

Defined benefit and defined contribution in pension schemes accounting essay



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Pension is fund that is built during the working life of the employee and then used to secure the income after retirement. These funds can be operated by employer (occupational pension) who invests over time or alternatively employee can invest in a fund of their choice (private pension scheme). Both of these schemes generate income after retirement.

The pension funds are operated in many countries. According to international financial service the UK pension fund is \$1, 464 billion, Germany had \$268 billion and France had \$164 billion.

Pension schemes are of two major types:

Defined benefit scheme

Defined contribution scheme

DEFINED BENEFIT SCHEMES:

Define benefit scheme is a type of pension scheme which ensures a particular level of income/benefit after retirement. Most of the cost of the benefit and risk of the investment is borne by the employer however in the <https://assignbuster.com/defined-benefit-and-defined-contribution-in-pension-schemes-accounting-essay/>

contributory define benefit scheme employees also make compulsory contributions. The pension amount is either calculated on the bases of the final salary of the employee or depend upon the average earnings of the employee throughout his employment years.

From the employer prospective the final salary scheme is expensive for the employer as compare to other pension schemes.

Employee's contributions to the scheme are dependent on various factors such as:

Value of the scheme assets and investment yield.

The composition of scheme membership.

Rate of salary growth of the scheme members.

Longer life span after retirement.

Changing regulatory requirements.

In the cash salary scheme, a non contributory define benefit scheme, employer contributes a certain amount to the pension fund on behalf of the employee. There is no responsibility of the employee for these contributions.

Source : <http://www.opalliance.org.uk/decline.htm>

DEFINED CONTRIBUTION SCHEMES

Defined contribution schemes are also known as money purchase scheme in which the employee and the employer make contributions into a pension

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fund according to prescribed rules. At retirement the pension fund is used to buy annuity which is an income guaranteed for life of the recipient. Under defined contribution schemes following factors determine the pension income available at retirement.

The contributions invested in the scheme;

Product provider/managers charges;

The performance of the pension fund;

The annuity rate at retirement date.

In this scheme the risk of poor returns on investment or high cost lies with the employee instead of employer, however this scheme can provide a combination of investment growth and security by investing initial contributions in risky but high yield investments. Near retirement these contribution are invested in comparatively safer financial products. At the time of retirement employee also have the option taking a tax free lump sum amount from their pension fund. On changing the job the employee can either stop making payment to his fund or transfer it to his new employer with some additional cost. Some experts advise that the defined contribution plans have higher risk as these are dependent on the return on investments Most of the private and occupational schemes in the UK are define contribution schemes.

COMPARISON OF DEFINED BENEFIT AND DEFINED CONTRIBUTION SCHEMES.

The defined benefit and defined contribution schemes can be best differentiated by determining where the risks lie. In a defined benefit scheme, the employer bears the vast majority of costs and if investment returns poor yield or costs increase, the pension fund can become insufficient and the employer must replenish the fund out of the business revenues. Whereas in a defined contribution scheme the employer's contributions are paid at a fixed level and therefore it is the employee who bears these risks. If they are not able to increase contributions when fund performance is poor or cost increases, then their retirement income will be lower.

In UK there is an upper limit to the level of income from a define benefit scheme where as there is no such upper limit to the level of income generated from define contribution scheme. Hence the economic conditions like inflation, cost of living etc will have less effect on the employees in defined contribution scheme.

Employees have no control over the investment decisions in the defined benefit scheme and are only eligible for predetermined excess returns on the investment where as in defined contribution scheme employees have full control of their investment and eligible for receipt of all the returns on the investment.

Define contribution scheme can be easily transferred between employers as employee changes his job this may involve some additional cost and hence

the employee can continue making investment in his own pension fund.

However in case of define benefit scheme the benefit from previous contribution cannot be easily transferred but the employee can stop making future payments of benefits acquired till date.

Several recent studies have examined define benefit or contribution plans.

Balcer and Sahin (1979) compared both plans in a lifecycle setting, and found that earnings fluctuation and job transfers effect gains from define benefit plan . Bodie, Marcus, and Merton (1988) mentioned that define benefit and define contribution plans both have risks, but that these risks are different.

However Both these studies failed to make quantitative estimation of relative risks. The results of later studies by Samwick and Skinner (2004) suggest that for many workers define contribution plan will result in more post retirement earnings when compared to the actuarial present discounted value (PDV) of define benefit plan benefits. Finally, Schragger (2005) analyzed data on earnings and job change patterns from the Panel Survey of Income Dynamics and found that increased job turnover in the 1990s made define contribution plans more attractive relative to define benefit plans for many workers

Why are Defined Contribution Schemes becoming more important:

In the last few years there is a large shift towards Defined Contribution schemes and many firms have frozen define benefit plans. Munnell and Sotos(2006) analyzed data from Department of Labor and found that the number of defined benefit plans have decreased to 6. 6 million in year 2003 from 9. 6 million in the year1990. The major factors behind the decline of

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defined benefit schemes are connected with the regulatory and accounting restructuring.

New Regulations: In UK the new regulation require employers to represent actual pension fund liabilities arising from contractual deficit or negative investment return within their accounts.

Increased cost: Now a day people are living longer hence putting extra pressure on pension funds causing reduction in fund values. Additional costs are involved due to removal of advance cooperation tax relief and due to regulatory requirements introduced to protect employee's interest.

Peer pressure: many high profile companies closing their define benefit scheme encourages other to do the same.

Defined contribution schemes are becoming increasingly popular due to various perceived benefits mainly for employers and also for employees as well.

Risk Stratification: In the private sector, this trend has helped in shifting the risks associated with the investment from the employers to employees.

Employers do not have to replenish pension fund in case of loss from poor yield from investment or increasing cost. Recipients are now in full control of their investments and have increased responsibility to manage their retirement assets. Employees are becoming more involved with the financial markets as their pension fund is invested in these products.

Growth and Security: With the Defined Contribution Plan there are more

chances to have growth in pension fund than the Defined Benefit Plan. Post <https://assignbuster.com/defined-benefit-and-defined-contribution-in-pension-schemes-accounting-essay/>

retirement earnings are based on average career income rather than final salary and also on the performance of investment. Defined Contribution Plans provide the option of receiving fixed income with a fixed annuity and at the same time has potential to increase the pension fund. Therefore it provides both security and growth of employee funds

Workforce Mobility: One main reason behind the increased importance of Defined Contribution Plan is the workforce mobility. Employees move from one place to another for better job. It is easier to transfer defined contribution plan between employers whereas defined Benefit Plan is non transferrable.

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Pension Regulations and Tax Policies: Define Benefit Plans are directed by the complicated pension regulations and taxation policies to protect the interests of employees. These complicated regulations and policies have increased the cost of administering Define Benefit Plans and has resulted in the shifting towards Define Contribution Plans.

Decline in manufacturing industries: Define Benefit Plans were mostly used by the manufacturing industry. But with the decline in these industries the use of Define Benefit Plans has also decreased and this has lead to the increased usage of Define Contribution Plans particularly by service sector such as various non -profit making government organizations.

Life Cycle Funds: Define Contribution Plans also provides the employees with products such as Life Cycle Funds. The main purpose of these funds is to simplify the complicated investment process for the employees. Life Cycle <https://assignbuster.com/defined-benefit-and-defined-contribution-in-pension-schemes-accounting-essay/>

Funds have also resulted in the shifting from Define Benefit Plans to Define Contribution Plans.

Conclusion

Both define benefit and contribution schemes are meant to ensure a guaranteed income for employees after retirement. Each has its advantages and disadvantages both for employers and employees. Although employers are preferring define benefit scheme now a days, certainly when looking back at the recent credit crunch and troubled financial markets, it was not uncommon for defined benefit arrangements to be holding surpluses and/or to be taking contribution holidays This will not be possible under a defined contribution scheme where the employer is required to maintain the agreed level of contributions irrespective of how well the investments are performing.

When employers try to compare the real overall cost of providing a typical defined benefit scheme with a typical defined contribution scheme, they usually forget that employers benefit from favorable investment returns with defined benefit schemes as many defined benefit arrangements actually cost a lot less when contribution reductions and contribution holidays are taken into account.

Under define contribution schemes, workers are in more control of their pension fund. In addition to this risks are also under the control of the worker, who may decide whether or not to work for a firm with particular pension characteristics, whether or not to voluntarily separate from a firm

with a define benefit plan, or whether or not to contribute the maximum amount to a define contribution plan.

Where the employer cant maintain a defined benefit scheme for all employees then the objective must be to ensure that the defined contribution scheme agreed is essentially based upon contributions that will actually deliver an adequate pension for future retiring employees.