Characteristics of Japanese retirement benefit plans and pension accounting

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1. Introduction

In this paper, we explain the historical background and advantages of the benefit/year-of-service method[1] to calculate Projected Benefit Obligations (PBO) of the defined benefit plans stipulated in the Japanese accounting standards (J-GAAP), whereas the benefit formula method is stipulated in IFRS and US-GAAP. Different methods are used due to the characteristics of the Japanese benefit plans. One such characteristic is that they are back-loaded[2] for historical reasons.

The historical background of Japanese private pensions is described in Section 2, followed by Sections 3 and 4, which discuss the general opinion about vesting in Japan. Section 5 explains the advantages of the benefit/year-of-service method, followed by a conclusion.

2. Origin of Japanese retirement benefit plans

Since the 18th century, the Edo era, most Japanese retirement benefits have been of a lump-sum type. Indeed, there were some private pension plans that were copies of pensions for public officials and not of a lump-sum type, but the number of such plans was very small. Only about 400 enterprises in Japan had pension plans in 1961 as the

[1] For example, if a 35-year-old person has worked for company A for 10 years, and the retirement benefit for these 10 years of service is $1,000 while the benefit for normal retirement at 65 is $6,000, the benefit/year-of-service accrual is $1,500 ($6,000 divided by 40 years of service multiplied by 10 years of service). Conversely, the accrual calculated by the benefit formula is $1,000. The amount calculated by discounting these accruals from the assumed retirement date is the PBO, which is commonly used as a measure of a company's liabilities, both in Japan and in IFRS and US-GAAP.

[2] Some companies try to decrease the degree of back-loading, but back-loaded benefit plans are still the majority in Japan.

tax system at that time did not treat corporate pensions preferentially[3]. After the establishment of a preferential tax system for TQPPs (Tax Qualified Pension Plans) in 1962, pension plans became more prevalent and were used by more than 70,000 enterprises in 2001. However, many pension plans were designed to completely or partially replace the original lump-sum plans. Most of them provide an annuity certain whose present value equals the amount of the lump-sum benefit substituted with the option for retired employees to receive a lump-sum benefit payment, while only a few excellent enterprises provide employees with an additional annuity for life without the option of a lump-sum payment after the period of annuity certain. Although the plans provide annuities, many retirees prefer the option of lump-sum payments because they have to cover things, such as mortgage payments with it and because lump-sum payments are better for them than annuities in terms of income tax. Therefore, many pension plans inherited the characteristics of the original lump-sum payment plans in practice. The strong tradition for lump-sum payments has continued since the middle of the Edo era. And the traditional perception and way of thinking about retirement benefits affect the current design of retirement benefits.

We need to go back to the Edo era to explore the origin of retirement benefits in Japan. In the 18th century, drapery was a key industry in urban areas. Some drapery companies had employment systems that are comparable with those of today's large enterprises. They employed hundreds of people, which was a large workforce at that time, and had branches in Edo (present-day Tokyo), Osaka, and Kyoto. We have selected Mitsui Echigo-ya[4], one such drapery company for our research as there is a lot of literature and documentation about this company.

Mitsui Echigo-ya only employed male workers, most of them hired at the age of 12 or 13. The employees graduated from an apprenticeship period when they were about 20. Some of them were further promoted to the manager level at around 30, and a few of them became executives when they reached about 40. Wages were not paid periodically, but were kept in individual accounts administered by the company, and the employees could withdraw funds when required. No problems arose with this inconvenient payment method because apart from executives, all employees were live-in employees with the food and dormitory accommodation provided by the

[3] Hiroshi Itoga. "Tax qualified pension plan." (Japanese language), 2004
[4] The explanation of Mitsui Echigo-ya is by Yasushi Nishizaka in "Research about employees of Mitsui Echigo-ya." Tokyo University Press (Japanese language)

company, which meant that the ordinary workers had little need for cash.

In general, employees were not allowed to resign for personal reasons unless it was to run their own business, having inherited it from their family or family in law. The reason for this exception was that the primary objective for working in Mitsui Echigo-ya was for employees to run their own businesses after they retired, and to learn the management know-how and save the necessary money while they were employed by the company. Employees who wanted to resign for other personal reasons sometimes escaped from the company, and Mitsui Echigo-ya treated this as a breach of discipline.

Eligible retirees were provided with either lump-sum benefits or *noren-wake*[5].

Noren-wake is a system in which the parent company (in this case Mitsui Echigo-ya) allows retirees to use the same or a similar trade name and trademark when starting their own business. Since the brand of the parent company will be damaged if the retiree's business fails, the company only allowed retirees with distinguished service and business ability to use this system. Furthermore, the parent company continued to keep an eye on the retirees' businesses and helped struggling ones by using the capabilities of family companies.

When a manager or high-level employee retired, the company provided them with a lump-sum benefit, called *motode-gin*[6] (money for initial expenses). This was regarded as a payment to cover the initial expenses of starting up business. The company determined the amount by considering the employee's position and length of service at the time of retirement. One characteristic of *motode-gin* was that the amount increased significantly for employees that reached the middle of their service and for those that had been promoted to a middle rank (refer to Figures 1 and 2). This was done to prevent the best employees from retiring early.

In summary, the retirement allowance system of Mitsui Echigo-ya, especially *motode-gin*, has the following factors in common with the retirement benefit systems of

[5] *Noren* is a cloth curtain with a trademark placed at the entrance of a business. It is seen as a symbol of the company. *Wake* means "sharing."

[6] *Motode* means an initial expense. *Gin* means silver, which was legal tender in the bimetallic standard in the Edo era, together with gold.

the present-day enterprises.

1. Early retirement for personal reasons is considered rare.
2. Retirement benefit is used to prevent employees from retiring early
3. Benefits are back-loaded

3. Concept of vesting in present-day Japan

In Japan, an employee's claim for any portion of the retirement benefit is not regarded as legally enforceable until that employee retires. This concept is supported by a ruling, which said:

". . . A claim for retirement benefit occurs at retirement and is not legally enforceable before retirement. Furthermore, a retirement benefit plan (non tax-qualified) can be easily changed if all parties involved agree. Even if there is no such agreement, there is still scope for the plan to be changed, which means that it is pointless to call for retirement benefit plans to be affirmed, and it is not too late to claim the retirement benefit at retirement."
(The case of *Hakusuitech*, Osaka High Court)

The plaintiff of this case was an employee, and he called for the restoration of his benefit provision, which was changed after his company changed its retirement benefit plan. But, this ruling says that it is pointless to call for retirement benefit plans to be affirmed because a claim for the retirement benefit is not legally enforceable before the employee retires. It says if the employee and the company could not agree on changes to the retirement benefit plan when the employee retired, then the employee should challenge this judgment.

This concept of weak vesting can be called "vested at retirement" and this concept is valid for both tax-qualified pensions[7] and the non tax-qualified plan mentioned above.

The phrase "not legally enforceable" above implies that retirement benefit policies can be changed before retirement and that doing so will change the retirement

[7] Tax-qualified pensions include not only TQPPs but also defined benefit corporate pensions and employees' pension funds.

benefits of the individual employees. But, even if a company does not change its retirement benefit policies, retirement benefits will not be determined until employees retire because the amount of benefit to be paid depends on the way employees retire, which could be retirement for personal reasons, for company reasons, because of employee disability or illness, or for other reasons. In particular, it is legally, politically and socially accepted that an employee will forfeit his or her retirement benefit if employment is terminated because the employee seriously breaches a law, such as committing an act of embezzlement or malfeasance.[8]

4. Benefit deductions

Many benefit plans have recently reduced the amount of benefit to be paid to employees. Benefit reduction is not seen as something special and the procedures involved have almost become standardized.

Many plans are still final-pay-related and the rate of the benefit payment is not regulated as an additional rate per year, but is regulated in rate-to-service tables (see Figure 1), in a similar way as Mitsui Echigo-ya's benefit plan. In many cases, amending benefit plans means amending these rate-to-service tables, which changes the amount of the benefit while disregarding the difference between the portion of past service and that of future service. (It is clear that the "vested at retirement" concept enables such table amendment.)

In general, employees are guaranteed a lump-sum benefit before the amendment of the rate-to service table. In particular, TQPP regulations clearly require this kind of guarantee. Corporate pensions under the Defined Benefit Corporation Pension Law and the Employee Pension Insurance Law are almost the same as TQPP. Although this concept of maintaining this lump-sum payment as guaranteed as an outstanding amount is deep-rooted, this lump-sum benefit as guaranteed before the amendment also can be reduced when a non tax-qualified plan is amended if the employees agree or if the reduction is deemed necessary. In some cases, benefits for inactive participants, such as retired pensioners can also be reduced for the same kind of reason. Reducing the

[8] The weakness of pension rights is sometimes discussed in Japan. As a rare example, the Defined Contribution Pension Law stipulates that benefit cannot be withheld even in cases of punitive dismissal after three years of service.

conversion rate from a lump-sum benefit to a pension benefit, which reduces the interest included in the pension benefit, is easier than reducing (the walk-out amount of) the lump-sum benefit because the interest is just additional to the lump-sum benefit.

In any case, reducing a non tax-qualified plan only requires the agreement of the employee. When a retiree claims a benefit whose reduction has not been agreed, the benefit is reduced if the reduction is fair and necessary and if the employer has made considerable efforts to explain the reduction.[9]

Reducing a tax-qualified pension also requires the employee's agreement and the government's approval.

Any retirement benefit plan, whether tax-qualified or not, can be reduced if the reduction is fair and necessary and if the employer has made considerable efforts to explain the reduction. Although there have been some lawsuits against benefit reduction, they are few and far between. Therefore, an enterprise may reduce its employees' retirement benefits before it goes bankrupt. In that sense, retirement benefit claims can be regarded as being subordinate to normal debts.

In summary, any portion of the retirement benefit is forfeitable in Japan while the employee is in service. Moreover, reducing retirement benefits is easier than reducing debts. This is important information when investors are reading financial statements. It is best for companies to clearly state whether their financial statements include such information or not.

5. Allocating retirement benefit

In J-GAAP, US-GAAP and IFRS, retirement benefits are accounted for on an accrual basis, which means recognizing an expense for an event when it occurs. In Japanese retirement benefit accounting, a company incurs an expense when the event occurs that an employee renders a service, whereas a company incurs an expense when the event occurs that a benefit accrues in US-GAAP and IFRS. Therefore, it is important that an allocated benefit is sufficient to cover the service rendered in a fiscal year in

[9] Hideyuki Morito "Law and policy of corporate pensions." Yuhikaku (Japanese language)

J-GAAP. This is different from US-GAAP or IFRS, which allocate benefits using a benefit formula.

Considering the historical background mentioned earlier, Japanese retirement benefit formulas are now also designed like Figure 1, not only to cover services rendered, but also to keep the best employees. That is to say, increased benefit for a particular year does not always match the services rendered. Therefore, allocating benefits using a benefit formula does not always mean expenses that are booked match the services rendered. This is because it is reasonable that J-GAAP allocate retirement benefits using the benefit/year-of-service method.

Allocating benefits using a benefit formula means that an expense is recognized when benefits accrue. This also means a PBO under this method includes a characteristic as accumulated amount of accrued benefits. In fact, US-GAAP, the origin of allocating benefit using a benefit formula, requires the purchase price of annuity contracts, which is necessary to pay the portion of the accrued benefit settled, to be used to measure a company's obligation. (In the U.S., there is a transaction called "reversion" for a pension plan, which includes buying annuity contracts to settle the accrued benefits, terminating the plan and withdrawing the excess plan assets. The company's obligation for accrued benefit settled has to be measured when accounting for this transaction. This obligation of accrued benefit is called ABO (Accumulated Benefit Obligation), and it is also said that avoiding the component of salary increase from PBO leads to ABO. This clearly shows that PBO is strongly related to a company's cost of settling its accrued retirement benefits.[10]) This transaction is supported by the Employee Retirement Income Security Act (ERISA), which provides that certain accrued benefits of employees in service are legally enforceable.

On the contrary, in the Japanese legal system, it is possible that an employer reduces its obligations of retirement benefits, that is, the provisions of the retirement benefits usually permit the employer to forfeit the benefit of a retiree who retires

[10] The accounting transaction of reversion is described in Statement of Financial Accounting Standards No. 88 "Employer's Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits" in US-GAAP. The legal aspect is also summarized in an information letter dated March 13, 1986 from the U.S. Department of Labor to John N. Erlenborn, chairman of the Advisory Council on Employee Welfare and Pension Benefit Plans, as a fiduciary responsibility.

because of a breach of discipline and an employer can amend the provisions to reduce the benefits if the employees agree. This means that PBO is not very strongly related to the cost of settling the benefit. Therefore, measuring the PBO of a Japanese pension plan by allocating benefits using a benefit formula, as stipulated in US-GAAP, may mislead investors. It is better to allocate benefits using the benefit/year-of-service method to make it clear that a company's financial statements do not include information on the wind-up value of benefit obligations.

If a PBO does not relate to the wind-up value, a PBO shows only the information of the future cash flows. Therefore, PBOs of retirement benefit plans with similar cash flows should be measured at similar values. Then, allocating benefits using the benefit/year-of-service method is better, as shown in the example below.

Example:

Almost all employees of companies A and B are hired when they are 20 and retire when they are 60.
Companies A and B both have retirement benefit plans whose benefits depend only on the years of service. Company A's plan provides the same amount of benefit as company B's if an employee has 40 years of service, but company A's benefit for an employee retiring after 20 years of service is lower than that of company B's.

The PBOs measured using the benefit/year-of-service allocation method are almost the same, but the PBOs measured using the benefit formula are clearly different. The latter gives a lower obligation for company A than for company B for plans with almost the same cash flow.

Furthermore, there is another problem relating to the design of a benefit allocation formula, as outlined below.

Many Japanese pension plans are designed to take over a portion of the benefit of their original lump-sum benefit plans. Some of them take over the portion of benefit for employees over a certain age of around 50. These plans have a problem in determining the benefit accrued for each pension plan and the remaining lump-sum benefit plan. Allocating benefits using the benefit/year-of-service method avoids this problem by calculating the expected value of retirement benefits to be paid.

6. Conclusion

It is reasonable for J-GAAP to adopt the benefit/year-of-service method, whereas US-GAAP and IFRS adopt the benefit formula method. The reasons are outlined below.

First, let's consider the event in which an expense is recognized. The benefit formula method in US-GAAP has been developed historically to fit the pension protection system of the U.S., which makes accrued benefit legally enforceable. That is, a PBO in the benefit formula method implicates a company's legal obligation for retirement benefit in the U.S., because the ABO, which is the PBO minus the portion of an employee's future salary increase, is a measure of cost at settlement. Then, when a retirement benefit obligation of a Japanese benefit plan is measured by PBO using the benefit formula method, readers of a company's financial statements may believe that the PBO also implicates a legal obligation, the same as with a U.S. benefit plan, when in fact retirement benefits of Japanese plans are not legally enforceable until retirement. On the contrary, the benefit/year-of-service method does not cause such misunderstanding because it is clear from the definition that PBO in the benefit/year-of-service method does not implicate a legal obligation.

Second, let's consider the adequacy of an allocated benefit amount. Using the benefit formula method means the maximum service cost occurs in the middle of an employee's service years for many Japanese retirement benefit plans whose benefit formulas lead to the maximum benefit increase in that term, which is traditionally designed to retain employees rather than reward them for their service. This is unreasonable as it leads to less allocated benefit for employees with a longer service term as opposed to allocated benefits for employees with a shorter service term. On the other hand, the benefit/year-of-service method is reasonable because it allocates benefits evenly according to the number of years of service.

The above shows that it is reasonable for J-GAAP to adopt the benefit/year-of-service method.

Furthermore, similar cash flows lead to similar PBOs in the

benefit/year-of-service method, although they are calculated by clearly different benefit formulas, and the benefit/year-of-service method does not require a company to specify its accrued benefit using a benefit formula even if it is not clear how the accrued benefit was calculated.

The argument for the advantages of the benefit/year-of-service method mentioned above also applies to any country whose legal system for retirement benefit protection does not allow a claim for retirement benefit to be enforceable until retirement. Therefore, the benefit/year-of-service method should continue to be allowed even after accounting standards have converged.

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- Information letter (March 13, 1986) from the U.S. Department of Labor to John N. Erlenborn, chairman of the Advisory Council on Employee Welfare and Pension Benefit Plans

figure 1

years of service	samples	average of benefit
4	1	215
5	17	332
6	17	448
7	17	664
8	10	827
9	15	868
10	9	1,043
11	8	1,286
12	14	1,909
13	9	2,307
14	8	2,678
15	12	3,683
16	2	4,250
17	11	4,882
18	13	5,742
19	11	7,273
20	2	10,500
21	5	11,000
22	4	12,167
23	9	13,978
24	5	18,750
25	11	18,227
26	15	19,464
27	7	18,500
28	3	19,333
29	1	21,500
30	1	20,000

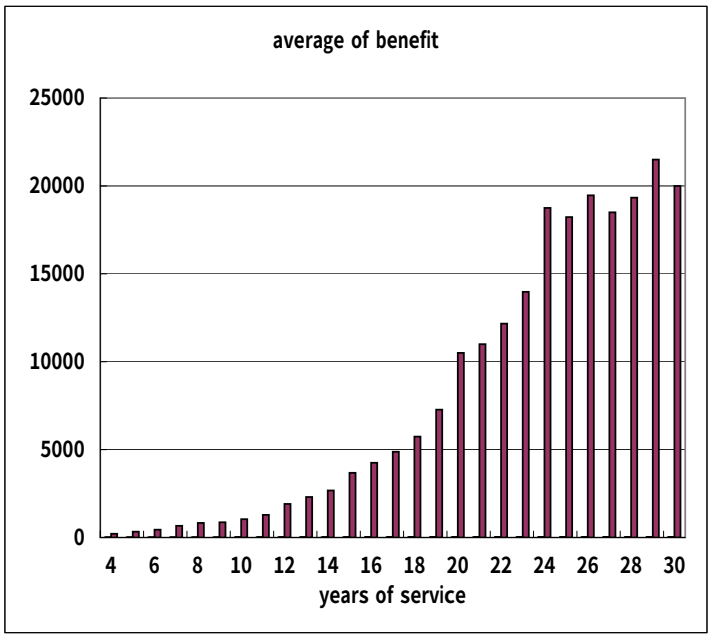

figure 2

final rank	aveage of benefit	samples	service
1-1	440	41	4-8
1-2	1,674	73	7-17
2-1	4,271	7	14-18
2-2	4,740	5	15-18
2-3	5,807	15	17-19
2-4	5,600	2	18
3-1	6,125	4	18-19
3-2	7,000	1	18
3-3	8,000	4	19-21
4-1	11,063	8	19-23
4-2	12,500	2	22-23
4-3	14,114	7	21-26
4-4	14,000	2	23-24
5-1	16,500	1	25
5-2	18,222	9	23-27
5-3	19,107	14	25-28
5-4	19,300	10	23-29
5-5	19,000	2	25-27
5-6	20,000	1	30
end of live-in work	23,000	2	26