



R&I's Analytical Approach to Retirement Benefit Obligations

(This report is an English translation of the original report in Japanese.)

Substantive Determination on Priority of Claims and Possibility of Deferral

Key Point: Handling of Shortfall in Reserve

The retirement benefit accounting system considers lump-sum payment and pension together as retirement benefits and calculates the total amount of retirement benefits to be paid at the time of retirement. Retirement benefit obligations are calculated by discounting at a certain rate the compensation for labor, deemed to have been generated to date, based on the period from the expected time of retirement to present. Plan assets that have been accumulated externally in the form of tax-qualified pension plans and pension funds are excluded from the obligations and unrecognized prior service cost, which are allowed to be deferred for a certain period of time from the accounting perspective, are deducted and the final figure is recorded on the balance sheet as allowance for employees' retirement benefits. Allowance for employees' retirement benefits is the only figure recorded on the balance sheet and the total of retirement benefit obligations and plan assets is stated in the explanatory note. How R&I is handling the shortfall in retirement benefits, which is the difference between retirement benefit obligations and plan assets, is the key factor in rating assessment.

Reducing Pension Payments When Earnings Decline

Unlike borrowings and corporate bonds, it is difficult to determine the definitive value of the obligations when assessing retirement benefit obligations. It goes without saying that monetary liabilities need to be repaid at some stage. While retirement benefit obligations are debts that the company has to pay to recipients and employees, the amount to be paid is not necessarily fixed at present, as they are to be paid over a long period of time. The amount of the obligations may be affected by any changes to the financial environment or due to the review of relevant systems. For this reason, retirement benefit obligations cannot be handled in the same manner as obligations whose amount to be repaid and repayment timings are definite, as in the case with interest-bearing debts including borrowings and corporate bonds as well as accounts payable.

In Japan, the pension rights, which is the employees' rights to receive retirement allowance and pension, is weaker compared with countries such as the U.S., and there are many instances where the management proposes a reduction in payment or a cut in benefit rate when the company's earnings deteriorate drastically. If such a proposal succeeds in getting through labor negotiations, it will lead to a decline in retirement benefit obligations. Not only pension plan holders who haven't started receiving payments (active employees) but also former employees who have already retired and are currently receiving pension may become subject to reduced payments.

If retirement benefits and pension are considered as future payments of compensation, reducing payments to former employees, who have already provided the labor that should be compensated, can be termed irrational. However, it is often true that these former employees themselves agree to the reduction out of a feeling of loyalty to the company.

To be sure, if the company is based in the U.S. or other countries where such rights are strictly protected and employs local people, the pension rights earned by provision of labor cannot be infringed upon. In such cases, borrowings, etc. may possibly increase in order for the local entity to make up for the shortfall of retirement benefits. In other words, there is a possibility of retirement benefit obligations turning into interest-bearing debts. If it amounts to a considerable amount it would become necessary to handle the shortfall in allowance for retirement benefits similar to interest-bearing debts.

If Unfunded Retirement Benefit Obligations Exceed Shareholders' Equity, Should It Be Considered as Excess Liabilities?

As described above, retirement benefit obligations incurred domestically have low definiteness, and even if the off-balance portion of the unfunded obligations exceeds shareholders' equity, the company would not be immediately referred to as being virtually insolvent. Likewise, in rating assessment, R&I does not make financial adjustment to add the shortfall, exceeding the level of the allowance set under the current accounting system, directly to the balance sheet. Still, when R&I judges that the off-balance portion of unfunded retirement benefit obligations is quite significant, based on situations such as when the amount of retirement benefit obligations is extremely large reflecting the industry or individual business's characteristic or when the figure swings significantly due to fluctuations of share prices and interest rates, it analyzes the situation after carrying out adjustments including calculating the financial ratio based on the shareholders' equity calculated by subtracting off-balance portions of the absolute figure of the shortfall in retirement benefit allowance and unfunded retirement benefit obligations (excluding tax effect portion).

Cash-Out Timing Differs from Timing of Recording Expense

There is a gap between the timing of recording retirement benefit expenses in accounting and that of cash-out including provision of contributions and payment of retirement lump sum grants. In rating assessment, R&I pays attention not only to the amount of retirement benefit expenses but also to the changes in cash flow base. If the amount of shortfall in retirement benefit allowance is significant in accounting for pension, the amount of contributions may be increased in the future. Especially when stock prices are slumping and investment performance deteriorates, it requires caution, as the discrepancy between plan assets and retirement benefit obligations tends to grow greater. In order to address the shortfall in funding, companies may make changes to the system such as cutting the benefit rate, introducing cash balance plans and adopting defined contribution pension plans. There have also been cases in the past where companies made up for

the shortfall in plan assets by procuring funds on liabilities and establishing employee pension trusts. R&I takes into account the impact of such measures on the cash flow as and when needed.

Impact of Changes and Differences in Accounting Standards

Focus also needs to be maintained on the trends in retirement benefit accounting. As it is seen in the revisions carried out in 2008 to its accounting standards, such as the elimination of the regulation allowing the discount rate, for calculating retirement benefit obligations to be determined after taking into account the fluctuations in bond yields for a certain period, the Japanese accounting standards are on course to be made consistent with the U.S. and international accounting standards. Among the remaining differences, the discrepancy in actuarial calculation and the method of recognizing prior service costs are the only items having a relatively large impact. However, the corridor approach (where companies do not amortize the portion that do not exceed 10% of pension liabilities or plan assets, whichever is larger, of the unrecognized cumulative amount) adopted in international and other accounting standards could at times result in comparatively large differences in the service cost figures for each period. If the immediate recognition of the discrepancy in actuarial calculation, as stated in the Memorandum of Understanding (MOU) announced by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in September 2008, is actually adopted, it would lead to even larger discrepancy with the Japanese standards.

Among such differences in accounting standards, R&I reflects those with significant impacts on the rating evaluation by employing measures such as adjusting the financial statements upon considering the balance with the companies that are target for comparison.

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