Original Article

Pensions in Australia and South Korea: A comparative analysis

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ABSTRACT This article compares the social contexts and institutional arrangements of pensions in South Korea and Australia. South Korea and Australia are experiencing demographic changes, prompting the reform of pension arrangements and pension accounting. South Korea is currently undergoing major changes as its pension system is restructured, while Australia's pension arrangements continue to evolve but the accounting for these arrangements has lagged pension developments. The visibility of pensions increased in Australia with the convergence of local accounting standards with international financial reporting standards (IFRS) in 2005. When South Korea adopts IFRS between 2009–2011, the costs of the pension promise and the effect on the employer's profit and loss and balance sheet will be more transparent to stakeholders.

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INTRODUCTION

Before 1992, South Korea and Australia were among the few nations without a private national employment-related retirement income plan.¹ Australia introduced legislation covering a compulsory employment-related system for superannuation in 1991, whereas pension reforms in South Korea are more recent, with the introduction of private occupational pension plans in December 2005. Both nations have a similar history of accounting for pensions; however, with the transition to international financial reporting

standards (IFRS) in Australia in 2005, their accounting for pensions radically changed.

Before 2005, in Australia disclosure (and not recognition) requirements applied to accounting for pensions, which meant that Australian firms could keep their defined benefit obligations off-balance sheet. With the convergence with IFRS, pension accounting represented a major area of difference for Australian companies. Similarly, the impending transition to IFRS for South Korea in 2009–2010 promises to radically change accounting for pensions. Given the similar accounting histories of South Korea and Australia, the Australian experience can provide a useful lesson for South Korea.

In South Korea and Australia, retirement allowances/pensions are a central component of

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the employment contract. The pension contract tends to be particular to a nation and is culture-laden,² and the social institutional contexts influence accounting for pensions. For each jurisdiction, the genesis, social context and institutional pension rules are linked to the accounting regulations in the context of the incidence of investment, bankruptcy and longevity risk. Accounting records the pension transaction and reflects the investment, bankruptcy and longevity risks, as the incidence of these differs between defined benefit and defined contribution arrangements. Until recently, both South Korea and Australia arguably had limited need for IFRS pension accounting owing to the less significant role of traditional defined benefit plans, compared to other jurisdictions.

This article reports a study in which pension disclosures for the top-200 listed companies in Australia for the year immediately preceding the introduction of IFRS (2004) in Australia and for 3 years subsequent (2005–2007), and for the top-100 listed South Korean companies in 2007 were collected.^{3,4} Financial reports of the top-200 Australian listed companies were accessed using the online Connect 4 annual reports database. The financial reports of the top-100 listed companies in South Korea were accessed using the TS – 2000 database.⁵

THE SOUTH KOREAN CONTEXT

The genesis of retirement benefits in South Korea is in redundancy payments, rather than post-employment income. Since 1961, private sector employees have been offered mandatory retirement allowance plans (RAP) by employers under the Labor Standards Act.⁶ RAP cover approximately 30 per cent of the workforce⁷ and provide lump sum termination indemnities. Some South Korean companies provide ‘progressive’ and/or ‘top-up’ benefits that are greater than the mandatory minimum.⁷ RAP are technically considered defined benefit plans unless accrued benefits are consistently paid out to employees at the end of each year (a practice followed by a number of South Korean companies). Tax laws in South Korea provide a significant incentive for employees to take a lump sum. RAP may be

internally funded, externally funded or both, with tax exemption up to certain limits for internal funding (although these tax incentives are declining). The use of retirement insurance products offered by South Korean insurance companies such as Samsung Life, Kyobo Life and South Korea Life is common. Although there is no insurance protection plan, retirement insurance assets are protected as part of a general deposit plan. Most retirement allowance benefits (approximately 80 per cent) are paid upon termination before retirement and are used for purposes other than directly providing retirement income. To this extent, RAP payouts resemble redundancy payments. RAP represents the ‘second tier’ of retirement provision.

South Korea’s national pension system (NPS) was introduced in 1988, and represents the ‘first tier’ of pensions in the country. During the 1980s, economic growth created employment, and the resulting increase in household income made the introduction of the NPS possible.⁸ Employees (both public and private sector) agreed to pay certain percentages of their income as pension premiums for their future benefit. These benefits include a public pension, social health insurance, unemployment compensation and industrial accident insurance. The NPS provides for a target pension of 60 per cent of final salary for the average worker with 40 years in the system with a normal retirement age of 60, and a funded system with a 9 per cent contribution rate (split equally between employers and employees). In addition to the NPS, there are three special occupational plans in South Korea: the government employees’ pension, the military personnel pension and the private school teachers’ pension.⁹ Along with the NPS, these comprise the ‘first tier’ of pensions in South Korea. The public sector pension schemes are strongly supported by policy makers because they are a source of investment capital for government economic projects.

The NPS is an essential component of the social safety net, but it currently faces questions as to its long-term sustainability.⁹ South Korean public pension schemes favour early contributors, and thus the benefits outweigh the actual

contributions. This imbalance between high benefits and low contributions weakens the NPS, despite the fact that its coverage has broadened over the years.⁹ The military personnel pension has been in deficit for several decades, and the government employees' pension is showing similar signs.⁹ To address the NPS imbalance, the National Pension Act was amended in 1998 to increase the retirement age and reduce the replacement rate.¹⁰ In addition, the traditional system of old-age support within families is on the decline, and this trend will worsen over the next few years as changes in lifestyle and economic opportunities impact family structure.¹¹

Although South Korea is the tenth largest economy in the world, it has only recently introduced an occupational pension system focused on providing an income stream after retirement (as distinct from a redundancy payout). Traditional defined benefit and defined contribution plans were encouraged from 1 December 2005 as replacements for the RAP.^{11,12} The Employee Retirement Security Act (ERSA), which allows private sector defined benefit and defined contribution pension plans, was passed by the South Korea National Assembly on 29 December 2004. Although ERSA may be regarded as limited legislation, its objective is to reform private sector occupational pensions by encouraging the substitution of RAP with defined contribution plans and defined benefit plans. A related objective is to move away from lump sum payments and encourage the use of annuities as retirement income streams.¹³ ERSA is simple and provides a limited number of choices for employers: to continue a mandatory RAP, to adopt a defined benefit plan in place of a RAP or to adopt a defined contribution plan in place of a RAP.

Challenges to replacing mandatory RAP with defined benefit plans and defined contribution plans under ERSA include providing adequate incentives to encourage retirees to choose annuities rather than lump sums, and encouraging employers to meet the high costs of the introduction of corporate pension plans, especially as plan assets will be separate from the firms' assets.⁷ The requirement for external funding

under ERSA should provide employees a sense of security that they will actually receive their benefits. However, the plans under ERSA require at least 50 per cent employee consent. In a highly unionised industry, this translates to majority approval by the union members for the defined benefit plans or defined contribution plans. Unions are opposed to these ERSA plans, especially defined contribution plans.¹⁴ On the other hand, the nature of the old RAP system possessed some of the defined benefit characteristics that may facilitate administrative transition to a defined benefit plan. The popularity of defined contribution plans is limited, as this type of plan is new to South Korea,¹⁴ even though defined contribution plans offer the younger workforce portability. It is likely that the balancing of investment and longevity risks, and the jostling of political interests between the unions and employers, will determine whether defined benefit plans or defined contribution plans dominate in South Korea.

The pension assets of defined benefit plans/defined contribution plans are typically separate from those of the firm, and thus pension assets cannot be used as collateral for loans by the firms, as is the current practice by South Korean firms with RAPs.¹⁵ As RAPs are replaced by conventional pension plans, funds under management in South Korea will increase dramatically. However, it is expected that the transition to ERSA will not occur until 2010.

THE AUSTRALIAN CONTEXT

For more than 100 years, superannuation schemes in Australia were generally defined benefit funds.¹⁶ In the early years, superannuation was regarded as a managerial gratuity because members were predominantly managers, white collar workers¹⁷ and male.¹⁸ These early superannuation funds were established mostly by banks, insurance companies and financial institutions.¹⁹

At the same time, some public sector superannuation funds were established, for example the Police Superannuation and Reward Fund in 1862.¹⁶ The use of selective accrual and

vesting rules in Australian defined benefit plan trust deeds was common, and restricted superannuation benefits to a select few. Therefore, coverage of pension benefits for the general Australian workforce was limited until the advent of award superannuation in the mid-1980s.

Dissatisfied with the inadequate coverage of superannuation for the general workforce, the Labor Government's 'Accord' in 1983 encouraged union interest in superannuation. As the union movement became involved in negotiating superannuation benefits for its members, the popularity of the defined contribution plans structure increased.^{18,20} The achievement of full wage indexation also made it easier for the Government to shift union interest towards extra benefits, such as superannuation. The 1986 National Wage case delivered a 3 per cent wage productivity increase through superannuation rather than direct wage increases.

After compulsory superannuation was introduced in Australia, superannuation was regarded as a form of deferred pay. To the extent that the employer 'guarantees' the retirement benefit for the defined benefit plans, the investment risk is retained by the employer. On the other hand, for the defined contribution plans, there is immediate vesting of benefits while the employer's risk ceases on termination of the labour services. For the defined contribution plans, the employee retains the investment risk, as well as the risk that the retirement monies will 'run out'.²¹

Superannuation coverage of the general workforce in 1986 was 47.3 per cent, but female and part-time workers were under-represented.¹⁸ With the introduction of the Superannuation Guarantee Charge legislation on 1 July 1992, the coverage of superannuation for Australian workers was increased.²² By 1992, 92 per cent of the Australian workforce was covered by superannuation, compared to 32 per cent in 1974.²³

To protect superannuation arrangements, the Government enacted superannuation-related legislation in Australia, setting out the duties of trustees, auditors and plan administrators, including the reporting requirements of

superannuation plans.²⁴ The Australian Prudential Regulation Authority (APRA) is responsible for supervising and regulating superannuation plans. The objectives of the Superannuation Group within APRA are to ensure the prudent management and sound growth of retirement income savings through superannuation, to protect members' benefits and to ensure that taxation concessions for superannuation plans are used for approved purposes.

Australia's institutional pension arrangements have shortcomings, namely, the lack of security for defined benefit arrangements if the employer becomes insolvent. In addition, the restricted membership of the early defined benefit plans in Australia spurred the introduction of many corporate defined contribution plans that increased workforce coverage, but also shifted the incidence of the investment risk from the employer to the member.

Before IFRS, Australian companies were subject to disclosure-only requirements. This meant that in the presence of a pension deficit, it was possible to keep the pension liability off the sponsor's balance sheet. Conversely, in the event of a pension surplus, it was possible for the sponsor to take a contribution holiday and not necessarily disclose this fact. The pension recognition and disclosure requirements post-IFRS are mandated by Australian Accounting Standards Board (AASB) 119 'Employee Benefits', and require recognition of the net pension asset on the sponsor's balance sheet with year-to-year differences in the profit and loss. In Australia, the sponsors of defined benefit plans are mostly top-150 listed companies, and most firms in the sample have at least one defined contribution plan and one hybrid fund.

In Australia, the total assets invested by superannuation funds have grown substantially since compulsory superannuation legislation in 1991. For example, in 1991 the total value of assets invested by Australian superannuation funds was US\$135 billion, and by 1999 this had grown to \$408.643 billion.²⁵ The assets invested by superannuation funds²⁶ at March 2007 totalled \$1.1 trillion, declining to \$1.05 trillion as at December 2008 as a result of the recent credit

crisis. In Australia today, the business of superannuation is conducted primarily through defined contribution plans, although in economic terms the defined benefit plan and hybrid fund (which is technically a defined benefit plan) is still relevant.²⁷

PENSION ACCOUNTING IN SOUTH KOREA AND AUSTRALIA

Given the shared pension accounting histories of South Korea and Australia, the Australian IFRS pension accounting experience is relevant to South Korea's transition to IFRS in 2009–2010. Global accounting standards can be considered an 'enabler',^{28,8} by providing a common platform for comparison of pensions across nations. But the varying social and institutional contexts of pensions across jurisdictions, for example South Korea and Australia, must be a factor in any comparison.

One of the overarching objectives of accounting for pensions is to ensure that the incidence of investment, longevity and bankruptcy risks is accurately portrayed by the employer so that the actuarial position of the pension plan may be understood by users of the employer's financial accounts. Unlike the defined contribution plan, the employer accepts the investment risk in a defined benefit plan and is required to recognise the net pension position on its balance sheet. Year-to-year differences in the net pension position from one period to the next are taken to the profit and loss, potentially introducing market volatility. As a result, sponsors of defined benefit plans are concerned about the volatility of the profit and loss induced by the new pension accounting rules and the recognition of a net pension liability if the market is declining and the pension plan is in deficit. On the other hand, the accounting for defined contribution plans by the employer is straightforward because the employer's obligation to the defined contribution plans is discharged once the contributions to the plan are paid (as the investment risk resides with the member).

Standard-setters overseas have addressed some of the complex accounting issues for accounting

for defined benefit plans, although compromises have been made to reduce the volatility in the sponsor's profit and loss, and to limit the pension liability recognised by the sponsor in their balance sheet. For example, with convergence with IFRS, AASB 119 in Australia (and IAS 19) followed the accounting standard in the United States (SFAS 87 'Employers' Accounting for Pensions'), and permitted the 'corridor method' to deal with actuarial gains and losses. The corridor method smoothes the impact of market returns evident in actuarial gains and losses (AGL), and alleviates concerns about volatility in the sponsor's profit and loss by allowing recognition of AGL outside a 10 per cent corridor (if net cumulative unrecognised actuarial gains and losses exceed the greater of 10 per cent of the projected benefit obligation or 10 per cent of the fair value of plan assets).²⁹ This method is designed to reduce the reporting of large unexpected pension expenses, and softens the profit and loss impact of pension accounting. Its arbitrary nature has been criticised.³⁰

Since 1 January 2005, Australian sponsors of defined benefit plans have been required to use accrual accounting and disclose the components of the pension expense (such as normal cost, interest cost, actuarial gains, and losses and return on plan assets). This study finds that in Australia, the impact of IFRS on pension accounting for defined benefit plans was minimal in the employer's profit and loss (owing to declining defined benefit plans expenses over the period) and balance sheet (owing to the net pension positions being, on average, close to zero). On the other hand, the mean contribution expense for defined contribution plans as a proportion of firm profit before interest and tax is material (that is, greater than 5–10 per cent of net profit) over the period of the study.³¹ This finding likely reflects the widespread uptake of defined contribution funds in Australia, and the fact that the membership of most defined benefit funds in Australia is restricted and declining. Further, many Australian companies in 2005 appeared to be unsure of the pension disclosure requirements for both defined benefit as well as defined contribution funds.

Similarly, the general finding reported by this study that South Korean companies to date are not opting for defined benefit plans as part of their corporate pension restructure (from RAP) will likely reduce the impact of IFRS for pension accounting, at least in the short term. In the long term, if South Korean companies follow the Japanese example and introduce defined benefit plans, the potential impact of pension accounting on the sponsor's balance sheet and profit and loss will likely increase. On the other hand, it is not clear the extent to which defined contribution plans are being adopted by South Korean companies.

WHAT ARE THE LESSONS FOR SOUTH KOREA FROM AUSTRALIA'S IFRS EXPERIENCE?

The history of pensions is longer in Australia than in South Korea. As South Korea dismantles its RAP system and introduces traditional defined benefit plans/defined contribution plans, employers can decide whether to retain the investment risk (for example, by introducing defined benefit plans) or to shift this risk to the member by introducing a defined contribution plan (or some hybrid combination of the features of the defined benefit plan/defined contribution plan). The accounting for the defined benefit plans by the sponsor is more problematic because the investment risk is retained by the sponsor and must be recorded in its financial accounts according to IAS 19. Currently, South Korean firms record the RAP net liability in their accounts. Transferring a RAP to a defined benefit plan would require the sponsor to engage an actuary to calculate the accrued benefits and value the assets, and record the difference between plan assets and accrued benefits on the sponsor's balance sheet. On the other hand, for the defined contribution plans, IAS 19 requires disclosure of the contribution expense so that employees/members can see that the company is meeting its statutory obligations.

A review of the pension accounting practices of the top-200 companies in Australia from 2004 (pre-IFRS) to 2007 shows a preference for defined contribution plans, even during profitable

periods. Where defined contribution plans are the favoured option, financial literacy is an important policy consideration of governments to ensure the sustainability of pension systems, because the investment risk rests with the member.

At present, South Korean firms are in a state of transition from the old RAP system to ERSA-type plans. Whether South Korean firms exhibit a preference for defined contribution plans over defined benefit plans as in Australia or a preference for defined benefit plans (as in Japan) depends on an assessment of the risks, including investment and longevity risks. If the RAP system is more easily replaced by defined benefit plans, then the more difficult accounting, disclosure and actuarial issues attached to defined benefit plans will be relevant to South Korean firms. If South Korean companies follow the Australian (and current worldwide) experience and favour defined contribution plans, the more difficult accounting and actuarial issues attached to defined benefit plans may be avoided. Financial literacy is equally a concern for South Korean policy makers.

Australian firms were not always uniform with their pension disclosures when converging with IFRS, and in some cases it took firms 1 or 2 years to understand the disclosure requirements, for example for the disclosure of actuarial assumptions. The advantage for South Korean companies is that they can use Australian pension disclosures as a 'boiler-plate' to ensure that their pension accounting and disclosures are in accordance with IAS 19.

POLICY IMPLICATIONS OF PENSION ACCOUNTING

Pension accounting research has policy implications for governments in South Korea and Australia. This is because pension reforms typically highlight first, the amount of contributions required to make the pension system sustainable into the future, and second, who bears the risks of the reforms. This creates policy challenges for governments with ageing populations, declining dependency ratios and declining asset values as a result of the recent global financial crisis. One of the likely policy

challenges for both the South Korean and Australian governments includes the trend towards defined contribution plans where the investment risk is borne by the member, who may be less equipped than the employer to bear this risk. Another policy challenge for the South Korean government may be to encourage large South Korean corporations to respond to the recent ERSA initiatives on a timely basis. Policy initiatives for the Australian government, given widespread defined contributions plans, should aim to improve the financial literacy of the general populations so that they may better handle the investment risk, and to legally enforce the defined benefit plan guarantee by the sponsor (especially for the public sector).

As the adoption of defined contribution plans/defined benefit plans options must be approved by the unions in South Korea, it is unclear the extent to which the transferring of risk to the general workforce will be accepted. South Korean companies may likely follow the Japanese in their reluctance to adopt defined contribution plans, despite their apparent public support.³² Political factors, such as a government deficit and an ageing population with improved longevity, acted as a counterbalance to place pressure on Japanese companies to accept some of the risks attached to the ageing population.³³ It is likely then that in South Korea the uptake of defined contribution plans/defined benefit plans will depend on a balancing of the investment risk and political factors. The results of this study will have policy implications as the urgencies of ageing populations, declining dependency ratios and falling asset prices take hold in both Australia and South Korea.

CONCLUSIONS

The substantial tensions in society with regard to the sharing of risks and benefits for pensions between the parties in an employment contract makes pension accounting an important issue for accounting standard-setters and policy makers. Accounting standard-setters need to be cognizant of the way the social and institutional contexts allocate the risks in providing for pensions, and of how this affects accounting for the pension transaction. South Korea is planning to adopt

IFRS in 2009–2010. Given the shared pension accounting histories between South Korea and Australia, South Korean companies stand to benefit from insights from their Australian counterparts with regard to pension accounting.

The importance of pension systems is more pronounced in those countries that are experiencing ageing populations and increasing costs to support the elderly, such as South Korea and Australia. This article compared the social context and institutional and accounting regulations of pensions in South Korea and Australia by addressing the incidence of investment, longevity, inflation and bankruptcy risks. It serves as a 'starting point' in assisting South Korea's transition to IFRS for pension accounting by allowing South Korean companies to gain insights about the recent Australian experience with pension accounting. For example, although the genesis of pensions in South Korea is a type of redundancy payment, the move to either a defined contribution plan/defined benefit plan structure should be made after an assessment of the incidence of investment, inflation, longevity and bankruptcy risks. Using the Australian experience as a benchmark, if South Korean firms introduce defined contribution plans, on the one hand the accounting for pensions is more straightforward, but on the other hand the financial literacy of the population becomes an important policy issue. Political issues such as the state of government finances may intervene (as they did in Japan) and require companies to shoulder some of the longevity risk of populations with the government so that defined benefit plans become the required option. If South Korean firms introduce defined benefit plans, they will need to handle the more difficult accounting issues attached to defined benefit plans in the future as the defined benefit plans matures.

Australian policy makers also benefit from this research. Presently, Australia has a private mandatory pension system that encourages defined contribution plans. This benefit structure transfers the investment and longevity risks to the employee/member. To this extent, the financial literacy of the Australian population assumes

greater significance to policy makers. To date, there is no evidence on how well employees/members manage these risks and how adept they are at asset management for their retirement. While companies may not be interested in this in the short term, policy makers should be concerned about the longer-term implications of a generation of potentially mismanaged assets that will place further stress on the public purse. The upshot is that the public pension system underwrites a minimum level for the investment and longevity risks in case the source of private retirement plans runs out. Because of the culture-laden aspects of pensions, comparisons between culturally diverse nations such as South Korea and Australia offer broader social and institutional insights that may be helpful to international accounting standard-setters.

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- 5 For the top-100 listed South Korean firms, only two companies (STX Shipping, STX Engine) disclose that they have a defined contribution plan (DCP) and another four companies (Daehan elcctornic, S-one, Dong-A Comp, Kyeung bang) disclose that they have a defined benefit plan (DBP). For the remaining 94 firms, we could not locate disclosures of pension plan information. For the six South Korean companies that do disclose (limited) pension information, there was no financial information supporting their pension disclosures.
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- 20 In 1982-1983, only 18 per cent of members were covered by the DCP benefit structure, compared to 82 per cent for the DBP structure¹⁸.
- 21 Combination plans, now referred to as hybrid plans, emerged in Australia during the 1970s. These plans had a dual benefit structure, with the employers' benefits placed in the DBP section and the employees' contributions plus investment earnings in the DCP section. In this way, the advantages of both forms of plan design (that is, defined benefit and defined contribution) could be obtained. As at June 1995, of the total assets invested by Australian superannuation funds, DBPs account for 19 per cent, DCPs for 51 per cent and hybrid funds for 29 per cent (Bateman, H. and Piggott, J. (1996) *Private Pensions in OECD Countries Australia*. School of Economics, UNSW, August, p. 62). By June 1999, total assets

invested by superannuation funds (excluding funds with less than five members) comprised 7.5 per cent for DBP, 50.79 per cent for DCP and 41.71 per cent for hybrid funds.

- 22 This legislation imposed a non-tax deductible levy on employers that did not abide by the 'compulsory' superannuation contribution rates. The superannuation guarantee charge (SGC) commenced on 1 July 1992, starting at 3 per cent of employee earnings (7 per cent from 1 July 1998; 8 per cent from 1 July 2000) and increasing to 9 per cent by 2002. It applies to all employees earning more than \$450 per month. Two important aspects of the SGC are that it endorsed a 'compulsory' system of superannuation, and that superannuation became a taxation issue rather than an industrial relations issue administered through awards.
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