rate by the PBO determined at the start of the period.

*Expected return on assets*

Expected return on assets is the expected return accrued from the plan assets determined at the start of the period, and evaluated by multiplying the reasonable rate of return on assets by the plan assets determined at the start of the period.

*Amortization cost of transition liability*

Amortization cost of transition liability is the amortized cost of the current period of transition liability accrued at the time of transition to the new standards, and the liability will be amortized over a certain period within 15 years. The period of amortization is not allowed to change once adopted.

*Past service cost*

Past service cost is the recognized amount of the current period of unrecognized past service cost, and the unrecognized past service cost will be recognized over a certain period within the employees' average remaining service period.

*Net actuarial gains and losses recognized*

Net actuarial gains and losses recognized is the recognized cost of the current period of unrecognized actuarial gains and losses, and the unrecognized actuarial gains and losses will be recognized over a certain period within the employees' average remaining service period.

f. Simplified method applied to small companies

For small companies whose number of employees is relatively small (less than 300 employees), a reasonable actuarial evaluation might be difficult, or their retirement benefits might be insignificant. In these cases, the standard allows the retirement benefit cost to be to evaluated by the simplified method.

g. Disclosure

The liability related to the retirement benefits will be recorded as a retirement benefit allowance on the company's B/S.

In addition, an increase in past service cost due to newly adopted retirement benefit plans or a significant change in retirement benefits can be recognized and amortized promptly, and when the amount of the amortization is significant that amount can be recorded as another

expense.

The following notes are required in the financial statement:

A general description of the type of plans adopted

A description of retirement benefit obligations

1. Liabilities and assets
    1. retirement benefit obligations
    2. plan assets
    3. advanced received retirement benefit cost
    4. retirement benefit allowance
    5. unrecognized past service cost
    6. unrecognized actuarial gains and losses
    7. other liabilities (including transitional liability)
2. Retirement benefit expense
    1. service cost
    2. interest cost
    3. expected return on assets
    4. past service cost
    5. net actuarial gains and losses recognized
    6. other costs (including amortization cost of transitional liability, cost for a temporary benefit)
3. Actuarial assumptions
    1. discount rate, expected rate of return
    2. attribution method
    3. a period of recognition of past service cost
    4. a period of recognition of actuarial gains and losses
    5. other assumptions (including a period of amortization of transitional liability)

Fig3. Comparison between Japanese GAAP, FAS and IAS

| Items | Japanese GAAP | U.S. GAAP | IAS / IFRS |
|---|---|---|---|
| Standards | • Accounting standards for retirement benefits | • Employers' Accounting for Pensions (FAS 87)<br>• Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits (FAS 88)<br>• Employers's Disclosures about Pensions and Other Post-retirement Benefits (FAS 132(R)) | • Employee Benefits (IAS 19) |
| Scope | • Retirement benefits | • Retirement benefits | • All employee benefits |
| Definition of defined contribution scheme | • Schemes under which plan sponsors have no obligation to pay further contributions | • Schemes which provide an individual account for each participant, and benefits depend only on the amount contributed and the returns earned | • Schemes under which plan sponsors have no legal or constructive obligation to pay further contributions |
| Multi-employer plan schemes | • In principle, treated as defined benefit schemes<br>• When the plan assets cannot be attributed to each plan sponsor, the contribution can be regarded | • Treated as defined contribution schemes | • Treated as defined contribution schemes or defined benefit schemes |

| Items | Japanese GAAP | U.S. GAAP | IAS / IFRS |
|---|---|---|---|
| | as the retirement cost (treated as defined contribution schemes). | | |
| Measurement date | • At the balance sheet date | • At the balance sheet date or, if used consistently from year to year, at a date not more than three months prior to that date | • At a date of sufficient regularity where the amounts recognized in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date |
| Actuarial valuation method | • Projected unit credit | • Projected unit credit | • Projected unit credit |
| Attribution of the benefits to periods of service | • According to a straight-line of years-of-service. A salary basis, a benefit formula basis or an accumulated points basis are allowed in limited cases. | • According to the plan's benefit formula. If the plan defines benefits similarly for all years of service, a years-of-service approach should be used. | • According to the plan’s benefit formula. If in later years the benefit formula leads materially higher level of benefit than in earlier years, straight-line basis should be used. |
| Actuarial assumptions | • Updated according to material standard (needs to be decided reasonably) | • Reflecting the best estimate | • Unbiased and mutually (market based) compatible |
| Discount rate | • Reference to market yields on high quality bonds (adjustment using the yield of a certain period is allowed) | • The rates at which the pension benefits could be effectively settled | • Reference to market yields at the balance sheet date on high quality corporate bonds |

| Items | Japanese GAAP | U.S. GAAP | IAS / IFRS |
|---|---|---|---|
| Expected rate of return | • Estimated separately from discount rate | • Estimated separately from discount rate | • Estimated separately from discount rate |
| Future salary increase | • Reflected as an actuarial assumption if it can be definitely assumable | • Reflected as an actuarial assumption | • Reflected as an actuarial assumption |
| Future benefit changes | | • Reflect the changes if these are contractually agreed | • Reflect the changes if these are in the formal terms of a plan (or a constructive obligation that goes beyond those terms) or legislation |
| Valuation of plan assets | • At fair value | • At fair value<br>• For purposes of determining the expected return on plan assets and accounting for asset gains and losses, a market-related asset value is used. | • At fair value |
| Past service cost | • Arises at the time of introducing a defined benefit plan or changing the benefits payable under an existing defined benefit plan.<br>• Recognized over the average remaining service period in principle (prompt recognition is allowed) | • Arises at the time of introducing a defined benefit plan or changing the benefits payable under an existing defined benefit plan.<br>• Amortized over the average remaining service period, if almost all of a plan's participants are inactive, amortized based on | • Arises at the time of introducing a defined benefit plan or changing the benefits payable under an existing defined benefit plan.<br>• Amortized on a straight-line basis over the average period until the benefits become vested, to the extent that the benefits are already |

| Items | Japanese GAAP | U.S. GAAP | IAS / IFRS |
|---|---|---|---|
| | | the remaining life expectancy. | vested, amortized immediately. |
| Actuarial gains and losses | • Treated as the same as past service cost (without corridor rule) | • Maximum 10% corridor approach is applied.<br>• The excess portion (i.e. outside corridor) is amortized over the average remaining service period. | • 10% corridor approach is applied.<br>• The excess portion (i.e. outside corridor) is amortized over the average remaining service period.<br>• Any systematic method that results in faster recognition can be adopted.<br>• Also can be recognized immediately outside profit or loss in a statement of total recognized gains and losses. |
| Settlements and curtailments | • Curtailments (decrease of benefit): treated as negative past service cost<br>• Settlements: recognized promptly at the date of settlement | • Recognized promptly at the date of settlement / curtailment (FAS 88) | • Recognized promptly at the date of settlement / curtailment |
| Recognition of retirement benefit expense | • Recognize using a projected unit credit method | • Recognize using a projected unit credit method | • Recognize using a projected unit credit method |
| Balance sheet | • Recognize a liability using a projected unit credit method (under consideration of | • Recognize a liability using a projected unit credit method (under consideration of corridor | • Recognize a liability using a projected unit credit method (under consideration of corridor |

| Items | Japanese GAAP | U.S. GAAP | IAS / IFRS |
|---|---|---|---|
| | amortization) | approach and amortization).<br>• Recognize an additional minimum liability based on ABO. And an equal amount is recognized as an intangible asset until it exceeds the amount of unrecognized prior service cost, the excess is reported as a separate component of equity. | approach and amortization). |
| Disclosures | a. A general description of the type of plans<br>b. Amount of liabilities and assets<br>1. PBO<br>2. plan assets<br>3. advanced received retirement benefit expense<br>4. retirement benefit allowance<br>5. unrecognized past service cost<br>6. unrecognized actuarial gains and losses<br>7. other liabilities (including transitional liability)<br>c. Amount of costs | (FAS 132(R))<br>a. A reconciliation of beginning and ending balances of the benefit obligation<br>b. A reconciliation of beginning and ending balances of the fair value of plan assets<br>c. The funded status of the plans, the amounts recognized / not recognized in the statement of financial position<br>d. Information about plan assets<br>e. The accumulated benefit obligation<br>f. The benefits expected to be paid | a. The enterprise's accounting policy for recognizing actuarial gains and losses<br>b. A general description of the type of plan<br>c. A reconciliation of the assets and liabilities recognized in the balance sheet<br>d. The amounts included in the fair value of plan assets<br>e. A reconciliation showing the movements during the period in the net liability (or asset) recognized in the balance sheet<br>f. The total expense recognized in |

| Items | Japanese GAAP | U.S. GAAP | IAS / IFRS |
|---|---|---|---|
| | 1. service cost<br>2. interest cost<br>3. expected return on assets<br>4. past service cost<br>5. net actuarial gains and losses recognized<br>6. other costs (including amortization cost of transitional liability, cost for a temporary benefit)<br>d. Actuarial assumptions<br>1. discount rate, expected rate of return<br>2. attribution method<br>3. a period of recognition of past service cost<br>4. a period of recognition of actuarial gains and losses<br>5. other assumptions (including a period of amortization of transitional liability) | in each of the next five fiscal years, and in the aggregate for the five fiscal years thereafter<br>g. The employer's best estimate of contributions expected to be paid to the plan during the next fiscal year<br>h. The amount of net periodic benefit cost recognized, showing separately each cost<br>i. The amount included within other comprehensive income for the period arising from a change in the additional minimum pension liability<br>j. The assumptions used in the accounting for the plans<br>k. The measurement date<br>l. The assumed health care cost trend rate<br>m. The effect of a one-percentage-point increase and decrease in the assumed | the income statement, and the line item(s) of the income statement<br>g. The actual return on plan assets, as well as the actual return on any reimbursement right recognized as an asset<br>h. The principal actuarial assumptions used as at the balance sheet date |

| Items | Japanese GAAP | U.S. GAAP | IAS / IFRS |
|---|---|---|---|
| | | health care cost trend rates<br>n. The amount of securities in the plan assets and the transaction relating to the employer and related parties<br>o. Any alternative method used to amortize unrecognized costs<br>p. Any substantive commitment<br>q. The cost of providing special or contractual termination benefits<br>r. An explanation of any significant change in the benefit obligation or plan assets | |
| Transferring the substitutional portion of EPFs to the Japanese government | a. Measure a past service cost at the date of transferring the obligation for the future employee service.<br>b. Recognize a difference between the PBO and the asset which will be assumed to be transferred to the government, and also the amount of the net unrecognized gain or loss related to the | a. Remeasure the entire PBO immediately prior to the date of transferring the asset related to substitutional portion.<br>b. Recognize a difference between ABO related to substitutional portion and the transferred asset as a subsidy from the government. Also the amount of the net unrecognized gain or loss | |

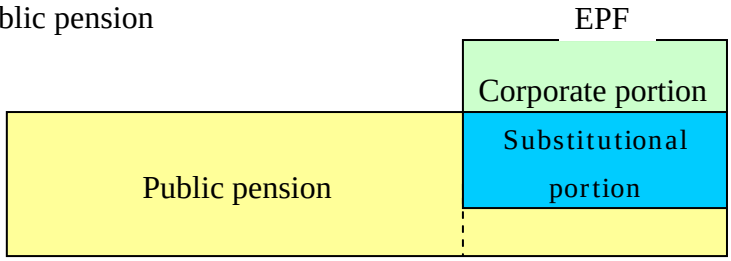
| Items | Japanese GAAP | U.S. GAAP | IAS / IFRS |
|---|---|---|---|
| | substitutional portion promptly as profit or loss at the date of transferring the remaining obligation.<br>c. Recognize a difference between the assumed and the actual transferring asset promptly as profit or loss at the date of transferring the asset to the government. | related to the substitutional portion and the derecognition of accrued salary increase will be recognized as the net settlement gain or loss. | |
| Transition | • Amortize transition liabilities less than 15 years<br>• Effective date: April 2000 | • Amortize transition liabilities less than 15 years<br>• Effective date:<br>• U.S. plans: December 1986<br>• Non U.S. plans: December 1988 | • Amortize transition liabilities less than 5 years<br>• Effective date: January 1999 |

## 2. ISSUES ARISING AFTER ADOPTING THE NEW JAPANESE ACCOUNTING STANDARDS FOR RETIREMENT BENEFITS

### I. The problems related to the substitutional portion of the Employee Pension Fund

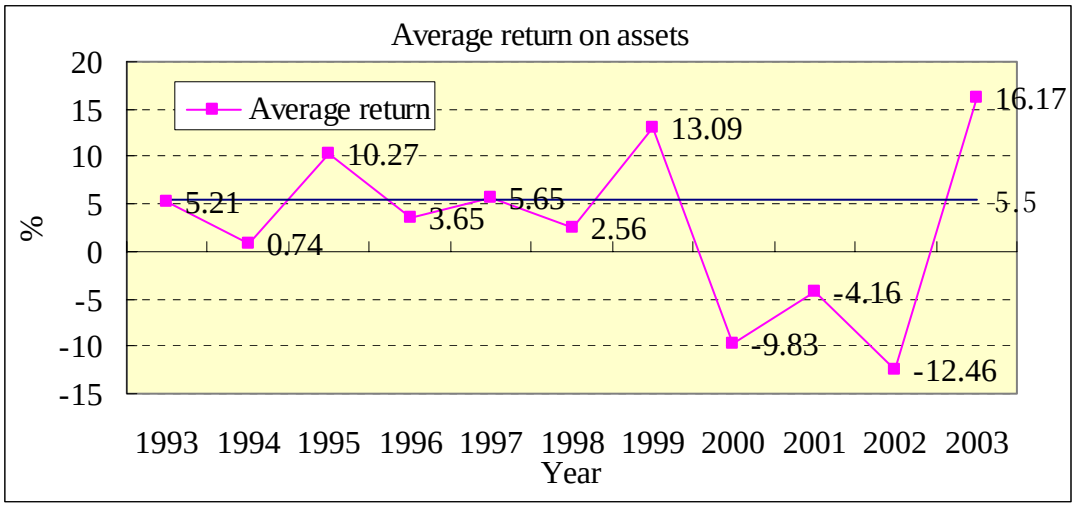
The Employee Pension Fund (EPF) scheme allows EPF substitute payments and funding of a portion of the old-age pension benefit prescribed by Employee Pension Insurance (EPI). EPF allows companies to add their own unique corporate portion benefits varied between the plan sponsors. The scheme came into effect in 1966, and has been very popular for its provision of old-age security realized by a corporate portion benefit in addition to a substitutional portion. Furthermore, EPFs have large funding amount because of their substitutional portion. And they can easily enjoy the advantage of scale and receive larger interest gain when the actual return exceeds the projected return on pension assets. However, when there is a deficit of funding it is mandatory for the sponsors to cover it. In other words the plan sponsors are responsible for the entire plan including the substitutional portion. EPFs have been developed as the representative scheme of Japanese pension plans, and the participants of EPFs accounted for more than one-third (12 million employees) of all employees covered by EPI at its peak.

Fig 4. EPF and the public pension




However, EPFs faced poor investment performance around the mid 1990s and as the deficits have increased rapidly the plan sponsors came to realize it was costly to maintain EPFs (especially their substitutional portion). To make matters worse, EPFs faced negative performance for the third year in a row from the 2000 fiscal year, thus the plan sponsors felt an increased burden.

Fig 5. Average return on assets of EPFs



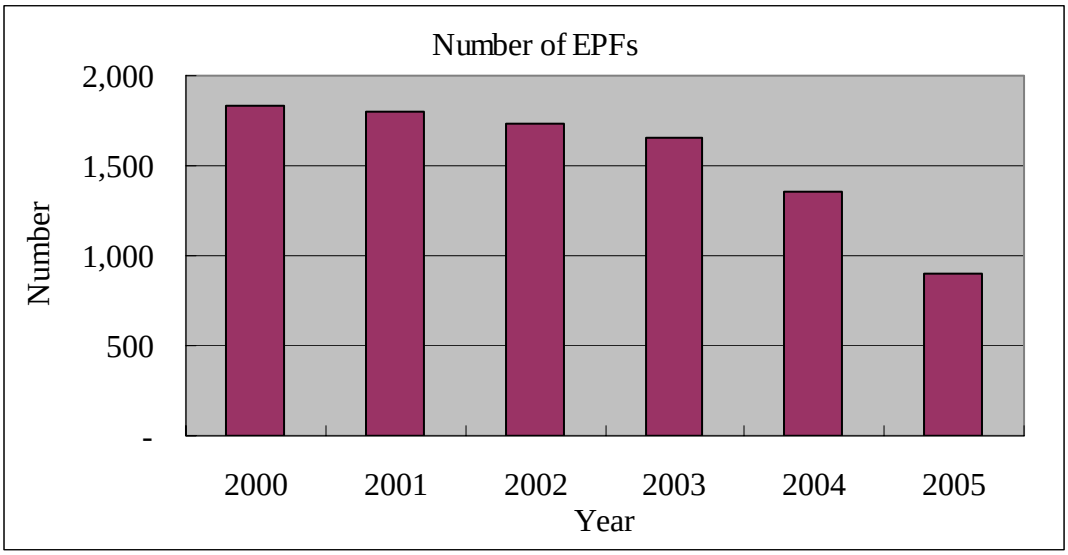

Further, the substitutional portion which occupies 60% of the amount paid by EPFs became the significant factor influencing the plan sponsors' B/S. The newly adopted accounting standards for retirement benefits in 2000 forced them to evaluate the liability of not only the corporate portion, but also the substitutional portion by the same methodology. In addition, the very low discount rates were used to evaluate the liabilities under conditions where interest rates were extraordinarily low. As a result of this, the plan sponsors have been struggling from the expansion of the liabilities. Due to the increasing plan sponsors' sense of uncertainty to EPFs, a number of issues have been discussed. These include transferring the substitutional portion to the government, giving approvals to the new benefit formulas (such as cash-balance plans or defined contribution plans) and other topics concerning the reorganzation of pension plans.

Reasons for transferring the substitutional portion to the government ("Daikou-Henjou")

a. Poor performance of investment
b. Adoption of the new accounting standards for retirement benefits
c. Expansion of the liability caused by using very low discount rates

Under such circumstances, the Defined Benefit Corporate Pension Act came into effect in 2002, which allowed EPFs to transfer their substitutional portion to the government and the remaining portion (the corporate portion) to continue to exist exclusively as Defined Benefit Corporate Pension Funds (or DB plans). Subsequently, many EPFs, particularly sponsored by the major companies, chose to transfer their substitutional portions. Therefore, the number of EPFs have been decreasing rapidly.

Fig 6. Number of EPFs




## II. Cash-balance plan

The Japanese companies' PBO or funding deficits have increased significantly due to the poor performance of the plan assets investments, the newly adopted accounting standards for retirement benefits, and the prevailing circumstances of extraordinarily low interest rates and so on. Companies have been struggling with liabilities and/or expenses which arise from outside their main line of business, and have been intending to restructure their retirement benefits with the view to decrease or stabilize the liabilities and expenses. Although the defined contribution plan scheme is popular when restructuring plans, in most cases both the employers and employees are reluctant to switch the entire former defined benefit scheme to the defined contribution scheme. Many plan sponsors have been selecting to retain a certain part of defined benefit schemes, although the benefit formulas have not remained the same in many cases.

The most attractive scheme in recent years is a cash-balance plan, which was introduced in 2002. The reason for the popularity of a cash-balance plan may be explained by its unique characteristics, the connection between the benefit level (which increases automatically as the service period increases at a final-pay plan) and changes of interest rates, and the expectation to reduce the volatility of PBO to interest rates.

In a cash-balance scheme, the pension resource is determined by the accumulation of

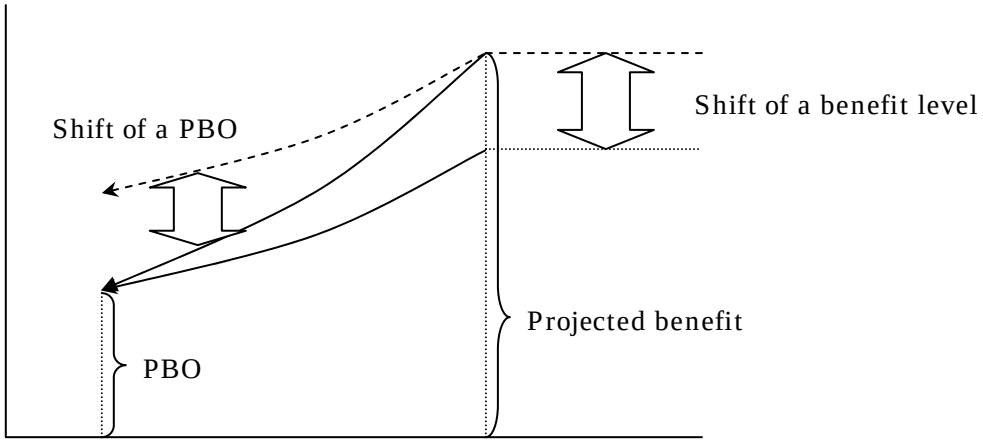
the contribution credits and the annual interest credits. As is well known, a cash-balance plan has characteristics of both the defined benefit plan and the defined contribution plan. In Japan, the rate of the interest credit can be defined by:

1. A constant rate
2. An earnings yield of Japanese Government Bonds or similar rates
3. A combination of 1 and 2
4. A rate with higher or lower limits.

Generally, the rates of the interest credit are defined by 10 year (or 20 year) Japanese Government Bond yield with higher or lower limits.

The discount rates in Japanese accounting standards are to be set by the earnings yield of Japanese Government Bonds or the high-security corporate bonds. Companies can use not only the current rates but also the average or some other adjusted rates of a certain period. The expected rates of the interest credit can also be set by the past average or the future expectation and not only by the current rate. Therefore, according to the average service period of the employees and the definition of the interest credit rate, the company has the opportunity to make some connection between the interest credit rate and the discount rate in the accounting evaluation. In such cases, the shift of a PBO caused by the shift of a discount rate can be balanced out by the shift of a benefit level caused by the shift of an interest credit rate. Consequently, a PBO is expected to be less volatile to interest rates.

Fig 7. PBO of a cash-balance plan




The decline in earnings yield of bonds results in both the reduction of a projected benefit and the increase of a PBO.

In Japanese pension plans, schemes which accumulate only the contribution credits have been very popular (a point based plan). This may be one of the reasons for the prevailing adoption of cash balance plans.

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