Occupational pensions will impact the future of all generations.
Thanks for clicking into Disclose! The theme of this issue is pensions. It’s a hot topic that has always stirred controversy, so I think you’ll find plenty of interesting and though-provoking reading.

Pensions are all about making certain sacrifices now so that you’re well looked-after later on. In this issue of Disclose we’ll be looking at the burden borne by the second pillar, and how this is shared and funded by the various generations. We’ll be discussing the implications of the system for the working population, employers and pensioners – the roles each of these groups currently play, and the roles they might play in the future.

Switzerland’s three-pillar system helps ensure social security and good industrial relations while allowing flexibility for people to meet their own individual needs. Those are all good reasons for taking care of the system. But occupational pensions face enormous challenges: people are living longer, interest rates are at rock-bottom, and funding pension benefits in the long term is turning out to be a herculean task. These are challenges pension funds and the social partners involved have to confront. They have to take care of the system and take responsibility for how it turns out.

One of the keys to funding occupational pensions is the conversion rate – or rather the ‘right’ conversion rate. We ask whether there’s even any such thing as the ‘right’ rate, and what this definition means for companies and the benefits they promise their employees. We also present PwC’s dynamic pension model, an entrepreneurially courageous solution designed to bring real-world circumstances, and the interests of pensioners and active members into alignment.

As always, Disclose also contains relevant information on accounting and financial reporting. In this issue we show how the same facts may be presented differently in the accounts depending on the financial reporting standard adopted. For example we look at the implications of
measures to remedy situations where a pension fund’s ability to weather risk is impaired – not just for the insured persons, but for the financial statements of the company affiliated to the fund. We also explain why pension plans are an attractive option for both employees and employers.

This issue of Disclose looks at pensions from many different angles. That’s important, because whether you’re responsible for a pension fund or otherwise involved, you have to keep your eyes open and look to the future.

Alex Astolfi
### In the spotlight

- **Swiss pensions system: assuring social security and peaceful industrial relations** by Brigitte Zulauf and Dr. Marcel Widrig – page 5
- **Getting out of the impasse of the ‘right’ conversion rate** by Heinz Hartmann – page 19
- **1e pension plans: about to become much more attractive** by Adrian Jones – page 32
- **Room for manoeuvre despite regulation: effective interplay in governance** by Michael Bührle and Matthias Sutter – page 10
- **Dynamic pensions** by Josef Bachmann – page 22
- **Understanding what you (don’t) read in the accounts** by Stefan Haag – page 26
- **Funding occupational pensions: a thorny challenge requiring awareness and intelligence** by Markus Schneeberger – page 15
- **Update**
  - Expert articles about the latest relevant developments in tax, financial reporting and employment law – page 36
- **Reader service** – page 60
Swiss pensions system: assuring social security and peaceful industrial relations

Switzerland’s three-pillar benefits system enjoys an excellent international reputation, and is seen as exemplary in terms of social security and intelligent funding. The system is flexible and provides scope for adjusting the mix of cash payments, risk insurance and retirement savings in line with the needs of individuals.

The three-pillar benefits system in Switzerland is designed to give people financial security in their old age and cover them for the risks of accident, illness and death. The first pillar is the federal old-age and survivors’ insurance scheme (AHV/AVS). This also includes disability insurance (IV/AI), income compensation during military and civilian service (EO/APG) and maternity, and unemployment insurance (ALV/AC). All first-pillar social security is mandatory, and is designed to ensure a minimum subsistence level. The second pillar, occupational benefits (pensions), is based on the Swiss Federal Law on Occupational Retirement, Survivors’ and Disability Pension Plans (BVG/LPP). It is also mandatory. The second pillar covers the risk of death and disability, and beyond this allows people to accumulate retirement savings so that they can maintain their accustomed standard of living following retirement. The third pillar has two components: tax-advantaged, voluntary retirement savings, and individual savings without any tax advantages.

The three-pillar model ensures a high level of social security and facilitates peaceful industrial relations. But it is expensive by international standards. Countries in Southeast Asia and South America have no or only very limited social security systems. The only countries to offer their citizens a similarly high level of social security as Switzerland are the majority of western and northern European nations plus countries such as Canada and Australia that are part of the British Commonwealth.

Solidarity in the first pillar

The AHV/AVS was introduced in 1948, the IV/AI in 1960. At that time Europe was rebuilding after World War II. Many people had vivid memories of their terrible experience of totalitarian political movements in the period between the world wars. The concept of a social market economy where free competition coexisted with social
security found broad acceptance.

The AHV/AVS system is funded by employee and employer contributions, together accounting for more than 10 per cent of a working person’s gross pay. Employers bear a slightly greater burden than employees, having to cover the administrative costs themselves (the costs billed vary depending on the social security authority). Employers must also pay contributions to the funds for family allowances paid to families with children. Here too the contributions vary depending on the canton and the authority.

Most people in Switzerland still see the AHV/AVS pension as a well-earned reward for the work they have done. The basic principles behind the first pillar also include solidarity and guaranteeing a minimum level of subsistence. In the past this has led to repeated expansion of the system. If pensions and other income are not sufficient to cover the minimum cost of living, people are legally entitled to supplementary benefits.

The AHV/AVS system requires solidarity on two levels. First, the active generation finances the pensions paid to the older generation and trusts that subsequent generations will do the same. Second, higher earners support employees in a less fortunate position by paying considerably more into the AHV/AVS than would be needed to fund their own pension.

Here nothing is likely to change in the near future. However, if in the years to come the digital revolution erodes the service industries to the same extent that manufacturing has been eroded in past decades, the current rates for AHV/AVS contributions will no longer suffice. Maintaining current pension levels will mean either raising the retirement age and contributions, or reducing benefits.

As a result of structural changes, in time the AHV/AVS could take on the character of a minimum income. If this actually happens it’s likely to put pressure on solidarity. The rates for AHV/AVS contributions are the same regardless of pay. Currently the maximum AHV/AVS pension for unmarried people is CHF 28,200 a year, and CHF 42,300 a year for married couples. Many high earners – including, notably, foreigners who are only working temporarily in Switzerland – already view the first pillar as an additional income tax.

Second pillar allows individuality

The second pillar, occupational pensions, is designed to supplement the
basic cover provided by the AHV/AVS and IS/AI. The goal is to enable people to preserve their accustomed standard of living in their old age or in the event of illness, disability or the death of the family’s main breadwinner.

Occupational pensions are financed on an individual contribution basis. Employees with annual pay of between CHF 21,150 and CHF 84,600 who exceeded age 17 but have not yet reached retirement age have to be covered by second-pillar (BVG/LPP) insurance. People who earn more than CHF 84,600 a year can take out extra-mandatory cover if their employer offers such insurance (see Room for manoeuvre despite regulation).

In most cases employers and employees contribute equally to the mandatory pension fund. The rate of these contributions increases in four stages over the course of the person’s working life. In combination with the first pillar, second-pillar benefits cover up to 60 per cent of the final salary for single people and up to 75 per cent for married people.

Since they became compulsory in 1985, occupational pensions have become a very significant economic factor. The amount of money accumulated in the second pillar is many times greater than in the first pillar. Nowadays pension funds are among the investors with the greatest financial clout in the country.

In 1993 the Swiss parliament filled what had been a gaping hole in occupational benefits by adding the Vested Benefits Act to the BVG/LPP legislation. Since then employees have been able to take all their benefits with them if they change jobs, transferring their retirement assets to the new employer’s pension fund without any financial penalty. The law on vesting removed the ‘golden handcuffs’ that had kept many employees tied to a particular employer. Prior to the new legislation, an employee leaving a company would have had access to only part of the money they had paid in, or none at all, depending on how long they had worked for the company and the set-up of the pension plan.

Younger employees, many of whom don’t yet earn so much, are often sceptical about occupational pensions. They have doubts as to whether the mandatory contributions are invested in their retirement profitably, or at least well enough to preserve the value of their capital. These concerns are magnified in the current environment of low interest rates. The BVG/LPP provides leeway for the set-up to be adapted on an individual basis, especially on the extra-mandatory side. For example employers can choose to offer their employees a less comprehensive BVG/LPP solution but cover risks such as illness, accident, disability
and death via supplementary insurance. Many different models are used in practice. Depending on the age and income structure of the workforce or the corporate philosophy, an employer might cover the additional costs fully, partly, or not at all.

The second pillar can be very attractive for people with extra-mandatory cover. As their income increases, people have more money available to contribute to their pension fund. And these contributions can be deducted in their entirety from income and wealth tax. Absolute top-earners can put aside several million francs over the course of their career. If the contributions were deductible at a tax rate of 40 per cent and the pension or lump sum benefit is taxed at a lower rate at the moment it is paid out, considerable tax savings are possible over a person’s full working life.

The BVG/LPP allows employers with gaps in their second pillar cover to buy into the pension fund tax-free. Such gaps can arise, for example, if an employee had a low income early in their career and now earns a lot, or if an employee didn’t pay into the occupational pension scheme for a time because they were abroad or had interrupted their career. Anyone considering the tax benefits of buying in voluntarily should also remember that as things stand any cash they pay in will be tied up.

**Third pillar tax privileges**

The third pillar has two components: 3a and 3b. Pillar 3a is tax-advantaged provided contributions are paid into a recognised form of pension or benefits set-up. The annual tax-free amounts are adjusted in line with increases in maximum AHV/AVS pensions. Employees with a second-pillar plan are entitled to pay in CHF 6,768 and deduct it from their direct taxes. Self-employed people who don’t belong to a pension fund can pay in a maximum of five times this amount tax-free. In concrete terms this is CHF 33,840, although the actual amount paid in may not exceed 20 per cent of their net income. Money saved in pillar 3a is paid out in accordance with the rules that apply to the second pillar.

Many sole traders don’t have full cover for their retirement, taking the view that their business constitutes their pension fund. Since 2011, Corporate Tax Reform II has enabled business assets to be liquidated at tax-advantaged terms. Before 2011 the liquidation of business assets incurred taxes of well over 50 per cent. Now this is subject to tax at around the same rate as a payment of capital from a second pillar plan.

Pillar 3a savings are unattractive for self-employed professionals such as lawyers and doctors who don’t have substantial investments. But in
most cases they have the option of joining a benefits scheme offered by their professional body and thus enjoying the same tax advantages as people who work on an employed basis.

Pillar 3b covers individual savings in the form of cash, equities and other assets. It is free and individual, doesn’t enjoy any tax advantages, and can be liquidated at any time.

**Summary**

The three pillar system helps ensure the cohesion of the social partners in the Swiss employment market. But it comes at a price: mandatory contributions to the first and second pillar make up between around 20 and 30 per cent of gross pay. These high ancillary wage costs reduce companies’ competitiveness and are an incentive to automate and cut jobs – a trend that is likely to become even more pronounced as digitisation sweeps the tertiary sector.

The costs of administrating the first and second pillars are high. Employers have to evaluate suitable benefits solutions for their employees, record joining, leaving and absences correctly, settle contributions and handle employee benefits. Accounting for first-pillar benefits may seem straightforward at first glance. But things can get more complex, especially when employees work part-time or on a flexible basis. With the BVG/LPP offering a wide range of individual alternatives, it becomes even more complicated when it comes to the second pillar. Many companies have difficulty determining the pay used as the basis for calculating social security contributions.

But the benefits of the three-pillar system outweigh the disadvantages: the Swiss old-age and risk insurance set-up helps create a level of social security unmatched in most other countries. The system ensures peaceful industrial relations in this country, and can be adapted flexibly to individual needs. For this reason we should take good care of it.
In the spotlight: occupational pensions

Room for manoeuvre despite regulation: effective interplay in governance

A pension fund’s governing body has far-reaching room for manoeuvre. The board defines the fund’s investment policy within the scope of the law, and decides at its own discretion what benefits it will pay and how these benefits will be funded. Occupational pensions in Switzerland are governed by a number of federal laws and ordinances and regulated by state supervisory authorities. Besides this, independent pension fund experts and external auditors perform an important control function.

The idea of making financial provision for the future has a long tradition in this country. Over 100 years ago various public law institutions set up schemes to provide financial security for widows and orphans. In the 1960s and 1970s many private companies established their own pension funds or joined a collective scheme. When, at the beginning of the 1980s, the Federal Council and parliament decided to make employee benefits and pensions mandatory, a network of pension institutions was already established across the country.

Onus on employers and employees

Occupational pensions and employee benefits are regulated by a series of laws and ordinances. The basic rules are set out in Article 331a to 331f of the Swiss Code of Obligations (CO). For example, these rules stipulate that contributions to an employee benefits scheme may not be credited to the company affiliated to the fund, but must be transferred to an independent third party, such as a foundation, a cooperative or a public law institution.

The Swiss Federal Law on Occupational Retirement, Survivors’ and Disability Pension Plans (BVG/LPP) of 25 June 1982 and the Ordinance on Occupational Retirement, Survivors’ and Disability Pension Plans (BVV 2/OPP 2) constitute the most important legal foundation for the second pillar of the Swiss pension system. Among other things the legislation regulates the statutory duties of employees, the obligations of employers, and the organisation of employee benefits schemes.

Under the terms of the law and the ordinance, contributions to an employee benefits scheme are mandatory for employees with an annual
salary of between CHF 21,150 and 84,600 who exceeded age 17 but have not yet reached retirement age. Up to age 24 only the risks of disability and death have to be covered. After that the savings process begins. Employees are not free to join any pension fund of their choosing, but are tied to their employer’s scheme. The law on vesting of 17 December 1993 and the accompanying ordinance of 3 October 1994 are designed to prevent this obligation from putting ‘golden handcuffs’ on employees. You can read more about this in see Swiss pensions system.

In return for the obligation imposed on employees, BVG and BVV 2 impose a duty of care on employers, who have to either join a benefits scheme on the official register or establish their own. The social security authority checks whether employers have met the obligation to join a scheme. If they have not, the authority notifies the Substitute Occupational Benefit Institution accordingly.

**Figure 1: Pyramid of controls for occupational benefits**

- **Supreme occupational benefits supervisory authority (OAK BV/CHS PP)**
- **Cantonal and regional supervisory authorities**
- **Pension fund experts**
- **External agents of control**
- **Auditors**
- **Board of trustees with equal employer and employee representation**
- **Internal control matched to the size and complexity of the fund**

**Equal representation and internal controls**

The BVG is designed to give employers and employees an equal say in the management of benefits schemes, with each group entitled to an equal number of representatives on the pension fund board. The
board’s duties are set down in Art. 51a para 1 BVG. The governing body of the employee benefits scheme is responsible for the overall direction of the scheme, ensuring that the relevant legal requirements are met, and determining the strategic objectives and principles of the scheme and the means used to implement them. The governing body also determines the way the scheme is organised, assures its financial stability, and monitors its management.

In practice, trustees and the other management bodies of benefits schemes generally make full use of this room for manoeuvre. The governing body is also responsible for internal control. Each pension fund decides for itself how this control function is to be performed. Naturally it has to be adequate for the risks. But here too, pension fund boards have extensive leeway.

According to Article 35 para 1 BVV 2, the auditors must check whether internal controls are in place and are appropriate to the size and complexity of the scheme. There is no legal requirement for benefits schemes to set up a system of internal controls. While large pension funds have set up such systems on their own initiative and linked them with their risk management systems, many small and medium sized funds have some catching up to do. A system of internal controls is particularly important in terms of corporate governance. For many insured persons, the retirement savings accrued in their pension fund represent the lion’s share of their personal wealth.

External control by pension fund experts and auditors

Art 52a BVG specifies two external bodies responsible for scrutinising benefits schemes: the pension fund expert, and the auditor. They have equivalent status but perform different roles. Art. 52e BVG specifies the duties of pension fund experts and Art. 52c BVG sets down those of the auditors.

The pension fund expert serves as an actuary, periodically checking whether a scheme can be sure of meeting its obligations at all times. The pension fund expert also checks whether the technical rules governing benefits and funding are in compliance with the law. They make recommendations regarding the technical interest rate and other technical parameters to the pension fund board. If a scheme is underfunded they will recommend the corresponding measures.

The auditor is the second external oversight body. Under the terms of the BVG auditors have a broader remit than statutory auditors under
In addition to auditing the financial statements, auditors specialised in employee benefits check whether the statements are compliant with the rules of the pension fund. Among other things they look to see whether the fund’s organisation, management and investments satisfy the requirements of the regulations and the law. When it comes to pension obligations and technical reserves, the auditors work on the basis of the report of the pension fund expert, checking to see whether the expert’s calculations are plausible, and in particular whether the data used for calculations are complete and whether the terms of the regulations have been complied with.

**Federal and cantonal oversight**

Benefits schemes are also subject to the oversight of cantonal authorities and the Supervisory Commission for Occupational Pensions (OAK BV). This dual oversight structure was introduced in 2011 as part of structural reforms of the BVG system. For reasons of cost and efficiency, some cantons have joined forces to allow oversight on a regional basis. The cantonal and regional oversight structures are set up as public law institutions with their own legal personality, and are not subject to outside direction.

The cantonal and regional oversight authorities check whether benefits schemes are in compliance with their bylaws and the law. They also check the regulations of each individual institution under their oversight and inspect their annual reports and the reports of the pension fund experts and auditors.

The OAK BV is the independent commission presiding over the cantonal oversight authorities. Its main role is to assure quality and legal certainty. It is responsible for ensuring consistent supervisory practice. To this end it can issue directives and carry out inspections.

This dual oversight of benefits schemes is the exception. In other industries such as banking, insurance and at first pillar level there is only one central authority. The advantage of this two-tier structure is that each supervisory authority knows the schemes it oversees well and can address their circumstances on an individual basis.

**Summary**

The Swiss system of pension fund supervision has proven its worth. The pyramid oversight structure, from internal control to the supreme federal oversight body, makes sense and serves its purpose. In the past there have only been isolated glitches, which in most cases were due to criminal behaviour.
Employee benefits and pensions face major challenges, most of all because of increasing longevity and low interest rates. The resulting issues cannot be addressed with more laws and government oversight. The problems can only be tackled by the bodies responsible for benefits schemes and the social partners involved. To do this, they need sufficient room for manoeuvre.
In the spotlight: occupational pensions

Funding occupational pensions: a thorny challenge requiring awareness and intelligence

Low interest rates and rising life expectancies have made it problematic for many Swiss occupational pension funds to pay the pensions due to people who have already retired. And with most experts forecasting no improvement in these fundamentals in the medium to long term, delivering on current promises to future retirees looks set to become an even greater challenge. How should the various parties involved – from pension fund boards and employers to people currently in work and pensioners – be thinking about addressing the issue of how occupational pensions are to be funded going forward?

Swiss occupational pension funds face substantial funding challenges, primarily because of a combination of two problems: low interest rates and increasing longevity. A quick definition of terms will make the significance of these mechanisms easier to understand. Pension funds calculate their pension liabilities based on two actuarial assumptions: the so-called discount rate and the expected time the pension will have to be paid depending on how long the pensioner lives (longevity).

The discount rate is the interest rate it is assumed will be necessary to pay out a pension over the whole period for which the pension is due. Based on this long-term perspective, the discount rate is fixed at, say, 2.5%. A simple example: a pension fund promises a pension of 10, for which it needs capital of 200. The following year the capital is no longer 200 because a pension of 10 has been paid and interest has been earned on the remaining capital. In reality the interest earned depends on the market situation, and normally doesn’t correspond to the discount rate. When performance on invested capital is in reality lower than the assumed discount rate of 2.5%, the remaining difference must be financed from other sources. This is one key component of the problem currently faced by pension funds, employers and their active members.

The other main actuarial assumption pension funds have to make is longevity. Naturally you can never know how long an individual pensioner will live and hence how long their pension will have to be paid. Pension funds therefore use actuarial tables of assumptions, which are usually updated every five years on the basis of large populations of insureds. In the past 50 or 60 years, longevity has increased by around one year every ten years.

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To illustrate the implications for funding pensions, let’s take the hypothetical example of a pensioner who retired twenty years ago. At the time this person retired, discount rates of 4% (much higher than present rates) were normal, and longevity was two years lower than now. So the pension promise made to this pensioner back then was much too high because it was based on assumptions that were much more optimistic than the present reality. This equates to a funding problem.

**Problem on a huge scale**

To give some idea of the actual scale of this problem, consider that the most recent so-called reference discount rate set by the Chamber of Swiss Pension Fund Experts back in September 2015 was 2.75%. Pension funds will use the reference discount rate as a benchmark to define their individual discount rate. A rolling calculation done by PPCmetrics for March 2016 shows a reference discount rate of only 2.42% – a decline of more than 0.3% in a matter of only a few months. With Swiss Statistics putting the volume of money set aside as reserves for pensioners in this country at about CHF 300 billion, and assuming that this was calculated with the reference discount rate of 2.75%, it would be necessary to increase these reserves by around CHF 10 billion simply to cover the shortfall for current pensions that has arisen since the end of September 2015. Consider that these figures only relate to existing pensioners and liabilities, and don’t even take account of the increase in longevity, and it all adds up to massive financial challenges.

**What does this mean for active members?**

As things stand at present, the funding of pensions can primarily come from only two sources: the active employees and the employer. In the worst case (in an underfunding situation) this could take the form of increased contributions from active members and the employer.

Even if there is no underfunding, active members will suffer from low performance on invested capital at a much earlier stage. When the performance is lower in reality than the discount rate on which the calculation of the pension liabilities is based, active members must indirectly subsidise pensioners by accepting reduced interest credits on their own savings. Over the long term this will lead to significant gaps in the savings of active members – a painful reality that in effect means that younger working people are being expected to fund retirement benefits they will never enjoy themselves because they have taken a cut in the interest paid on their retirement assets in favour of the pensions paid to people who have already retired. Not only this, but the younger
an active member is, the higher life expectancy will be at their retirement age, resulting in an additional decrease in their pension expectations.

**What will have to change?**

Basically there are three options for resolving the issue: active members work longer to accumulate more savings, the savings level is increased to achieve a similar outcome, or benefits upon retirement are reduced. Most probably a combination of all these options will even be necessary.

Theoretically there are a number of other variables that could be tweaked to solve the funding problem. But at the moment the legal, political and cultural framework means that only small improvements are possible. For example, the pensions paid to people who have already retired could be reduced. But according to the current legal understanding, it’s simply not possible for a fund to reduce the pensions paid to people who have already retired.

Reducing the pension promise for active members by cutting the so-called conversion rate (the mechanism used to determine the amount of pension someone is paid on the basis of their retirement assets) is also a legal no-no as far as the mandatory part of occupational pensions is concerned. It’s true that within the framework of the ‘Altersvorsorge /prévoyance vieillesse 2020’ legislative project, the conversion rate is to be reduced step by step from 6.8% to 6.0%. But this is still perceived as being too high by pension specialists. In another area there’s also the matter of political will: even though the OECD famously declared two years ago that in terms of retirement age, ‘67 is the new 65’, any politician earnestly pursuing an increase in this country at present is likely to seriously upset their constituents. Any moves in this direction would require a substantial change in the public’s mindset: people would have to start managing their expectations in terms of when they will retire, how many hours they will have to work in their lifetime, and what portion of their pay they’re prepared to invest to assure themselves of a decent pension once they retire.

On the other hand, Swiss companies can’t afford to reduce pension expectations too much. They have to tread the line between resolving the pension funding issue and remaining competitive as an employer in Switzerland and as a business operating in an international setting. With prices in this country so high, companies have to balance all these considerations to achieve a good compromise for all the parties involved. They have to be able to show employees that they pay fair salaries and provide for fair pensions. But they also have to show their investors that they have a solid balance sheet. If the Swiss employer
value proposition is a fine mechanical watch, pensions are one of the small, but important, cogs in the mechanism.

**Small steps possible at present**

Until difficult decisions are made at the political level and the general mindset regarding pensions has changed, the solution to the funding issue is likely to consist in a range of smaller measures. One move pension funds can consider is to pay retirees part of their assets as a lump sum rather than granting a pension for the entire assets accrued over the active period. This avoids the longevity issues for the fund. Another option could be a transition to flexible pensions, where only a part of the pension is guaranteed. Pension funds should also be taking a good look at their investment strategy in the light of their liabilities. If liabilities increase and a pension fund fails to adapt its strategy, the risk in terms of the volatility of returns increases significantly – a risk that pension funds can ill afford on top of all the other challenges they face at present.

**Summary**

Low interest rates and growing longevity are combining to create a serious funding problem for occupational pensions. While this is an issue in other countries too, the specific political, cultural and historical circumstances in Switzerland are creating a unique set of challenges when it comes to solving the funding problem. Until these challenges have been resolved, the people responsible for steering pension funds into the future will have to look very carefully and honestly at the situation and decide what combination of smaller steps will be required to keep their fund in shape and make realistic promises it can deliver on.
In the spotlight: occupational pensions

Getting out of the impasse of the ‘right’ conversion rate

The decision on how high to set the conversion rate for an employee benefits scheme (pension fund) has serious consequences. It will have an impact for decades to come on the income of pensioners, the finances of the pension fund, and the situation of the employer. Individual pensioners want as high a pension as possible, while the people responsible for the scheme have to be prudent to safeguard the long-term future of the fund.

So what is the ‘right’ conversion rate? Given that we can’t predict with any certainty whatsoever the basic assumptions – investment returns and pensioner life expectancies – that will apply for the next 20 or 30 years, how are we supposed to work out the right conversion rate? Once you set the conversion rate you can adjust it upwards, but only in certain circumstances can you adjust it downwards. That means you can’t afford to set the rate too high. As far as mandatory pensions are concerned, the decision lies with the sovereign power, in other words with the people. This could result in a one-sided bias towards the interests of pensioners. The political authorities and business must make due preparations and find ways of assuring the solvency of pension funds.

Complex dilemma

The authority over and responsibility for the extra-mandatory component lies with a pension fund’s board of trustees, which equally represents the employer and the employees. The trustees have to weigh up the various interests carefully.

- Cutting conversion rates will lead to painful reductions in income for future pensioners, who may well view any cut in the rate as an unnecessary overreaction.
- On the other hand, postponing the decision to adjust the conversion rate invites accusations of acting irresponsibly, as any delay may result in substantial changes in pensioners’ assets, or even put the pension fund’s solvency at risk.
- The employer wants to ensure that its pension fund remains also attractive for new people joining the organisation. Remedial contributions and low interest rates on retirement capital due to redistribution on the basis of inflated benefits promised in the past are a real turn-off. Subsidising pensioners at the expense of active

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members is in sharp contradiction to the idea of the second pillar.

- A reduction in the conversion rate will create apprehension among employees that the employer wants to mitigate reductions in benefits with extra savings contributions and compensatory payments.
- Reducing the conversion rate will mean that employees will need to work longer to avoid reductions in benefits – which will not always be in the interests of the employer.
- So-called 1e plans (see 1e pension plans) may be a topic for discussion. These plans allow insured members to choose their own investment strategy and assume the investment and longevity risk.

Seen in a sober light, the fact is that it’s impossible to set the ‘right’ conversion rate. There will always be a conflict of interest, and the circumstances will always turn out differently from what was originally expected.

**Figure 1: Complex challenge faced by pension funds**

![Diagram of pension fund components: Retirement capital, Retirement pension, Conversion rate, Interest, Cross-subsidisation by active members]

**Farsighted solution**

The trustees of PwC’s pension fund have opted for measures to reduce the redistribution that will also be advantageous and understandable for the people already receiving a pension. Their pension income
remains plannable. While the model adopted involves a significant cut in fixed pensions, it added a variable bonus component, which is determined periodically by comparing budgeted and actual returns. In other words, the bonus component may be cut if returns are insufficient, but it may also be raised if returns are good. This way it’s possible, to some extent, to adjust the conversion rate on an ongoing basis. The positive side-effect of this approach is that it indirectly links pensions to inflation, as inflation tends to be higher when interest rates are high – and vice versa. At first, PwC’s new model was only implemented for new retirees whose pension started in 2005 or after. Necessary cuts in conversion rates for future retirees, by around 50%, and expectations of low returns, mean that new retirees need more capital to finance their own retirement. For this reason the board of trustees wants to limit the redistribution by also applying the pension model to current pensions (existing retirees). In other words, the pensions of people who have already retired will be adjusted in line with returns. This does not constitute a remedial measure, but rather a switch to a more appropriate system. The result is that all pensions are indexed – and the redistribution effect is reduced.

The system underlying the model and the way it functions are described in part two of this article Dynamic pensions.

**Summary**

The general outlook for Swiss pensions is not particularly bright. So it’s all the more important to find financially sustainable solutions to the problems faced by the second pillar – solutions that don’t put younger generations of active members at a disadvantage. At PwC we have opted for a dynamic model geared to the reality that takes account of the interests of both pensioners and active members. This is our way of taking responsibility not only for our pension fund, but for the future of our society.
In the spotlight: occupational pensions

Dynamic pensions

Switzerland’s three-pillar system is rightly acknowledged as a success. But thanks to a steady, drastic shift in the equilibrium between active contributors and pensioners, the first pillar, funded on a pay-as-you-go basis, is gradually in danger of being thrown out of balance. So it’s a good thing it’s topped up by the second pillar. Here members and their employers both contribute to savings basically intended for the individual member. Cross-subsidisation is not supposed to take place.

But at the moment this pillar too is being shaken because the pensions promised in the past were too high. Given growing life expectancies and insufficient returns on investment, the capital accumulated up to retirement is no longer enough to fund current pensions for the full remaining lifetime of retirees. Additional funds have to be injected at the expense of active members. This doesn’t mean, however, that the second pillar has passed its sell-by date – on the contrary, in fact. On the other hand it is in urgent need of repair to reduce the scale of the imbalance, but because of a combination of unplannable parameters such as longevity and investment returns and benefits that can’t be changed, this isn’t possible. Benefits would have to be adjusted in line with reality.

More flexible with a pension bonus

In 2005 PwC’s pension fund in Switzerland introduced a new, dynamic pension model. Our aim was to reduce the cross-subsidisation by active members and assure the solvency of the pension fund in the long term. The idea behind this approach is to promise less but pay as much as possible. The model involves splitting benefits into a fixed retirement pension and a variable bonus component. The bonus component makes it possible to regulate the outflow of retirement capital.
The model in practice

The retirement pension paid by PwC’s pension fund is based on a technical interest rate of 1.5%, which translates into a conversion rate of 4.9% in 2020. In addition to this, a standard bonus of 12% of the retirement pension is paid. The pension and the bonus are both based on a technical interest rate of 2.5%.

Each year we work out whether the pension fund is making a gain or loss with the pensions it pays. To this end we do a comparison of targeted and actual investment returns. The percentage target return of approx. 3.1% results from the sum of the technical interest rate (2.5%), a supplement for the increase in life expectancy (0.5%) and the approximate administrative costs (0.1%). Any adjustment in the bonus component is determined by the result over an observation period of three years.
Adjustments in small increments

If the result after three years is positive, the bonus component is increased; if the result is negative it is reduced. The adjustment is made in moderate steps of two percentage points. The expenses of increasing the bonus or the savings resulting from a reduction are subtracted from the result. The remainder is carried forward to the next three-year observation period.

Figure 3: Bonus component makes benefits more flexible

1st Observation period

<table>
<thead>
<tr>
<th>Year</th>
<th>Coverage capital of pension</th>
<th>Target return</th>
<th>Actual return</th>
<th>Result in %</th>
<th>Result in CHF</th>
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<tbody>
<tr>
<td>1</td>
<td>100 Mio.</td>
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<td>+0.3 Mio.</td>
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<tr>
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<td>−1.4 Mio.</td>
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<tr>
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<td>+2.8%</td>
<td>+4.2 Mio.</td>
</tr>
</tbody>
</table>

Result for the observation period: +3.1 Mio.

2nd Observation period

<table>
<thead>
<tr>
<th>Year</th>
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<th>Profit</th>
<th>Loss</th>
<th>Bonus</th>
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Result: Loss

3rd Observation period

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<th>Year</th>
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<tr>
<td>2014</td>
<td>Loss</td>
<td>Profit</td>
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Result: Loss

Figure 2: Example of a profit and loss calculation (without carryovers from the previous observation period) for the variable bonus component over three years.
A solution for all seasons

The conversion rate can go either way: you can set it too high or too low. Whatever happens, you face a lot of bother and expense. The pension fund solution we’ve created on the basis of fixed pensions and performance-related bonuses matches our strategic objective of promising benefits that reflect reality as closely as possible and can be funded sustainably. The payments made to pensioners can be adjusted to the actual situation on an ongoing basis. This way active members and pensioners each get a fair slice of the pension fund’s gains and losses. Pensioners can plan for and weather any adjustments because they’re made incrementally.

By making retirement benefits more flexible we’re able to reduce the insidious cross-subsidisation, support the principle that the second pillar should be fully funded, and – as a positive side-effect – align pensions with purchasing power, all while keeping the administrative expense within reason. This way we’re able to provide maximum security and transparency for our pensioners and active members, and build trust in our pension fund.

Summary

The fact is that retirees are currently being massively and consistently cross-subsidised by the active members of pension funds. That was never the intention. Financing pensions on a fully-funded basis is only possible with variable benefits. PwC’s dynamic pension model bolsters trust in the second pillar as a fundamental principle of social security in Switzerland. At the same time it helps us avoid the risk of problems entailing remedial measures that make a pension fund, and ultimately the employer, unattractive. It’s time to take an unprejudiced look at the intergenerational contract. Our pension fund solution is a step towards achieving sustainable, respectful coexistence between the generations. We’ve chosen a solution that will work for us in the long term. Not everyone has applauded the move, but the large majority of our employees and pensioners have received it favourably.
In recent years it’s been increasingly apparent that it will not be possible to fully fund the benefit promises made by second-pillar occupational pension schemes in the long term. People are living longer, the current legal situation means that current pensions can, de facto, not be reduced, and for years investment returns have fallen short of the mark. The result of all this is that the costs of pension benefits – running into the billions – are shifting to the generation of active members.

So it’s no surprise that employee benefits schemes are adjusting their pension plans. The question arises as to how measures related to employee benefits are presented in a company’s financial statements. Significant here is not just the set-up of the measures themselves, but the standard under which an entity reports.

**Two views of the same state of affairs**

In financial reporting practice in this country, the Swiss Code of Obligations (CO) is relevant for statutory (stand-alone) financial statements, and Swiss GAAP FER, International Financial Reporting Standards (IFRS) and US GAAP for consolidated accounts. Depending on the standard used, there are two different approaches to presenting pension liabilities in the accounts.

a) Financial reporting under CO/FER: this approach primarily presents the legally accrued benefits and their funding. Financial statements under CO/FER therefore work on the basis of cash flows resulting from the legal duty to fully fund pension benefits. The basis for the entity’s potential (pension) liability is the financial statements of the employee benefits scheme (i.e. the pension fund). The main question addressed in the pension fund’s financial statements, which have to be produced in accordance with Swiss GAAP FER 26, is the degree to which legally accrued benefits as shown on the balance sheet date are funded. To this end the assets in the pension fund are recognised in the balance sheet at fair value, while benefits to insured members are recognised in accordance with the actuarial (technical) assumptions set down in the pension fund regulations. The discount rate is calculated on the basis of a long-term average. A pension liability
is especially likely to accrue to the entity in cases where the benefits promised in the regulations are currently insufficiently funded and the pension fund is forced to take steps to improve its financial situation. The key question in terms of reporting under CO/FER is how the planned measures affect the funding of the pension fund?

b) Financial reporting under IFRS/US GAAP: this approach revolves around the benefits promised to employees on the basis of the currently valid pension fund regulations. The entity’s net defined benefit liability is calculated as the difference between the pension fund assets measured at fair value and the present value of the accrued prospective entitlements pro-rated on service. The requisite discount rate is calculated on the basis of capital market rates on the balance sheet date. Since all costs accruing to the entity on the basis of the promised benefits have to be considered, the actuarial calculations take account of future-oriented assumptions such as increases in pay and pensions and the anticipated development of life expectancies. Under this approach the degree to which the net defined benefit liability is funded plays only a subordinate role. If measures are resolved to improve the finances of the pension fund, the key question in terms of reporting under IFRS/US-GAAP is how the promised benefits will change?

**Be proactive**

If it becomes evident that an employee benefits scheme’s pension plan is going to be insufficiently funded in the future, it may be necessary for the board of trustees, and particularly the employer representatives, to take action even before compulsory remedial measures are required under employee benefits law. This requirement is closely linked to the actuarial funding ratio. Under the law, compulsory remedial measures have to be taken when the funding ratio falls below 100%. But this doesn’t mean that a scheme that is currently more than 100% funded will be able to fund the promised benefits in the medium to long term. This is reason enough to take appropriate steps in good time. When deciding on what measures to take in such situations, in addition to the legal requirements, a pension fund has to take account of various other factors, including the origins and magnitude of the shortfall, the fund’s risk tolerance, and economic considerations as well as the company’s interests in terms of its reputation as an employer and its ability to offer an attractive overall pay package.

Here is a summary of the most important preventive and remedial measures:

**Reduction in the conversion rate:** this mechanism is currently the subject of controversy. Reducing the conversion rate usually requires an
amendment to the pension fund rules to adapt the plan by reducing the benefits promised. The remedial effect for the pension fund is prospective, as it will require less capital to cover future pensions than it does to cover current pensions. Often a reduction in the conversion rate is accompanied by a reduction in the discount rate \( \text{see Figure 1} \).

---

**Digression on discounting**

Promised benefits result in long-term obligations. To take account of the time factor, discounted values are used in the presentation of pension fund obligations. The methods used to calculate the relevant discount rates vary according to the financial reporting standard.

The discount rate for Swiss GAAP FER 26 purposes is calculated on the basis of the technical reference interest rate, which represents the average of the performance of the BVG-Indices 2005 Pictet BVG-25 plus for the last 20 years and the yield on 10-year Swiss Confederation bonds.\(^1\)

The discount rate for IFRS/US GAAP purposes is determined by reference to market yields on high-quality corporate bonds at the end of the reporting period.\(^2\)

These differing calculation methods have led to divergence between discount rates in recent years \( \text{see Figure 1} \). This is one of the main reasons why benefit obligations come out significantly higher under IFRS/US GAAP than under CO/FER.

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**Lower interest on retirement savings:** this involves reducing the benefits without adjusting the plan. It is done at the expense of the active members, amounting to a reduction in their benefits in favour of the existing pensioners.

**The entity imposes a restriction of use on the funds in the employer contribution reserve account:** if such a restriction is imposed, for the period during which there is a shortfall in cover the employer contribution reserve cannot be used to pay employer contributions. While this mechanism does not reduce underfunding, it does give the pension fund time to work out additional measures.
Employers and employees pay remedial contributions: when this mechanism is applied, additional funds accrue to the pension fund without there being an increase in employee benefits. Under the terms of Art. 65 d BVG, the remedial contributions paid by the employer must be at least as high as those paid by the insured members.

Figure 1: Digression on discounting

(Source: Swiss Chamber of Pension Fund Experts)

Risks and side-effects

Depending on the financial reporting standard applied, the impact on the figure recognised in the company's accounts for preventive and remedial measures in connection with financial difficulties at the pension fund will vary. Figure 2 summarises the main implications:
The following accounting effects deserve special mention:

- Additional payments or payment obligations on the part of the entity result in an increase in expense under the Code of Obligations and Swiss GAAP FER. There is no direct impact under IFRS. The indirect effect is that in future the funding ratio will be better, with a corresponding reduction in interest expense and, possibly, pension expense.

- Adjusting the benefits promised by the plan has an immediate impact under IFRS but not under CO/FER. This is because under employee benefits law, adjustments of this type can only be made on a prospective basis.

- Underfunding calculated as per IAS 19, employee benefits, unlike underfunding under the terms of the BVG, does not result in a need for compulsory action under employee benefits law, either for the entity or for the pension fund. Even so, it may be an indication of financial problems to come for the pension fund.

### Pros and cons

The accounting approaches under CO/FER and IFRS/US GAAP each have their pros and cons. Those responsible for pension funds, employer representatives and users of financial statements are advised to take account of the various peculiarities and differences when making strategic decisions or assessing the need for action. Neither approach really does justice to the ‘truth’.
Meaningfulness of financial statements under CO/FER

Financial statements produced in accordance with CO/FER present cash flows in the relatively near future. This kind of presentation is easier to understand than long-term projections involving complex calculations and assumptions. It’s unproblematic as long as the pension fund has sufficient reserves. However, it does not give any indication on future risks for the entity on the basis of the benefits currently promised, or of the reserves necessary to ensure benefits are adequately funded in the long term.

In current financial reporting practice very few companies reporting under CO/FER provide more extensive information on their pension plans in their financial statements. In this respect, useful information would mean disclosing information on how an entity sets up its pension plans, the actuarial assumptions used (technical discount rate and mortality tables), and what the pension fund’s current financial situation is (for example the entity discloses the technical and the economic funding ratio and details of how they are calculated).

Meaningfulness of financial statements under IFRS/US GAAP

Financial statements under IFRS/US GAAP present extensive actuarial calculations and look far into the future. They present the entity’s risk on the basis of the pension benefits currently promised. This presentation fails to fully reflect the fact that extra-mandatory benefits can be reduced prospectively. When it comes to benefit obligations, both IFRS and US GAAP require very extensive disclosures, but in some cases these disclosures are not very meaningful.

Summary

Company directors and pension fund trustees should familiarise themselves with the impact of measures designed to address limitations on a pension fund’s ability to handle risk, not only in terms of the implications for insured members and the scheme’s finances, but also in terms of the associated company’s financial reporting. They should be aware that depending on the financial reporting standards adopted, the same facts may be presented differently. While financial statements under the Code of Obligations or Swiss GAAP FER often contain too little information, IFRS/US GAAP statements contain comprehensive information, some of which is less useful.

It would be fairly easy to make reporting under the Code of Obligations and FER more meaningful by disclosing information on the actuarial principles applied and the actuarial and economic funding ratio for the pension fund, in addition to details of how the company sets up its pension plans. Both the new financial reporting law and Swiss GAAP FER would encourage enhanced disclosure of this sort.

1. For precise details of how the rate is calculated, see Guideline FRP 4 of the Swiss Chamber of Pension Fund Experts
2. For calculations under IFRS see IAS 19.83
3. Defined Benefit Obligation
4. Other Comprehensive Income
In the spotlight: occupational pensions

1e pension plans: about to become much more attractive

‘1e’ pension plans are a form of ‘top-hat’ pension plan allowing employees much more flexibility in the management of the extra-mandatory portion of their pension contributions. Although they’ve been around for some time, so far they haven’t been adopted on a large scale. Impending changes to Swiss law will make them a much more attractive proposition for many more employers – so much so that 1e plans have the potential to significantly change the face of Swiss pensions.

Named after the legislation that forms their legal basis (Article 1e of the Ordinance on Occupational Old-Age, Survivors’ and Disability Benefit Plans, OBB2/BVV2), ‘1e’ pension plans are a special arrangement enabling employees to choose the investment strategy for pension contributions based on earnings above CHF 126,900 (1 January 2016). Typically that’s people in middle management and above, depending on the industry and organisation. In theory, 1e plans are a great way of giving financially aware and engaged employees greater control of, and greater responsibility for, their retirement savings – which will be vital to the health of occupational pensions in this country going forward (see Room for manoeuvre despite regulation). In practice, however, adoption of 1e plans (with the exception of a handful of large organisations) has been very limited. Why is this?

The main reason is an ‘accident’ of law whereby pension funds, and ultimately the employers behind them, had to guarantee the amount invested in the 1e plan, effectively retaining risk with the company. This has meant, above all, that 1e plans have been viewed as defined benefit plans for financial reporting purposes – which in turn has meant that the risk associated with this promise has had to be accounted for on the balance sheet, often in the form of substantial reserves. A change to the relevant law, due in 2016, should do away with the legal requirement to provide a minimum guarantee upon exit from the pension fund. Significantly, this will mean that ‘defined contribution’ accounting will be possible for the 1e plan under IFRS¹ and US GAAP². Once the fund promises a lump-sum benefit on retirement instead of a pension, and if other biometric risks are provided in the form of a lump sum and are insured, there will be no significant further risks to the company. The expense will be the cash contributions payable to the plan, but there will be no balance sheet item. A seemingly minor change in the law will
mean that suddenly 1e plans will look a lot more attractive for many employers that would previously not have considered offering them.

**Multiple benefits for employers**

The switch to much more advantageous defined contribution accounting has significant benefits, but it’s by no means the only advantage of 1e plans for employers. Another plus is that they reduce the risk of underfunding because the pre-retirement investment risk is transferred to the employee. In addition, as 1e plans usually provide a lump sum at retirement rather than a pension, the post-retirement risks are also removed. This has an added effect of eliminating some of the cross-subsidies between higher and lower earning employees and pensioners (see *Room for manoeuvre despite regulation*). Added to this, 1e plans encourage greater employee engagement in pension plans, which means better value for money on corporate spend. Implementing a plan is also an opportunity for an organisation to review its benefit and provider set-up for cost and value management purposes, as well as enabling combined IT solutions with other long-term incentive plans. This substantial upside means that 1e plans will become a much more attractive proposition for organisations, especially those that can’t afford to maintain the risk inherent in their current system, that are set to enjoy valuable financial reporting benefits, or whose employees value the ability to choose their own strategy.

**1e less of a challenge than generally assumed**

In our experience at PwC – reinforced by the findings of a comprehensive survey of Swiss employers’ views and awareness of 1e plans that we’re about to publish – many employers are not even aware of 1e plans, never mind the potential benefits under the new law. Many of those who do know about the option tend to assume that setting up a 1e plan will be too complicated. The fact is, however, that there are already providers in the marketplace, with more ready to go on stream, that can provide solutions for organisations of any size. Some of these providers will be able to offer the entire spectrum of services: from parts that an employer can use to build on their existing solution to a full package including access to the provider’s IT infrastructure and administrative services. While there are a lot of important questions to address before embarking on a 1e plan, specialist advice, and support with managing the transition from the old to the new set-up, is available. Getting neutral advice has the added benefit of building the trust of employees, as they may well value independent input on the changes.
Multiple benefits for employees

Implemented intelligently, a 1e plan is a win-win situation for employees and employers. A well set-up plan represents an attractive state-of-the-art pension solution that allows employees greater choice and responsibility in managing their retirement savings. A 1e plan gives them a better fit with their own individual risk/return profile and can enable them to harmonise and optimise the asset allocation within the 1e plan with their private investments. Last but not least, a 1e plan gives employees transparency.

Assuming you, as an employer, have become aware of the benefits for you and your employees and are seriously consider implementing a 1e plan, what questions do you have to consider? They’re not for everyone, so first of all you have to think about whether you have what it takes to make a 1e plan work. You need to see strong benefits on the accounting side. And you need enough financially aware high earners to justify the cost of setting one up (although it’s important to remember that many providers also cater for small numbers of employees). Significantly, our survey has showed that what Swiss employers and funds want in their plans is met by many of the benefits of 1e – so it pays to give it careful thought.

How to ensure successful implementation

Once you’ve decided to take the plunge, you have to negotiate the challenges of implementing a 1e plan. This includes deciding on eligibility: by grade or by salary or a combination? You have to identify provider preferences, prepare a short list, and organise a beauty parade. You should review your past service and decide how much of it can or should be transferred to the 1e plan. Moving out past service has implications for the remaining fund as there will be less assets and obligations in the portfolio. This needs careful review and some elements of the fund may need to be recalibrated. Finally, you have to assess the accounting impact and find out precisely how the plan has to be designed to ensure it’s accounted for as defined contribution. Above all this means avoiding offering any explicit or implicit guarantees such as retirement conversion rates. A 1e plan paying a lump sum is much more likely to qualify as defined contribution, and avoids the longevity risk to boot; a plan promising a pension will probably not qualify as defined contribution. It’s vital to seek external advice on these matters.

Other matters you have to consider include how to communicate the 1e plan and get your employees on board, how to set up (or buy into) the relevant systems, and whether to partially liquidate your present
pension arrangement. Plans for earnings below CHF 126,900 will not be directly affected by the changes, but if a plan or fund needs to be split into a 1e and a non-1e component there will clearly be design, structural and governance implications. Again, the situation varies from organisation to organisation, so it pays to seek advice.

As we said in the introduction, 1e plans have the potential to change the face of Swiss pensions by bringing the concept of individual choice of investment strategies, and individual responsibility for the risks of retirement, into the spotlight. Although the option has been possible in the past, the number of companies implementing 1e plans has been so small that it has really had no effect on the system as a whole. If 1e plans are a success following the change in the law, they may cover a greater proportion of the assets and liabilities in the system today, and they may be the precursor to further change in the system.

Summary

Following a change in the law due in 2016, 1e pension plans are set to become much more attractive for both employees and employers. Employees get greater control over their retirement savings, and employers can potentially reap significant financial reporting and risk management benefits – among other things. Despite reservations on the part of many employers, implementing a 1e plan need not be as costly or complex as anticipated, and may be an attractive proposition even for smaller numbers of higher-earning employees. Get the key details right and a 1e plan can be an important step in easing the pressure on pensions while giving employees what they want.

1. International Financial Reporting Standards
2. United States Generally Accepted Accounting Principles
Update

Getting all the dimensions of VAT right
by Niklaus Honauer and Saphira Borer – page 37

IFRS 16 Leases expands the balance sheet
by Gesa Mannigel – page 42

Recording working hours correctly
by Brigitte Zulauf – page 49

New financial reporting law: what’s happening in practice
by Roger Kunz – page 55
Getting all the dimensions of VAT right

From documentation and audits by the Federal Tax Administration (FTA) to the appeals procedure, it pays to think ahead and get all three phases of the value-added tax (VAT) process right. Here you’ll find why this is important, and how to go about it.

VAT is based on a self-assessment system, with every organisation responsible for filing its own declaration. Whether or not it has done so correctly will emerge, at the very latest, when the FTA conducts a VAT audit. So the first dimension in successfully handling VAT is accurate documentation. Master the second dimension by preparing properly for a VAT audit, and you’ll avoid surprises. And if you don’t agree with the findings of the audit, you can take remedial action in the third dimension, the appeals procedure.

Dimension 1: documenting VAT processes

It’s up to the taxable person to document VAT processes, but often a lack of time, awareness or resources means that errors creep in. Errors and shortcomings can remain hidden for years and only emerge when the FTA conducts a VAT audit. This can result in substantial additional charges. For this reason it makes sense to draw up a VAT handbook describing and documenting VAT processes – if necessary with the help of an expert.

When documenting VAT processes, the taxable person should keep the following special cases in mind:

- Is there evidence to prove the tax-exempt status of exports with export documents?
- Are supplies correctly assessed as VAT-exempt without credit?
- Can you prove that input tax has been paid?
- Is an input tax correction plausible on the basis of supplies exempt from the tax without credit?
- Are supplies to employees declared correctly (for example company vehicles)?
- Has the FTA issued instructions in previous audits, and are these instructions being followed?
- Are VAT processes reviewed on a regular basis and brought into line with the latest legislation and FTA practice?
If an organisation has particularly complex flows of goods and services and transactions, or if FTA practice is not clear, the organisation should have the legal situation clarified with a ruling. This gives maximum legal certainty, and means the organisation can fall back on the FTA’s definitive ruling if there are questions later on. Let’s look at an example: following discussions on the method of input tax correction a company was able to present a nine-year-old ruling to the FTA and convince the administration that the method it was using was correct. But this doesn’t always work; if the legal basis or the circumstances have changed, the ruling might no longer be binding. For this reason rulings should be regularly reviewed and updated.

**Dimension 2: preparing for a VAT audit**

Every year the FTA conducts around 9,000 VAT audits. According to a recent study, three out of four audited entities report their VAT incorrectly. For this reason VAT audits often result in an additional tax charge. In most cases the announcement of a VAT audit unleashes a flurry of hectic activity. It doesn’t have to be this way. You can prepare properly by addressing the audit actively and preparing your VAT documentation wisely.

You should work on the basis of the turnover and input tax reconciliation as defined in Art. 128 of the VAT Ordinance (MWSTV). If you don’t have a reconciliation, you might not have much time before the audit starts. A taxable entity that does a reconciliation every year can concentrate on reviewing special cases.

If documentation is missing or no plausible explanations of the practice applied can be produced, the VAT auditor can make corrections or a fair assessment of the tax claim. Experience has shown that it is often difficult to make the FTA change its stance. When it comes to the audit itself, the following considerations are crucial:

- Is it possible to access your accounting systems directly, and can access be restricted (for example to prevent access to personnel data)?
- Does the FTA auditor have a contact on site to whom they can address their concerns?
- Are external experts available in the event that there are differences of opinion?
- Have kick-off and debriefing meetings been organised?
Preparing thoroughly for a VAT audit pays off. Whatever happens, the entity should carefully check the assessment notice issued by the FTA following the audit, which will contain any corrections. It may have to explain the divergent item to the FTA in writing and submit additional documentation.

**Dimension 3: appeal proceedings**

If an assessment notice has been issued and the FTA cannot be convinced after further discussions, there is still the option of an appeal. The procedure consists of three stages: from filing a written objection with the FTA, followed by filing an appeal with the Federal Administrative Court, all the way up to the Federal Supreme Court.

A successful appeal requires an experienced tax lawyer; with a combination of in-depth knowledge of VAT and experience in legal proceedings, appeal proceedings do have a fair chance of success. Figure 1 shows that in the last five years, 278 VAT appeals have been rejected by Federal Administrative Court, and 108 have been approved. In other words, around one third of appeals are successful.

**Figure 1: Outcomes of VAT proceedings before the Federal Administrative Court**

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</tbody>
</table>

*incl. partially approved

Source: Federal Administrative Court
On the basis of published judgements, the success rate before the Federal Supreme Court is around 25%.

**Figure 2: Outcomes of VAT proceedings before the Federal Administrative Court**

<table>
<thead>
<tr>
<th>Year</th>
<th>Written-off</th>
<th>Not considered</th>
<th>Rejected</th>
<th>Approved*</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>0</td>
<td>4</td>
<td>13</td>
<td>3</td>
<td>20</td>
</tr>
<tr>
<td>2011</td>
<td>1</td>
<td>5</td>
<td>11</td>
<td>2</td>
<td>19</td>
</tr>
<tr>
<td>2012</td>
<td>1</td>
<td>7</td>
<td>20</td>
<td>1</td>
<td>29</td>
</tr>
<tr>
<td>2013</td>
<td>0</td>
<td>7</td>
<td>8</td>
<td>3</td>
<td>18</td>
</tr>
<tr>
<td>2014</td>
<td>0</td>
<td>1</td>
<td>12</td>
<td>10</td>
<td>23</td>
</tr>
<tr>
<td>2015</td>
<td>0</td>
<td>2</td>
<td>12</td>
<td>7</td>
<td>21</td>
</tr>
<tr>
<td>Total</td>
<td>2</td>
<td>26</td>
<td>76</td>
<td>26</td>
<td>130</td>
</tr>
</tbody>
</table>

* incl. partially approved

Source: PricewaterhouseCoopers AG

But the figures also show that many cases are sent back to the FTA for additional clarification of the facts, or end in not being considered because of a failure to meet certain procedural requirements. The reason for that may lie in a lack of knowledge of procedural law, for example a failure to meet deadlines or make applications correctly. This is especially unpleasant for an entity if the appeal is not heard by the Federal Administrative Court or Supreme Count despite having good chances of success.

Let’s examine an example of a positive ruling by the Federal Administrative Court that clearly demonstrates that litigation can make sense, even in cases where the chances of success seem limited. In the case at hand it was a question of whether an invoice without a VAT number qualified for an input tax deduction under the old VAT law (valid until the end of 2009). Since the supplier had become insolvent, the VAT was never paid to the FTA, resulting in a loss of tax. A key consideration for the court was that the formal error in the invoice was not directly causal in terms of the loss of tax. In addition to a refund of the rejected input tax deduction, the court awarded interest of more than CHF 130,000 and costs.
Summary

Given that VAT is based on self-assessment, it’s especially vulnerable to system error. This makes it all the more important for the taxable person to review its processes on an ongoing basis, adapt their documentation accordingly and check their filing at least once a year. If it comes to an FTA audit, it pays to act cautiously before, during and after the audit.
**Update**

**IFRS 16 Leases expands the balance sheet**

The new standard on leases, IFRS 16, affects the accounting for leases and rental agreements that are currently only recognised as an operating expense in profit or loss. Users should think about the implications of the new standard in good time.

IFRS 16, the new lease accounting standard, was published in January 2016, and will be applicable for periods beginning on or after 1 January 2019. For lessors there are virtually no changes in comparison with the current leasing standard, IAS 17. There is, however, a new accounting model for lessees.

Today all leases are recognised either as finance leases, and recorded on the balance sheet, or as operating leases. Under IFRS 16 this distinction no longer applies to lessees. Under the new provisions, all leases are comparable to the current finance lease, and therefore have to be recognised on the balance sheet in the form of a right-of-use asset and a lease liability. This expands the balance sheet. Lessees that currently hold only operating leases will in future have to recognise the rights of use for leased assets such as property, aircraft, vehicles, moving equipment and IT (see Figure 1).

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**Gesa Mannigel**

Director, Assurance
Lessors
Under IFRS 16 lessors, unlike lessees, must continue to distinguish between finance and operating leases. The standard-setters opted not to create completely new rules for lessor accounting, but preferred to carry forward the rules set down in IAS 17.

The only change for lessors under IFRS 16 is the enhancement of disclosures. For example, a lessor should disclose its risk management strategy for the rights it retains in underlying assets. The fact that lessors and lessees are treated differently could pose new challenges for existing financial reporting systems, especially when it comes to intragroup leasing arrangements.

As lessor accounting remains substantially the same, and IFRS 16 will have hardly any impact on a lessor’s accounting model, for the remainder of the article we will focus our discussion on the impact for lessees.

Definition of a lease
Under the terms of IFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for a consideration.

Lessee model
In the future a lessee will recognise a right-of-use asset and a lease liability. This figure is derived from the present value of the lessee’s minimum lease payments. To calculate this the lessee must first determine the lease term. The present value of the lease payments is discounted at the interest rate charged by the lessor to the lessee. If the lessee does not know the interest rate, it uses its incremental borrowing rate.

The right-of-use asset is initially measured at the amount of the lease liability, plus any initial direct costs incurred by the lessee in connection with the lease and payments made at or prior to commencement. The estimated costs to be due from restoration obligations to which the lessee may be subject also have to be taken into account. Under IAS 37 a provision for the costs of restoration is recognised in the balance sheet separate from the lease liability  (see Figure 2).

**Figure 2: Lessee’s lease liability and right-of-use asset**

The lease liability is subsequently measured at amortised cost using the effective interest rate method. The right-of-use asset is depreciated on a straight-line basis over the lease term. Interest on the lease liability and depreciation on the right-of-use asset will thus be recognised in the income statement. This results in a decreasing ‘total lease expense’ throughout the lease term. This effect is sometimes referred to as ‘frontloading’. Straight-line rental expenses under the IAS 17 operating lease model, will no longer exist.

**Extension and purchase options**

Under IFRS 16, the expected term of the lease is critical to the initial
measurement of the right-of-use asset. Options are taken into account if the lessee is reasonably certain to exercise these options. Whether extension, termination or purchase options are exercised will therefore affect the lease term and thereby the amount of lease payments included in the lease liability.

**Variable lease payments**
Variable lease payments are part of the lease payments if they depend on an index or a rate; variable lease payments that depend on another variable are not included. Hence, payments linked to a specified percentage of sales, sometimes known as landlords’ commissions, are recognised in the income statement in the period in which the sales occur.

**Lease versus service components**
Contracts that contain lease and non-lease/service components will have to be carefully analysed in the future. This could apply, for example, when leasing a property with a cleaning service or a vehicle with insurance. Lessees can account for these elements separately or elect to account for all components as a lease, and not separate lease and service components. However, because non-lease components are also recognised on the balance sheet, this results in the recognition of a higher right-of-use asset.

**Recognition and measurement exemptions**
The standard contains two recognition and measurement exemptions. Both exemptions are optional and they only apply to lessees:

- **“Short-Term Leases”:** leases with a lease term of 12 months or less.
- **“Low-Value Leases”:** Leases where the underlying asset has a low value when new (USD 5,000 or less per asset).

If one of these exemptions is applied, the leases are accounted for in a way that is similar to current operating lease accounting (that is, payments are recognised on a straight-line basis). Before electing for one of these options, the entity should make sure this really will result in a simplification.

**Example: property lease**
Let us take the example of a five-year lease for business premises. The rent is fixed at CHF 100,000 a year. The interest rate agreed in the contract is 5% per annum. Initial direct costs of CHF 10,000 are incurred. On this basis, the present value of the lease payments for the lease liability comes to CHF 432,948. The right-of-use asset has to be
increased by the amount of the initial direct costs, and thus comes to CHF 442,948 (see Figure 3).

Figure 3: Leasing business premises from the lessee’s point of view

<table>
<thead>
<tr>
<th>Balance sheet</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right to use asset</td>
<td>442'948</td>
<td>354'358</td>
<td>265'769</td>
<td>177'179</td>
<td>88'590</td>
</tr>
<tr>
<td>Lease obligation</td>
<td>432'948</td>
<td>354'595</td>
<td>272'325</td>
<td>185'941</td>
<td>95'238</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income statement</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>21'647</td>
<td>17'730</td>
<td>13'816</td>
<td>9'297</td>
<td>4'762</td>
</tr>
<tr>
<td>Amortisation ROU</td>
<td>88'590</td>
<td>88'590</td>
<td>88'590</td>
<td>88'590</td>
<td>88'590</td>
</tr>
<tr>
<td>Annual cash payment</td>
<td>500'000</td>
<td>100'000</td>
<td>100'000</td>
<td>100'000</td>
<td>100'000</td>
</tr>
<tr>
<td>Total lease expense</td>
<td>510'000</td>
<td>110'237</td>
<td>106'319</td>
<td>102'206</td>
<td>97'887</td>
</tr>
</tbody>
</table>

Now that the lessee recognises an interest element of what were previously operating leases as financing activities, the distribution of expense for these leases over the lease term is no longer even but degressive. This is because the interest expense at the commencement of a lease is greater than towards the end. As a result the lease expense in the first year for our example comes to CHF 110,237, considerably more than the lease instalment of CHF 100,000, while the lease expense in the last year of the lease is lower than the instalment, at CHF 93,351. This front-loading effect is even more pronounced for long-term leases.

Main implications for lessees

The new standard will have far-reaching consequences across most organisations. Alongside the financial statement the main areas affected include key financial performance indicators and business decisions (such as lease or buy).

The front-loading effect and the fact that what were previously operating leases are now recognised on the balance sheet may in individual cases have a considerable impact on a lessee’s balance sheet figures. This is because rental expense is replaced by interest expense and depreciation, leading to an increase in EBITDA (earnings before interest, taxes, depreciation and amortisation). An expanded balance sheet results in changes in equity ratios and leverage. This in turn can influence loan covenants, credit ratings, internal budgeting processes and compensation systems. The new standard will also affect other
areas of the business, including investor relations, IT, controlling and legal.

Implications for individual industries
PwC has conducted a global lease capitalisation study to assess the impact of the new leases standard on reported debt, leverage, solvency, and EBITDA for a sample of 3,199 listed entities reporting under IFRS across a range of industries. The research identifies the minimum impact of capitalising existing off-balance sheet operating leases based on commitments disclosures in entities’ published financial statements in 2014. The median increase in debt and EBITDA for some of the most impacted industries can be summarised as follows below. According to the study, financial liabilities for retailers with their extensive rented retail space will almost double.

*Figure 4: Implications of IFRS 16 for individual industries*

<table>
<thead>
<tr>
<th>Median increase in debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>All companies</td>
</tr>
<tr>
<td>Retailers</td>
</tr>
<tr>
<td>Airlines</td>
</tr>
<tr>
<td>Professional services</td>
</tr>
<tr>
<td>Health care</td>
</tr>
<tr>
<td>Entertainment</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Median increase in EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>All companies</td>
</tr>
<tr>
<td>Retailers</td>
</tr>
<tr>
<td>Airlines</td>
</tr>
<tr>
<td>Professional services</td>
</tr>
<tr>
<td>Health care</td>
</tr>
<tr>
<td>Entertainment</td>
</tr>
<tr>
<td>Telecommunication</td>
</tr>
</tbody>
</table>

Recommendations for lessees
Given that virtually all leases will now have to be recognised on the balance sheet, an entity must first make an inventory of the relevant contracts, and thoroughly adapt internal processes and systems on a regular basis.

First it should make an inventory of existing leases, capturing all the important data such as lease term, lease instalments and extension or purchase options. The entity should ensure consideration of the new
standard when entering into any new contracts.

Other functions such as tax, IT, investor relations and treasury should also be informed about the new requirements. Entities also have to review their strategy and the terms of contracts to meet the operational and financial goals of the company.

**Summary**

Lessees will soon see major changes in the way they account for leases. To avoid surprises, companies should already be assessing the potential implications of the new standard, formulating measures to make sure the relevant contracts are recognised properly, and identifying points of overlap with other projects. Under certain circumstances this may involve new systems that will take time to acquire, implement and test. Before the changes to the accounting take effect, companies should be making sure they capture all the relevant information on existing and new leases.

Experience with the first projects in this area is showing that implementing IFRS 16 can turn out to be very complex, especially for entities with a large number of leases. Identifying and making inventories of these leases across the organisation is essential to implementing the standard, but also very time-consuming. For example, even working out everything that is defined as a lease under IFRS can be difficult.

IFRS 16 will be applicable for periods ending on or after 1 January 2019. Early implementation is possible in principle if IFRS 15 Revenue from Contracts with Customers has already been implemented early.
Update

Recording working hours correctly

The Swiss Federal Labour Act (ArG/LTr) has been in force since 1966, and is based on the Factories Act of 1877. As a result, the rules on recording working hours are no longer adequate to modern working arrangements. In recent years, many companies have failed official inspections of their timekeeping set-ups. Since 1 January 2016, new rules have been applied. They’re contained not in the act itself, but in Ordinance 1 to the Labour Act (ArGV 1/OLT 1).

To enable the Labour Act still to be modernised, we’re likely to see calls from employers, and in some cases from employees, for further changes to the law; some are already being debated in parliament.

Current rules contained in the law

At the heart of the Labour Act are measures designed to safeguard the health of employees. The rules governing working hours should also be seen against this backdrop. However, the Labour Act doesn’t apply to all organisations. It applies unrestricted to around 240,000 establishments employing some 2.6 million people. But it doesn’t apply to many types of establishment, including establishments in public transport and agriculture, and private households (except for the minimum age, which applies to the last two). In the case of public sector bodies, the Labour Act ultimately essentially only applies with regard to the general protection of health, but not to working time and breaks.¹

The duty to log working hours derives from Art. 46 ArG. Employers are obliged to provide the authorities responsible with the corresponding schedules and documentation to enable their compliance with the requirements to be checked. Above all, organisations must make the following information accessible and keep records for five years:²

- Working time per day and per week, including overtime and time off in lieu, and information on when these hours were worked³
- Rest days or days off in lieu granted per week, provided these do not regularly fall on a Sunday⁴
- Location and duration of breaks of one half hour or more⁵
- Statutory extra pay and/or time bonuses²
- Beginning and end of hours worked, including overtime and time off in lieu (per day and per week)³

Brigitte Zulauf
Leading Partner, Corporate Support Services
Timekeeping is unproblematic for people working fixed hours with prescribed breaks. Here you only have to note any deviations or discrepancies. You’ll find more tips on comprehensive timekeeping here (not available in English).

The requirements often don’t match the practical reality, as employers and employees want working time to be flexible. It’s no secret that many employers don’t adhere fully to the legal requirements, especially companies with employees with trust-based working hours.

**New timekeeping rules**

With the new rules designed to make timekeeping easier, the relatively complicated timekeeping rules laid down in the Labour Act continue to apply unrestrictedly, with violations liable to prosecution. This is a key consideration for companies deciding whether to record the working time according to the new rules or continue to record hours in detail, including all the relevant requirements – in line with the norm – or whether to introduce simplified arrangements for certain groups.

A word on the actual changes: the Federal Council has added two new articles to ArGV 1. The excerpt below from the SECO guide shows the new rules in the form of a table. You can find the entire guide here (not available in English).

**Figure 1: Summary of the three arrangements**

<table>
<thead>
<tr>
<th>Arrangement</th>
<th>Legal basis</th>
<th>Employees affected</th>
<th>Prerequisites</th>
<th>Documentation required from employer</th>
</tr>
</thead>
</table>
| Systematic timekeeping | Art. 46 ArG  
                        | Art. 73 ArGV 1                  | Anyone subject to the working hour provisions                  | None (standard rule)                  | - Start and finish of each phase of work  
                                                                             |                                                                                    | - Location and duration of breaks of half an hour or more  
                                                                             |                                                                                    | - Rest days and days off in lieu                                                  |
| Simplified timekeeping | Art. 46 ArG  
                        | Art. 73b ArGV 1                | Anyone who can freely determine their own working hours to a significant extent (at least 25%) | No collective labour agreement is necessary for this arrangement. Agreement between employer and employee (either with the employee representative or with the majority of employees, or also individually in establishments with fewer than 50 employees) | - Total duration of daily work performed  
                                                                             |                                                                                    | - Agreement between employer and employee meeting the requirements of Art. 73b ArGV 1 |
| No timekeeping      | Art. 46 ArG  
                        | Art. 73a ArGV 1                | Anyone who has a great deal of autonomy in their work and can freely determine their own working hours to a large extent (at least 50%), with gross annual pay of more than 120,000 including bonuses | Collective labour agreement between employer and one or more representative employee organisations (unions), regional or cross-industry collective labour agreements also possible | - Collective labour agreement meeting the requirements of Art. 73a ArGV 1  
                                                                             |                                                                                    | - Schedule containing details of the pay of employees who have opted not to record their hours  
                                                                             |                                                                                    | - Individual declaration from each employee that they have opted not to record hours |
What’s involved in implementing the new arrangements?

Simplified timekeeping
On the basis of the Workers’ Participation Act (MWG), private business establishments with more than 50 staff can elect employee representatives to exercise specific rights of information and consultation (for example regarding the impact of business on employees’ work, health and safety at work as per the law on accident insurance, and employee protection as per ArG 48). Otherwise each employee is entitled to these rights directly. If an establishment already has employee representation, it shouldn’t take too long to implement simplified timekeeping. In smaller establishments or companies without employee representation, the company has to budget enough time to reach individual agreements with each person affected (informing them, drawing up and signing the agreement, etc.). The effort involved can vary accordingly.

Dispensing with timekeeping
Even in organisations with collective labour agreements, the time required to properly implement the process of dispensing with timekeeping shouldn’t be underestimated. The employee organisation must agree to the following points:

- Certain categories of employees to be given working hour autonomy on the basis of objective criteria
- Pay level (at least CHF 120,000 gross annual pay)
- Health measures
- Officer responsible for matters regarding working hours

Each person affected must personally agree to these arrangements. The health-related measures should reflect the latest scientific insights, otherwise the company runs the risk of being liable for damages in the event that employees have stress-related health problems further down the line.7 The officer responsible has to make line managers aware of the issues related to working hours and time off, monitor employee workload on a regular basis, support employees who have problems with their working time, and propose measures in good time if action has to be taken. This person is also the point of contact for the social partners to the collective labour agreement in such matters.

Controls
Opinions are divided as to the extent to which there will be an increase in inspections by the relevant bodies. In the past they conducted only
sporadic checks on companies. Employers that failed to comply with the rules or were unable to present detailed timekeeping records when inspected had six months to take steps to ensure compliance with the law.

In November 2015, organisations were given a tool to simplify compliance with the rules on working time. Companies needing to take action must budget a certain amount of time for implementation – including the time required by the authorities. Depending on the resources available to the cantonal authorities, they are likely to check compliance more frequently. Added to this, an employee can call the authorities at any time if they suspect their employer is failing to comply. By law the authorities have to respond.

### Autonomy in terms of working hours

It remains to be seen how working hour autonomy can be achieved in practice. Here are a few possibilities:

- **Giving staff the right to determine the number, location and distribution of hours worked themselves.** We recommend formulating this in writing.
- **The nature of the work and the way it’s organised must permit self-determination.** For example, it’s more difficult for people whose job requires collaboration with other staff or customers to determine their own hours.
- **Ability to determine own hours:** In practice, employees need sufficient leeway in terms of deciding on and organising their work, plus the ability to determine their own hours autonomously.
- **Line managers have to be able to evaluate employees’ performance without reference to their working hours.**
- **No more normative influence:** Besides formal directives (regulations, contracts, etc.) there are business- and industry-specific norms and value systems that are opposed to the autonomous self-determination in terms of working hours.

### Possible solutions

Different solutions may be appropriate depending on an organisation’s size, industry and headcount. Answering the following questions will
help find the best approach:

- Do the new rules apply to the organisation as a whole, to individual areas of the business, or not at all?
- What people aren’t subject to these rules – apart from the health-related provisions – because they constitute an exception in the personal scope of the Labour Act (for example, senior management, travelling salespeople or research staff)?
- What employees qualify for simplified timekeeping or a dispensation from timekeeping? Is the effort of simplifying or dispensation timekeeping worth it?
- Is there a collective labour agreement for the group of employees to whom the dispensation from the timekeeping requirement applies, or can the company sign up to such an agreement without the prospect of too many conditions or consequences?
- What additional costs can the company expect to incur to implement the new arrangements properly in the form of
  - Extra pay
  - Implementation costs, for example, implementing timekeeping hardware and software, other implementation costs such as amendments to employment contracts and regulations, employee representation, and measures related to psychosocial health, creating additional line management positions or costs related to collective labour agreements
  - Recurring costs (expenditure and time) analogous to implementation costs

**Timekeeping solutions**

First, a company should check whether its existing software can entirely meet the complex timekeeping requirements of the Labour Act. If it has to replace its existing solution or invest in new software, depending on its size and needs the company should take account of the fact that staff are becoming more and more mobile and work will no longer necessarily be performed at a fixed workplace. There are applications, for example, that allow employees to record their working time on their mobile phone and then send this information to their employer.

**Amendments to employment contracts and regulations**

Organisations with trust-based working hours or arrangements that are not in compliance with the law should think about how much they are going to amend employment contracts and regulations. Changes require considerable administrative work. Since a company has to take account
of the relevant periods of notice pending changes of contract, it’s not
going to be possible to introduce new arrangements from one day to the
next. Since employees on trust-based working hours are often not paid
overtime either (this is covered by their salary), not changing contracts
and regulations could lead to an increase in personnel expense.
Otherwise reductions in salary might be necessary.

**Summary**

*The issue of timekeeping and modifying timekeeping arrangements shouldn't be underestimated. It’s a challenge that companies have to meet – although there are different ways of going about it. Addressing the issue can increase employee awareness and knowledge of the rules set down in employment law. Recruiting and developing good people is a major challenge for many organisations. So they should be aware that their present solution to the timekeeping issue – or any solution they implement in future – may affect their reputation as an attractive place to work.*

1. SECO guide to the Labour Act and Ordinances 1 and 2, February 2016 (not available in English)
2. Art. 73 ArGV 1 lit. h
3. Art. 73 ArGV 1 lit. c
4. Art. 73 ArGV 1 lit. d
5. Art. 73 ArGV 1 lit. e
6. Art. 73a ArG on dispensing with timekeeping, and 73b ArG on simplified timekeeping
7. Duty of care on the basis of Art. 328 of the Code of Obligations (CO)
Update

New financial reporting law: what’s happening in practice

The entities have moved over to the new financial reporting law as the basis of their statutory financial statements. In the course of implementing the new rules, a number of pitfalls have emerged – and not just the fact that it’s no longer possible to value investments on a group basis.

With the transitional period elapsing on 31 December 2014, most entities moved over to the new financial reporting law for their 2015 statutory financial statements. Some of the pitfalls had been clear in the run-up to the new legislation, others could hardly have been foreseen. Although they are by no means the only problems that have emerged, in this article we focus on three of the key issues.

Individual valuation

Under the old law, it had become common practice to net losses and gains in the value of assets of the same type within the same balance sheet item. This meant that valuation losses on individual investments or properties only had to be recognised in profit and loss if they could not be offset by corresponding (unrecognised) gains on the same type of assets. So it only made sense to do valuations on a group basis if gains were possible for the balance sheet item in question in the first place – as is the case, for example, with investments or properties where the difference between the acquisition price and the market value could result in a gain. The maximum figure for loans and equity-like loans, by contrast, is the nominal value. So no gains are possible for this item, meaning that it is de facto not possible to value loans on a group basis. Even under the old rules it was not permissible to do group valuations across multiple balance sheet items.

The abolition of group valuation for investments and properties was seen as one of the main changes in the run-up to the new financial reporting law, and was the subject of a heated debate. While it’s true that the change has led to painful impairments for some undertakings, the broad mass of companies haven’t been affected in practice. Firstly, this might have something to do with the generous transitional period, which gave companies plenty of time to do the necessary restructuring or reorganisation. Secondly, the new rules don’t absolutely require
individual valuation; what they do is raise the question of the correct unit for valuation. If assets are usually measured together because of their similarity, this is also deemed to be an appropriate unit under the new rules. What’s important is that the requirements are met with regard to similarity and economic unity. Transparent disclosure is also seen as a must.

**Appropriation of retained earnings for financial statements in foreign currencies**

Under the new financial reporting law an undertaking is permitted to present its financial statements in the functional (foreign) currency. However, if it does so it must also present the figures in Swiss francs (CHF) and specify the exchange rates used for the conversion. The accounting and financial reporting legislation was revised independently of company law. The result is that the nominal share capital of a Swiss company limited by shares can only be denominated in Swiss francs. This means that all threshold values relevant to creditor protection related to the nominal share capital must also be expressed in CHF.

For any threshold values oriented to the balance sheet, it’s relatively straightforward to do this on the basis of the additional information in CHF, which has to be disclosed in any case. Things get more critical when it comes to calculating freely disposable equity in CHF in connection with the appropriation of retained earnings. Here the question arises as to the date – and by extension the exchange rate – used as the basis for calculating freely disposable equity in CHF. The following options are available:

- the balance sheet date
- the date of the auditors’ report
- the date of the annual general meeting deciding on the distribution of a dividend

The following example illustrates the problem: It shows the equity of Company A on the balance sheet date in USD, the presentation currency, as well as in CHF:
If a dividend is planned, the company must have enough freely disposable equity on the balance sheet date (in foreign currency and in CHF). Company A in Figure 1 has USD 140 (retained earnings plus profit for the year) in freely disposable equity on the balance sheet date or CHF 110 (retained earnings minus translation difference plus annual profit); paying the planned dividend of USD 120 doesn’t appear to be a problem.

However, the development of exchange rates has to be taken into account too. The planned dividend of USD 120 is equivalent to CHF 114 on the date of the auditors’ report, and as high as CHF 117 on the date of the AGM if exchange rates continue their upward trend. In both cases, the figure of CHF 110 in freely disposable equity is exceeded. Since neither the board of directors nor the auditors can predict the way exchange rates will have developed by the date of the AGM, the following approach is advisable:

The board proposes the appropriation of retained earnings of USD 120, adding a maximum in CHF:
In Figure 2, the appropriation of retained earnings in our example would result in a dividend of CHF 110 or USD 112.82 (CHF 110 divided by an exchange rate of 0.975).

### Disclosure of own shares taking account of reserves from capital contributions

The rules on minimum structure under the new financial reporting law require the disclosure of an undertaking’s own capital shares as a separate negative item at the end of shareholders’ equity. According to Circular 29a of the Swiss Federal Tax Administration (FTA), however, only the disclosure of the undertaking’s own capital shares as a negative item under legal reserves will avoid income or withholding tax implications, for example, when the shares are cancelled. So the question arises as to whether there is a way for an undertaking to disclose its own shares that satisfies the requirements of both tax and commercial law.

The FTA\(^1\) and the EXPERTsuisse financial reporting committee have agreed to a compromise whereby an undertaking’s own shares are disclosed as a negative item at the end of shareholders’ equity separate from the other equity items. At the same time, the undertaking must specify the share it formed from capital contribution reserves.

<table>
<thead>
<tr>
<th>Proposed appropriation of retained earnings</th>
<th>USD</th>
<th>CHF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributable</td>
<td>140</td>
<td>110</td>
</tr>
<tr>
<td>Proposed dividend</td>
<td>-120</td>
<td></td>
</tr>
<tr>
<td>Carried forward to new account</td>
<td>20</td>
<td></td>
</tr>
</tbody>
</table>

\(^1\) FTA: Swiss Federal Tax Administration

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**Figure 2: Possible proposal for the appropriation of retained earnings**

The board of directors proposes a dividend of USD 120. On the basis of the statutory provisions this is limited to a maximum of CHF 110 (using the exchange rate on the date of the AGM).
In Figure 3, it should be noted that a) capital contribution reserves recognised for tax purposes were recognised and disclosed accordingly and b) that sufficient capital contribution reserves were available on the date the undertaking’s own capital shares were acquired. Accurate documentation is required, especially if reserves are formed from capital contributions in the course of the year.

According to the FTA\(^1\) and the EXPERTsuisse financial reporting commission, the solution shown takes account of the requirements of both tax and commercial law.

**Summary**

The new financial reporting law has definitely brought greater transparency. In certain respects it has also raised some interesting questions. Some of the options (for example, presenting financial statements in a foreign currency) to some extent run contrary to the notion of creditor protection. Fiscal neutrality might be seen as a key element of the new law, but the details of the different rules have to be coordinated. Even if the changeover has cost companies a considerable amount of money and effort, it has been worth it, as it has resulted in much more meaningful financial statements.

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\(^1\) Swiss Federal Tax Administration
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