

One step ahead

International deals can involve pensions issues that can be costly or disruptive if not spotted early, as Shaun Southern and Christine Whatley reveal.

M&A activity, including cross-border transactions, has recently picked up. There is an increasing awareness that pension and other related benefit issues are often significant and therefore should be properly considered.

Every country has its own wide range of potential issues. So what might you discover in an international pensions due diligence? In practice, virtually anything. Here are three recent examples:

“Defined contribution” plan with a corporate sting

A defined contribution plan, based in Lichtenstein, covered a company’s internationally mobile executives. Company contributions are a defined percentage of pay and at retirement the invested fund is paid out. As it was described as a defined contribution plan, the company believed no corporate risk existed.

On inspection, the plan rules promised a minimum annual investment return of price inflation plus 3%. If the investments held did not achieve this, the company immediately had to make good the shortfall. A defensive investment strategy providing a low stable return had been adopted to reduce the potential payments, but as this generally provided below the promised return, the company had to inject additional funds each year.

As well as being a cash flow issue, the corporate obligation should be recognised on the balance sheet under many accounting standards (including International Financial Reporting Standards (IFRS)).

Shortfall under the Swedish ITP plan

Most Swedish companies provide defined benefit pensions to white-collar workers through the collectively agreed ITP plan. Many companies choose to finance ITP through Alecta, a mutual insurance company.

Historically no balance sheet position is held in respect of ITP if using Alecta. From 2004, this had been intended to change under IFRS and RR29 (the new Swedish accounting standard). However, Alecta currently lacks sufficient resources to provide the necessary data to companies, so for 2004 Swedish companies were permitted to continue to account as if ITP was defined contribution. This concession is not intended to apply indefinitely.

Alecta is considering how to notionally allocate its assets between companies for them to be able to comply with IFRS – the problem lies in determining the share of assets in respect of retirees and paid-up policies, versus active members.

As a guide, an IFRS measure of the liabilities might currently be of the order of 150% of Alecta’s calculation, although this is highly dependant upon the characteristics of each workforce.

If assets were deemed to be 128% of Alecta’s calculation of the liability (Alecta’s reported coverage ratio in December 2004), the resulting IFRS deficit would be of the order of 20%. However, a different method could be set by Alecta for determining assets, which

could significantly affect this result.

Companies are therefore in limbo, particularly when assessing a potential acquisition. At present, it is appropriate to have no balance sheet liability but this will change at some stage – although it is not yet clear when. It seems likely that there would be a deficit under IFRS, which could be material, despite Alecta’s healthy reported position.

We have worked on several acquisitions where this has been a major issue, and helped one company that had previously agreed a completion adjustment to a transaction on the basis that data from Alecta would be available in 2004. Without data they could not finalise the adjustment. We put forward a pragmatic solution that was acceptable to both sides.


Post-deal corporate structure

We advised recently on an acquisition that involved sales employees who were scattered globally, typically with a few per country. The post-transaction structure was to have a few centrally employing companies without legal entities in every country.

We identified that this could cause problems in some countries, as employees would lose or receive reduced state pension and insurance benefits because they would be classed as self-employed. We advised the cost to replicate benefits or compensate employees, and this was weighed up against the advantages of having central employing companies.

By highlighting this issue early, the proposed structure was reconsidered, and the extra costs built in. We also helped explain to employees the benefit changes, to reduce employee relations issues following the deal.

The examples highlight the variety and complexity of pensions issues arising from international M&As. It is impossible to predict these issues in advance – although there are standard problems occurring in particular countries. As every transaction is different, sound local knowledge must be combined with an enquiring mind.

Finally, pension liabilities can be significant relative to the overall value of a business – they should not be ignored. In a recent transaction for a South African purchaser, just the extra pension liability identified in the due diligence process was several times the value of the target business. It is therefore important that specialists are involved from the start of the due diligence process to avoid late discovery of deal-breaking or costly benefit issues. 

Shaun Southern and Christine Whatley are partners at Lane Clark & Peacock LLP.

The views expressed in this article are those of the authors and not necessarily those of LCP as a firm. The firm is regulated by the Institute of Actuaries in respect of a range of investment business activities.