TRANSNET PENSION FUND RESTRUCTURING CHALLENGES

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DECLARATION

I declare that this dissertation is my own unaided work. It is submitted for the degree of Master of Business Administration in the University of Natal, Durban. It has not been submitted before for any other degree or examination in any other university.

Gerald Mfanyana Salanje

---------- day of --------, 2002

DEDICATION

To my fiancé
For her love and encouragement
During the sleepless nights of writing this thesis

And

To Mpumelelo Salanje (son)
For tolerating my absence
During the writing of this thesis

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CHAPTER 1

Introduction

1.1 Restructuring in general

In recent years Nedcor attempted a take-over bid of Standard Bank Investment Corporation (Stanbic). In his statement as a Chairman of Nedcor in the 1999 Annual Report, Mr Chris Liebenberg said of Stanbic take-over bid: "*Our bid was prompted by the need for South African institutions to become internationally cost-competitive in line with global trends. The need for being internationally competitive in both domestic and regional markets was clearly demonstrated by our research, which highlighted the extent to which foreign banks have become active in South Africa since 1994, not only on the commercial and corporate fronts, but recently also in private banking – hence the need for a national and regional champion*".

During its1997/98 financial year, Tiger Oats Limited acquired ICS. In his statement in the 1997/98 Annual Report, Mr Robbie Williams, the Chairman of the group had this to say about this acquisition: "*The combination of Tiger and ICS has created a stronger, more competitive organisation with an enhanced ability to respond to the challenges facing the South African Food sector*".

Commenting on Nedcor's R 7.6billion friendly bid for BoE, the Chief Executive Officer of BoE, Mr Tom Boardman said: "*With the changing environment banks find themselves in, and in particular after what BoE has been through in the past few months, the Nedcor offer provides BoE shareholders, clients and staff a high degree of certainty and security. The incorporation of BoE's operations into those of Nedcor will create one of South Africa's largest banks in terms of domestic banking assets. The asset base will amount to approximately R 240billion*".

The need to be Generally Accepted Accounting Practice (GAAP) compliant, appointment of the new Board, the enactment of the Public Finance and Management Act (PFMA), the substantive increase in the size of the fund under management have necessitated an urgent restructuring of the Public Investments Commissioners (PIC). In response to these challenges, additional employees were hired, specialised skills base was put in place, and new world class IT systems were acquired. To sum it up, Mr N K Mlamla, the Secretary to the PIC, (2001) said: "*The overall objective of internal restructuring was to develop the PIC into a world class and professional investment organisation*".

The chairman of AT&T, Mr Robert E Allan, in announcing the restructuring of the group in New York in September 1995 said: "*The company is taking this bold step to capitalise on the opportunities in each business segment of the global information industry – communication services, communications equipment, and transaction-intensive computing. Changes in customer needs, technology and public policy are radically transforming our industry. We now see this restructuring as the next logical turn in AT&T journey since divestiture. It will make AT&T's businesses more valuable to our shareowners, even more responsive to their customers, and better able to focus on the growth opportunities in their individual markets. Under the plans announced here today, one of the new companies would focus on providing the world's best 'anytime, anywhere' communications and information services*".

The above are examples that highlight some of the objectives of restructuring. Restructuring include take-overs, mergers & acquisitions, re-organisations, re-capitalisation, downsizing, divestitures, business re-engineering, management buyouts, unbundling, share-buyback and privatisation of state owned assets such as Transnet, Eskom, etc. Some restructuring initiatives originate from management desire to increase stakeholder value. This could be achieved by cost containment strategies which sometimes result in retrenchments, outsourcing non-core activities such as information technology (IT), minimising executive packages, conversion of interest bearing obligations into equity, selling non-strategic investments and other business strategies. Other restructuring initiatives are due to circumstances beyond management control. These are mainly driven by risks inherent in a particular industry. Examples are sale of Saambou to First National Bank, sale of BoE to Nedcor and sale of Andersen resources to KPMG. Restructuring of retirement benefit funds are mainly driven by pressing need to comply with statutory requirements such as the Pension Funds Act, 1956, and the Financial Services Board requirements. The need to comply with Generally Accepted Accounting Practices by employer companies, particularly AC 116, which require employer companies to fully provide for deficit of the Defined Benefit Funds also force the Trustees to consider restructuring these retirement benefits funds.

To accelerate the agenda towards the restructuring of State Owned Enterprises (SOE), the government of the Republic of South Africa adopted a Policy Framework in 2000. This document is aimed at detailing a coherent framework that is intended to guide the government on the restructuring process. Four key sectors that this framework is aiming at are Energy, Transport, Telecommunications and Defence. On restructuring of Transport sector, the Policy Framework identified Transnet debt as impacting on the overall Transnet restructuring. *The restructuring of Transnet debt will enable the enterprise to operate on commercial* *principles. It will enable the various divisions to operate as independent business units without cross-subsidising each other's contributions towards the debt. Transnet and its various business units will be able to make market decisions* (An Accelerated Agenda Towards the Restructuring of State Owned Enterprises: Policy Framework, 2000, p.140). The restructuring of Transnet debt referred to in the Policy Framework document relates to the restructuring of the Transnet Pension Fund as it is the deficit of this Pension Fund that gave rise Transnet debt which on 01 April 1990 amounted to R 17.1billion. This debt, together with the general concerns of retired members of the Transnet Pension Fund regarding the overall Transnet business units restructuring such as SAA, Spoornet, Portnet and others gave rise to the restructuring of the Transnet Pension Fund.

1.2 Background to the case study

Transnet Limited (the company) was incorporated on 1 April 1990. The main business of the company is to carry on business in all aspects of transport and harbour operations as well as related services. The company, its subsidiaries and its associate companies (the Group) recorded annual turnover of approximately R 30billion and the Group had the total operating assets value of R 50billion as at 31 March 2001, the Group's year end. The total Group's workforce averages 86 000 employees. Membership of the retirement funds is compulsory.

At the date of incorporation of the company, the Transnet Pension Fund was established in terms of the Transnet Pension Funds Act, Act no. 62 of 1990. In terms of section 5 of this Act, the rules were published by the Minister of Public Enterprises in terms of which the Fund was governed. In terms of these published rules, Transnet Pension Fund qualified as a defined benefit fund. This meant that members' benefits were entrenched irrespective of the financial position or the financial performance of the fund. When the fund was established it inherited an actuarial deficit of R 17.1billion from the South African Transport Services (SATS). Approximately half of this deficit was attributable to SATS pensioners and the other half was attributable to the then Transnet employees. Of this total deficit, R 10.3billion was provided for in the books of the company at incorporation. In terms of Transnet Pension Fund Act and the agreements relating to the establishment of the Fund, Transnet underwrites the Fund's obligations with the State acting as ultimate guarrantor. The Fund's Trustees and the company management undertook the management of this deficit. During 1990/91 and 1991/92 financial years the company issued about R 10.3billion 16.5% non-tradable Pension Fund Debentures (T 011 Debentures) to this Pension Fund to partly address the deficit. In addition, the company undertook to contribute at a rate in excess of the required future service contribution rate as determined by the actuaries.

An actuarial valuation of the funding position of the fund is performed on an annual basis. At 31 March 2000, the results of the actuarial valuation indicated that the fund had a surplus of R 2.4billion. This surplus was not recognised in the books of the company, as it was not clear as to whom it belonged and the impact of the anticipated restructuring of this fund was not known.

Two main reasons gave rise to the need to restructure Transnet Pension Fund during the latter part of the 1990's. Firstly, the Board of Trustees of Transnet Pension Fund recognised the changing needs of the company and the Fund's members and pensioners. Secondly, it was clear from the interaction between the Board of Trustees and pensioners that the pensioners were concerned about the impact the company restructuring and privatisation would have on them and the Fund cash flows. Flowing from the above factors, it was agreed to establish two additional funds. In November 2000 the Transnet Pension Fund was restructured through an Act of Parliament. This restructuring resulted in this fund being restructured and split into three separate funds as follows:

Transnet Second Defined Benefit Fund

This fund was formed to house the SATS pensioner portion of the then existed Transnet Pension Fund. The transfer of this portion of the Transnet Pension Fund to a separate fund was motivated by the fact that this portion would only have cash outflows (pension payments). This Fund was also closed to new members. This means that its survival is entirely depended on the performance of its planned assets.

Transnet Defined Contribution Fund

This fund is structured as a Defined Contribution Fund. The portion of the existing company employees in November 2000 (current employees) was transferred to this fund. The company committed R 700millions as a conversion incentive to encourage active members to convert to this fund. Only those members who converted would be allocated their share, with the remaining balance retained by the company.

Transnet Pension Fund (Old Transnet Pension Fund)

This fund is the Old Transnet Pension Fund and was also closed to new members with effect from 1 November 2000. Members were current employees of the company as of November 2000 who elected not to convert to Transnet Retirement Fund. It continued to be a defined benefit fund. This is a contributory fund.

This split resulted in the restructuring of T 011 Debentures that at that time had a balance of R 8.4billion. Of the R 8.4billion, R 4.3billion related to the Transnet Second Defined Benefit Fund. This portion was cancelled per agreement reached between the members through the Board of Trustees of this fund and the company management. As part of the cancellation agreement, the company agreed to cede 75million M-Cell Limited shares held by the company at their market values to this fund. As at 31 March 2001, this fund recorded a deficit of R 3.6billion. The interim results of the company as at 30 September 2001 indicated that this deficit had increased by R 2.5billion. This deterioration is partly due to the decreased in interest rates during the six months period to 30 September 2001, which resulted in an increased fund's liabilities, and the continued decline in the market value of the M-Cell Limited shares over this period.

R 1.1billion was reclassified to other long-term interest bearing liabilities.

The remaining R 3billion (nominal value) of the T 011 Debentures were redeemed. At the time of redemption, the market value of these remaining debentures amounted to R 3.4billion. The redemption was effected partly by raising fresh interest bearing loans amounting to R 1.7billion and partly by transferring R 186 Government Bonds investments with the nominal value at R 1.3billion and a market value of R 1.67 billion to the Transnet Pension Fund. This redemption resulted in a net loss of R 622million as at 31 March 2001 (refer Figure 10 in Chapter 4 below).

1.3 Problem statement

Over the past eleven years the Trustees of the Transnet Pension Fund, the management of the company and the Government have adopted various investments and restructuring strategies to address the solvency, liquidity, cash flow and performance problems of the company created by the historic deficit assumed by the company at incorporation in April 990. Over this period, this deficit was partly resolved by the issuance of T 011 Debentures, increased company contributions to the fund, and the cession of the M-Cell Ltd shares held by the company to the Old Transnet Defined Pension Fund. These debentures had a significant negative impact to the company's cash flows and gearing. However, despite extensive restructuring programmes adopted during the late nineties and in the early

2000's, which resulted in the part cancellation and part redemption of the T 011's, the Transnet Second Defined Benefit Fund deficit is continuing to be a problem to the company's future profitability, liquidity, solvency, planned capital roll out and the overall restructuring initiatives as outlined in the Policy Framework document. This is likely to create negative perceptions regarding the ANC Government's privatisation performance. This may also adversely affect the country's overall credit rating.

The restructuring processes, investment strategies adopted to increase assets returns at acceptable risk levels and the day to day management of the Funds require compliance, by all parties involved, with the Companies Act, Generally Accepted Accounting Practices, Transnet Pension Fund Act of 1990, The Pension Funds Act of 1956 (as amended), the Rules of the Funds, the Income Tax Act of 1962 (as amended), the Public Finance and Management Act of 1999, Exchange Control Regulations, and the Corporate Governance, all designed to safeguard the interests of members of the Funds and the company stakeholders. Given the magnitude of the Old Transnet Pension Fund, with a total membership of more than 86 000, complete compliance with the above statutory and regulatory requirements poses major challenges.

The overall objectives of the restructuring of the Funds and the consequent part cancellation and part redemption of the T 011 Debentures were to generate annual cash benefits through interest savings of approximately R 800millon, and to improve the company's gearing levels in order to enable the company to finance the planned aggressive capital programme aimed at restoring the decaying infrastructure, especially port facilities, SAA ageing fleet, ageing rolling stock and wagons. It was also hoped that these cash savings will assist in restoring and acquiring new world class telecommunications equipment to better position Transtel, the company's telecommunications division for the second network operation. Given the continued deterioration of the Second Defined Benefit Fund deficit, these objectives are not likely to be realised. The challenges now facing the company management, as the employer organisation, the Government as the guarantor as well as the Board of Trustees of the Second Defined Benefit Fund, as custodians of the fund, are the effectiveness of the planned future funding and investment strategies that will bring this pension fund to a surplus position or that will reduce the deficit to acceptable levels. The impact of these planned strategies on the company balance sheet, cash flows and performance pose major challenges.

1.4 The objectives of the study

The objectives of this study are as follows:

- To establish why the restructuring of the Old Transnet Pension Fund failed to address the original restructuring objectives of improving the company's bottom line, creating a healthy state of affairs by improving gearing and cash flows.

- To assess whether during and after the restructuring processes all statutory and other relevant requirements have been complied with in order to safeguard the interests of members and the beneficiaries of the deceased members of the funds, and also to protect the interests of the company stakeholders.

- To examine investment strategies adopted during and after restructuring to ensure that they were sound, within the generally accepted theory per relevant literatures and in compliance with the legal framework and corporate governance governing all aspects of the funds.

- To assess future funding plans and strategies to establish whether they are acceptable in terms of the legal and regulatory framework, proven theories and practices, and most importantly, whether they will result in improved returns at acceptable risk levels without compromising the interests of members and without adversely affecting the company's financial soundness.

1.5 Chapter outline

This research report is structured as follows::

Chapter 2 - Literature review. This review will comprise the following:

- Review the Statements of Generally Accepted Accounting Practice. Particular emphasis will be placed on AC 000: Framework for the preparation and presentation of financial statements, AC 101: Presentation of Financial Statements, AC 116: Employee benefits, AC 133: Recognition and Measurement of Financial Instruments, AC 135: Investment properties, and AC 136: Accounting and reporting by retirement benefit plans.

- Review of legal matters will cover the following:

  - The Companies Act, in particular Section 286(3);
  - The Public Finance and Management Act;
  - The Financial Services Board requirements;
  - The Pension Funds Act of 1956;
  - Transnet Pension Fund Act of 1990;
  - The Income Tax Act of 1962

- Review of the Corporate Governance will cover the following:

  - Composition of the Board of Trustees and its objects;
  - Amendments to the Rules of the Funds;
  - Board meetings;
  - Board competency;
  - Minutes of the Board of Trustees;
  - Disclosure;
  - Investments objectives and strategies;
  - Risk management;
  - Unfair discrimination;
  - Administration service agreements;
  - Transnet Treasury acting as an asset manager; and
  - Government guarantee of the defined benefit funds deficit.

- The above reviews will cover theories and best practices. Quality of both non-financial and financial information communicated to all relevant stakeholders will be reviewed with reference to acceptable practices and other communications by other entities of similar nature. This review will mainly cover the annual reports of the Pension Funds and the company or group – quality and quantity, reasonableness, consistency and relevance of information presented.

Chapter 3 - Research methodology. This chapter will cover the following:

- Research questions. These are critical questions that will be answered by analysing this case study

- Data collection methodology and sources of data. This will cover explanation of the sources of both the secondary and primary data, how validity of data collected is verified, as well and how data is analysed and presented.

This chapter is done with reference to research theory and literature.

Chapter 4 – Data presentation and analysis. This chapter covers analysis and presentation of data gathered regarding the restructuring of the Transnet Pension Funds. This covers the analysis of the Annual Reports of both the Transnet Pension Fund from 1990/91 to 1999/2000 financial years and the Annual Reports of the three Pension Funds after the split for 2000/2001 financial year. This also covers the analysis of the Annual Reports of the company covering eleven financial years to 31 March 2001, including the interim results. The above analysis is done to assess the effectiveness of the restructuring initiatives of the Pension Funds. Particular attention will be paid to the following:

Pension Funds Annual Reports:

- The Chairman's Statement;
- The Principal Officer's Reports;
- The composition of the Board of Trustees;
- Report of the Actuaries;
- Report of the independent auditors;
- Accounting Policies;
- The statements of funds and net assets, revenue accounts and notes to the annual financial statements.

Transnet Limited Annual Reports:

- The Chairman's Statement;
- The Managing Director's Report;
- Pension Fund analysis (under the Performance Review of Support Services business units);
- Report of the Independent Auditors;
- The Directors' Report;
- Accounting Policies;
- Balance sheets, income statements, statement of changes in equity, cash flows, notes to the annual financial statements as well as the relevant annexures.

The above analysis will be done with reference to the theoretical framework, Statements of Generally Accepted Accounting Practices (GAAP) (with more emphasis on GAAP statements mentioned above), the Companies Act, the Public Finance Management Act, Pension Funds Act of 1956/Transnet Pension Fund Act 1990, and relevant literature, and where necessary, in comparison with the activities of entities of similar nature.

The following additional information is reviewed:

- The Rules of the Fund/s with more emphasis on Corporate Governance issues stated above. These are compared with accepted practice and are assessed for compliance with the Pension Funds Act 1956/Transnet Pension Fund Act 1990 and the Financial Services Board requirements;

- The Trust Deed of Transnet M-Cell Limited Trust. This document will be reviewed to assess the legality and acceptability of the way the benefits of this Trust are structured. More details will be outlined in Chapter 4 below;

- Extracts of the minutes of Transnet Limited Board of Directors relating to M-Cell Limited share transactions. These minutes will be reviewed to assess the way these share transactions were practically handled;

- M-Cell Limited/MTN (Proprietary) Limited/Transnet Limited shareholders' agreement. Transactions regarding M-Cell Limited/MTN (Proprietary) Limited will be reviewed in conjunction with this document.

- Transnet Limited and the Pension Funds Audit Committee documents. External independent auditors and internal auditors review these documents to assess areas of concerns. More emphasis will be placed on reviewing non-compliance with the requisite statute, weaknesses in the systems of internal controls and strategies adopted by management to implement recommendations made by both the external independent auditors and the internal auditors, investment strategies, risk strategies and Corporate Governance compliance as perceived by both auditors; and

- Analysis of Corporate Governance questionnaire;

The Chapter is concluded by recommendations of investments and risk strategies these Pension Funds, particularly Transnet Second Defined Benefit Fund and Transnet Pension Fund should adopt in order to minimise/eliminate the shortfall, improve the performance of the plan assets and adopt effective risk management strategies. Staffing and systems issues will also be looked at and recommendations made regarding improvements.

Chapter 5 – Summary and conclusion. In this chapter a summary of research findings is outlined followed by concluding remarks.

CHAPTER 2

Literature review

The aim of this chapter is to review the literature, theoretical, regulatory and statutory framework against which the Pension Funds and the company will be compared during the restructuring review. This review will also cover corporate governance, and investments and risk strategies.

2.1 Reporting requirements

AC 000: Framework for the preparation and presentation of financial statements

In terms of this statement the objectives of the financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. The statement outlines four qualitative characteristics that are attributes that make the information provided in the financial statements useful. These are:

Understandability: Users are assumed to have a reasonable knowledge of business and economic activities and accounting and willingness to study the information with reasonable diligence.

Relevance: To be useful, information must be relevant to the decision-making needs of users. Information is relevant if it influences the economic decisions of users by helping them evaluate the past, present or future events or confirming, or correcting, their past evaluations.

Materiality: Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Reliability: Information is reliable when it is free of material errors and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

The framework further deals with the disclosure, recognition and measurement of the elements from which financial statements are constructed. It also deals with the concepts of capital and capital maintenance.

This statement defines assets, among other elements of the financial statements, as a resource controlled by an enterprise from which future economic benefits are expected to flow to the enterprise.

This statement also deals with prudence. In terms of paragraph 37 of this statement, prudence is defined as the inclusion of a degree of caution in the exercise of judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities and expenses are not understated.

The development of the framework, whilst fraught with difficulty and criticisms from disparate accounting parties, is a significant milestone in accounting history. It provides an essential tool for future standard setting processes.

AC 101: Presentation of Financial Statements

In reviewing this accounting statement, emphasis is placed on the responsibilities for the preparation of financial statements, components of the financial statements, the concept of fair presentation and compliance with Statements of GAAP.

In terms of paragraph .07 the Board of Directors and/or other governing body of an enterprise is responsible for the preparation of the financial statements. This means that in the case of the retirement fund this responsibility lies with the Board of Trustees.

Paragraph .08 sets out the components of a complete set of financial statements. In terms of this paragraph, a complete set of financial statements includes balance sheet, income statement, statement of changes in equity, cash flow statement, accounting policies and explanatory notes.

In terms of paragraph .11, financial statements should fairly present the financial position, financial performance and cash flows of an enterprise. The statement further states that the appropriate application of statements of GAAP, with additional disclosures when necessary, results, in virtually all circumstances, in financial statements that achieve fair presentation.

The statement is emphatic on the fact that for financial statements to achieve fair presentation, it must have complied in all material respect with the applicable statement of GAAP except that it has departed from a statement in order to achieve fair presentation.

In terms of the South African Auditing Standards (SAAS 700) the independent auditor of an enterprise, in expressing his opinion should state that the financial statements fairly present, in all material respects, the financial position of the enterprise as at the reporting date and the results of operations and cash flows for the year then ended in accordance with GAAP, and where applicable, in the manner required by the relevant statute.

AC 116: Employee benefits

The objective of this statement as set out in paragraph .01 is to prescribe the accounting and disclosure for employee benefits. The statement requires an enterprise to recognise a liability when an employee has provided a service in exchange for employee benefits to be paid in the future, and an expense when the enterprise consumes the economic benefits arising from service provided by an employee in exchange for employee benefits.

In terms of paragraph .08 of the statement, defined contribution plans are post-employment benefits plans under which an enterprise pays fixed contributions into a fund and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. Paragraph .45 of the statement states that when an employee has rendered a service the enterprise should recognise the contribution payable to a defined contribution plan in exchange for that service as a liability in its balance sheet and as an expense in its income statement.

Defined benefit plans are defined in the statement (paragraph .08 (b)) as post-employment benefit plans other than defined contribution plans. Simplistically, the statement requires an employer company to recognise net benefit obligations as a liability in its balance sheet as at the end of the accounting period and as an expense in its income statement during the accounting period concerned. Net surplus can also be recognised as an asset in its balance sheet as at the end of the accounting period and as income/gain in its income statement during the accounting period concerned under certain circumstances and provided that recognition requirements in terms of AC 000 are met. Under the defined benefit plans, the enterprise's obligation is to provide the agreed benefits to current and former employees. The actuarial and investment risk fall, in substance, on the enterprise. If the actuarial or investment experiences are worse than expected, the enterprise's obligation may be increased.

Paragraph .51 of the statement details steps to be followed in accounting for defined benefit plans by an enterprise. An enterprise is required to use the actuarial techniques to make reliable estimate of the amount of the benefit that employees have earned in return for their services in the current and prior periods. This entails the enterprise determining how much benefit is attributable to the current and prior periods and to make actuarial assumptions about the demographic variables and financial variables that will influence the cost of the benefit. These benefits are therefore discounted using the Projected Unit Credit Method to determine the present value of defined benefit obligation and the current service cost. The next step is the determination of the fair values of the planned assets, the total amount of actuarial gains and losses. The sum of the amounts of actuarial gains and losses that should be recognised and the fair values of the planned assets should be netted against the present values of defined benefit obligations and current service costs as determined above to arrive at the net present obligation/deficit or surplus. Such deficit or surplus should be dealt with by the company as detailed above.

AC 133: Recognition and measurement of financial instruments

The purpose of this statement is to ensure that assets and liabilities of the funds, which constitute financial instruments, accurately reflect the economic realities and impact of the transaction.

In terms of this statement, the following accounting classification and policy apply:

Held for trading

This applies to financial assets and liabilities, which are acquired for the purpose of profiting from short-term fluctuations in price or margins. These assets and liabilities are accounted for on a fair value basis using the bid price for assets and offer price for liabilities on the balance sheet and marked-to-market through the income statement.

Held to maturity

This applies to financial assets that have a fixed maturity and which the enterprise has the ability and intention to hold to maturity. Such instruments are carried at amortised costs.

Originated loans and receivables

These financial assets are created by the enterprise through providing money directly to a debtor. The asset is carried at amortised cost on an effective yield basis.

Available for sale

This refers to financial instruments that are not classified in other categories. These instruments are carried at fair value and marked-to-market through the income statement or through equity until the asset is sold at which time the realised gain or loss is reported in net profit or loss.

The statement provides very strict guidelines regarding hedge accounting. In terms of this statement, hedge accounting provides for matching the gains and losses on the hedging instrument with changes in fair value or cash flow of the hedged item. Hedging for accounting means designating a derivative as an offset in net profit or loss, in whole or part, to the change in either the fair value or cash flows of a hedged item. The following criteria for every single hedging relationship applies:

- Designation, documentation and risk management – formal documentation is required at the inception of the hedge and must include:
    - identification of the hedging instrument and hedged item or transaction;
    - the nature of the risk being hedged; and
    - the risk management objectives/strategies;
- Effectiveness – a hedge is effective if at inception and throughout the life of the hedge, an enterprise can expect the changes in the fair value or cash flows of the hedged item to be almost fully offset by the changes in the fair values or cash flows of the hedging instrument and actual results are within a range of 80% to 125%. Any ineffectiveness is recognised in the net profit or loss for the period, regardless of the type of hedging relationship.

AC 136: Accounting and reporting by retirement benefit plans

This statement is applied in the reports of retirement benefit plans where such reports are prepared. This statement complements the statement on employee benefits detailed above.

Defined contribution plans

On the one hand the participants are interested in the activities of the fund because they directly affect the level of their future benefits. On the other hand the employer is interested in the efficient and fair operation of the fund. To satisfy these objectives this statement requires the report of the retirement benefit fund to include the following:

- a description of significant activities for the period and the effect of any changes relating to the plan, and its membership and terms and conditions.

- a statement reporting on the transactions and investment performance for the period and the financial position of the plan as at the end of the period, and

- a description of the investment policies.

Defined benefit plans

The report of the defined benefit plan should contain the following:

- a statement showing the net assets available for benefits, the actuarial present value of promised retirement benefits, the resulting excess or deficit, or

- a statement of net assets value for benefits including either a note disclosing the actuarial present value of promised retirement benefits, or a reference to this information in an accompanying actuarial report.

The statement requires the report to explain the relationship between the actuarial present value of promised retirement benefits and the net assets available for benefits, and the policy for the funding of promised benefits.

The statement also requires disclosure of minimum information for both the defined contribution and defined benefit plans as follows:

- a statement of changes in the net assets available for benefits;

- a statement of significant accounting policies, and

- a description of the plan and the effect of any changes in the plan during the period.

2.2 Legal requirements

This section covers review of legal requirements that the Pension Funds should have complied with during and after restructuring.

The Companies Act No. 61 of 1973

Section 286 (1) of the Act requires the directors of the companies to prepare the annual financial statements and lay them before the annual general meeting. In terms of the Act, the company financial statements shall constitute the balance sheet, the income statement, cash flow statement, directors' report complying with the requirements of this Act, and the auditor's report as required by section 301 of this Act.

The annual financial statements are required, in terms of the Act, to fairly present the state of affairs of the company and its business as at the end of the financial year concerned and the profit or loss of the company for that financial year, in conformity with GAAP. This section also places more emphasis on fair presentation, which is also covered under AC 101 above.

Public Finance Management Act No. 1 of 1999

The object of this Act is to secure transparency, accountability, and sound management of the revenue, expenditure, assets and liabilities of the institutions to which this Act applies. Institutions to which this Act applies include Transnet Ltd, being Schedule 2 public entity.

In terms of Section 40(3) the annual report and audited financial statements of the public entity must fairly present the state of affairs of the entity, its performance against its predetermined objectives and its financial position as at the end of the financial year concerned. Once again this legislation put emphasis on fair presentation. As noted above, for fair presentation to be achieved, the financial statements must be drawn in terms of GAAP.

Transnet Pension Fund Act, 1990 (as amended)/Pension Funds Act, 1956 (as amended)

Unlike other retirement benefit funds, Transnet Pension Fund is governed in terms of the Transnet Pension Fund Act established in 1990. This Act was subsequently amended in 2000, giving rise to the amended Transnet Pension Funds Act 2000. The purpose of this amendment was to enable the split of the Transnet Pension Fund into three separate funds, the Transnet Second Defined Benefit Fund, the Transnet Retirement Fund and the Transnet Pension Fund (the Old Pension Fund for members who did not wish to convert to the Transnet Retirement Fund). Transnet Pension Funds Act, 1990 is drafted the same way as the main Act, Pension Funds Act 1956. There are no differences in the original Acts. The differences are found on the Transnet Pension Fund Amendment Act, which is specifically drafted to cater for the establishment and activities of the Transnet Second Defined Benefit Fund (the pensioner fund) (refer Chapter 1 on background information). Therefore the following sections cover both Transnet Pension Fund Act, 1990 and the Pension Funds Act, 1956. Transnet Pension Funds Amendment Act (which are additional amendments are shown by asterisks).

Outlined below are selected sections of the Acts detailed above which are relevant to this case study.

Section 4

In terms of this section, every Pension Fund should apply for registration with the Registrar of Pension Funds. It requires that all Pension Funds apply for registration under this Act.

*Section 5**

This section requires the Board of Trustees to comprise six Trustees and their alternates appointed by the employer, of which two trustees and their alternates shall be nominated from amongst pensioners.

Section 7A

This section requires that every fund shall have a board consisting of at least four board members, at least 50% of whom members of the fund shall have a right to elect.
The section also requires that the constitution of the board, the election procedures of board members, the procedures at

meetings, the voting rights of board members, quorum for a meeting, the breaking of deadlocks and the powers of the board shall be set out in the Rules of the fund. Provided that if a board consists of four members or less, all members shall constitute a quorum at a meeting.

Section 7C

This section deals with the objects of the board. The object of the board shall be to direct, control and oversee the operation of the fund in accordance with the applicable laws and rules.

In pursuing its objects the board shall take all reasonable steps to ensure that the interests of members in terms of the rules of the fund and the provision of this Act are protected at all times especially in the event of an amalgamation or transfer of business of the fund, splitting of a fund, termination or reduction of the contributions to a fund by an employer, increase of the contributions of members and withdrawal of an employer who participates in a fund. The board is also required in terms of this section to act with due care, diligence and good faith, avoid conflict of interest, and act with impartiality in respect of all members and beneficiaries.

Section 8

In terms of this section, every registered fund shall have a principal executive officer. The board shall, within thirty days of the registration of the fund under this Act, notify the Registrar of the name of the principal officer.

*Section 9**

This section empowers the Board of Trustees to appoint:

- The auditor of the Fund;
- The Executive Committee which should comprise:
  - chairperson;
  - Principal Officer
  - One member of the Board and an alternative member; and
- The Investment Committee which should comprise:
  - the chairperson;

- member of the personnel of an employer; and one member of the Board and an alternative member.

Section 9A

In terms of this section, every registered fund, which is required in terms of this Act to have its financial condition investigated and reported upon by a valuator, shall appoint a valuator.

Section 12

This section requires that the pension fund register all amendments to the rules with the Registrar of Pension Funds within 60 days from the date of passing of a resolution amending the rules.

Section 13A

The employer of any member of the registered fund shall pay the member contribution that has been deducted from the member's remuneration and any contribution for which the employer is liable in terms of the rules. Such contributions shall be paid to the fund not later than seven days after the end of the month for which such contribution is paid. In addition the employer is required, in terms of this section, to furnish to the fund minimum information with regard to payments of contributions within 15 days after the end of the month in respect of which the payment is made. Interest will be levied at the rate as prescribed by the Minister from time to time in the Gazette on any late payments made to the fund.

Section 15

Every registered pension fund is required to furnish with the Registrar of the Pension Funds such statements in regards to its revenue, expenditure, the financial position as may be prescribed by the regulation, duly audited and reported on by the auditor of the fund. These statements are required to be furnished within six months of the end of the financial year.

Section 18

This section deals with the fund that is not in a sound financial position. In terms of this section, when any return under this Act indicates, in the opinion of the Registrar, that the fund is not in a sound financial position, the Registrar shall direct the fund to submit a scheme setting out the arrangements that have been made or which it is intended to make to bring the fund into a financially sound condition within a reasonable period. The fund is required to deposit such scheme within three months from the date of receipt of the said direction, together with the report of the valuator or auditor of the fund.

Section 19

In terms of this section, no assets of the registered fund in excess of 5% of the fair value shall be invested in the business of the employer participating in the scheme or arrangement whereby the fund has been established. However, the Board may apply to the register for a greater percentage. The Register may allow a greater percentage of the fund's assets, but not exceeding 10% of the fair value of the fund's assets.

2.3 Corporate governance

Governance is the system by which companies are directed and controlled (King Report on Corporate Governance). *Good governance extends beyond mere compliance with the letter of the law. It necessitates a system of operation based on the principles of good practice and proper conduct. Retirement fund management boards should apply the same principles in conducting the affairs of the fund as directors apply in conducting the affairs of the company.* (Pensions World – South Africa, December 1999). The following are some general checks, which will indicate the extent to which the principles of good practice and proper conduct are being adhered to. (References are to sections of the Pension Funds Act, 1956/Transnet Pension Funds Act, 1990).

Item	Source	Question
Administration services agreements.	Section 13B & PF87.	Are all administration services clearly documented? Does the service agreement detail condition for service deliveries, including time frames, measurements and costs?
Fund management and board meetings.	Section 7A.	Are management board meetings held often enough to ensure effective fund management? Are decisions and action items monitored and reported upon?
Fund management and board competency.	Section 7C.	Are board members satisfied that they are able to discern when they need to obtain expert advice and/or assistance in order to carry out their duties?
Record Keeping.	Section 7D(a) and Regulation 31(c).	Are the reasons for board decisions and resolutions recorded for future references?
Disclosure.	PF86 & PF90.	Are decisions of the board communicated to the members where these have a direct effect on members? Is the effectiveness of member communication monitored?
Investment objectives and strategy.	Implied from section 7C and 7D.	Does the fund have properly defined investment strategy? Are the investment objectives of the fund being met by the existing strategy?
Risk management.	Implied from section 7C and 7D.	Does the fund have a defined risk management strategy?
Unfair discrimination.	Constitution of the Republic of South Africa, 1996, and the determinations of the Retirement Funds Adjudicator.	Are the rules of the fund and their operation free from any unfair discrimination against any individual or group of members?

This list is by no means complete but merely set out the minimum corporate governance issues that any pension fund is expected to comply with.

Other corporate governance structures include, in addition to the Board of Trustees, the Audit Committee with the Audit Committee Charter and a clearly defined mandate, and the Risk Management Committee. These are sub committees of the Board of Trustees. Both these committees are required to be chaired by non-executive members of the fund who should report to the main Board of Trustees.

2.4 Investments and risk management strategies

An important aspect that trustees need to be acutely aware of is the risk versus return. While there are different types of risks associated with the pension fund investments, investment risk can be described as the possibility that a desired level of investment return will not materialise. There is a direct relationship between the amount of risk associated with an investment and the expected investment return. It is a well-known fact that the higher the level of risk associated with a particular investment, the higher the expected investment return will be. Trustees seeking higher returns will usually invest in portfolio's that have greater exposure to equities. On the other hand trustees who seek lower returns and lower risk will invest in portfolio's that have greater exposure to fixed income securities, real estate securities, gilts, and government bonds. (Pension World – South Africa, March 1998)

Risk is an extremely difficult concept to define. Trustees are expected to make an attempt to describe their own fund's risk profile. Risk can be expressed as:

- Volatility of return (either absolute or relative to market measure);
- Exposure to particular assets;
- The inability of a fund to meet its obligations;
- Negative returns or less than expected returns;
- Political or country risks;
- Foreign currency exposure risks (for offshore portfolios).

In Financial Management literature risk is categorised into unsystematic and systematic. *When a portfolio of investments is formed (i.e. when investing in more than one investment security type) one type of risk factor is eliminated – that which is specifically* *associated with the fortunes and misfortunes of particular companies. This is called unsystematic or unique risk. Once this is taken from the scene the investor merely has to concentrate on risks, which cannot be eliminated by holding over large portfolios. This is systematic risk, an element of risk common to all firms to a greater or lesser extent.* (Glen Arnold, p 284).

To reduce the level of risk exposure, the investment portfolio should be diversified among various investment securities. Diversification can also take place within a particular security (e.g. investing in a wide range of industries in the equity portfolio such as industrial, clothing, financial services etc). To reduce exposure to country specific risks such as unstable labour legislation or unstable economic or political climate, international diversification is used. This entails investing in offshore securities in more than one country. The risk unique to this type of diversification is foreign currency risk. This risk can be reduced or eliminated by using hedging instruments such as forward cover contracts.

A defined benefit plan's risk tolerance depends on the plan's funding status and its actuarial rate. For under funded plans, a more conservative approach towards risk is taken to ensure that the funding gap is closed over time. This entails a strategy whereby company makes large plan contributions and assumes a lower actuarial rate. For over funded plans, a more aggressive investment strategy can be taken, in which the firm reduces its contributions and increases the risk exposure of the plan assets.

Assets allocation within a diversified portfolio is another challenge facing the trustees of retirement benefit funds. Assets allocation depends on the type of retirement benefit fund and the type and ages of members. *Under defined benefit plan, the company carries the risk of paying future pension benefits to retirees; should the investment performance be poor, or should the company not be able to make adequate contributions to the plan, the shortfall will have to be made up in future years. Poor investment performance means the actual return on the plan's assets fell below the assumed actuarial rate of return.* (Frank K. Reilly and Keith C. Brown, p 52, 1997). Asset allocation decisions determine to a greater extent both the returns and the volatility of the portfolio. S&P 500 has shown that stocks are riskier than bonds or Treasury Bills. It also indicated that stocks have earned returns lower than Treasury Bills for extended periods of time. To be able to achieve optimal asset allocation Frank K. Reilly and Keith C. Brown (1997) recommend that investors should implement a portfolio management process. The following steps in the portfolio management process has been suggested:

- construct a policy statement;
- examine current and projected financial, economic, political and social conditions;
- implement the plan by constructing the portfolio; and
- monitor and update investor needs, environmental conditions and portfolio performance.

Merrill Lynch assets allocation recommendations in its new categories are:

- *Conservative for income*
  - *Stock 30%*
  - *Bonds 60%*
  - *Cash 10%*
- *Conservative for growth*
  - *Stock 60%*
  - *Bonds 30%*
  - *Cash 10%*
- *Moderate risk*
  - *Stock 50%*
  - *Bonds 40%*
  - *Cash 10%*
- *Aggressive*
  - *Stock 60%*
  - *Bonds 40%*
  - *Cash 0%*

(The Wall Street Journal, July 2,1990)

Most investment portfolios are managed by outside assets managers. Willie Kritzinger (Investment World – South Africa, June 1998) states that trustees should ensure that they can demonstrate to their members that they have acted in the best interest of the members at all times. In deciding on investment managers, trustees should:

- make use of investment;
- ensure that the investment managers election process is based on sound principles;
- ensure that the mandate to the investment managers does not allow investments and investments instruments which may be used to the detriment of the assets;
- communicate their decisions to members;
- keep proper documentation on all decisions.

The portfolio's performance should be compared to guidelines specified in the policy statement rather than be judged on the portfolio's overall returns. For example, if the portfolio performance is relative to a stock market index, the portfolio manager should not necessarily be fired, especially if the stock market has a higher risk than the client desires. (Frank K. Reilly and Keith C. Brown, p 42, 1997). Portfolio performance management is a necessary investment portfolio strategy, as without benchmarking performance, assets allocation strategy's performance cannot be reliably measured.

CHAPTER 3

Research Methodology

3.1 Research questions

Critical questions relating to this study are as follows:

- Did Transnet Pension Fund restructuring successfully address restructuring objectives?

- Was restructuring process sound and in compliance with legal and regulatory framework? Was it executed in the best interests of the members and the beneficiaries of the deceased members and stakeholders of the company?

- Were investment strategies during and after restructuring sound? Were they implemented in accordance with the legal, regulatory and proven theoretical framework in order to maximise returns on plan assets at acceptable risk levels?

- Are future funding plans and strategies to address Transnet Second Defined Benefit Fund's present continuing shortfall sound and effective? Will they be implemented without compromising the interests of the existing members and beneficiaries of the deceased members and without adversely affecting company's future performance, state of affairs and cash flows?

3.2 Data collection and sources

3.2.1 Secondary data

The following secondary sources have been used in this case study:

- *Pension Fund Story*

  This document was prepared by the Transnet Pension Fund Principal Officer, Mr Ian Smith. It details history and evolution of the Transnet Pension Fund, the establishment of Transnet Pension Fund Act 62 of 1990, strategies adopted in the management of the deficit, critical restructuring strategies and challenges and post restructuring reality.

- *The Pension Funds Act of 1956*

  In terms of this Act, more attention was paid to sections that mainly cover the registration of Pension Funds, the composition of the Board of Trustees, the objects of the Board of Trustees, the appointment of the Principal Officer, the appointment of valuators, rules amendments and payment of contributions by employer companies. Other sections of importance relating to this study include investment strategies of the Pension Funds, the preparation and auditing of the statement of revenue, expenditure and the financial position, as well as corporate governance issues.

- *Reports of actuaries*

  These include reports prepared by various actuaries of the Pension Funds in both capacities as advisors to the Board of Trustees and as the Reporting Actuaries in terms of Section 9A of the Pension Funds Act of 1956. These actuaries include JCH Geyer, JA Carson & Partners, Alexander Forbes Shepley & Fitchett, DT Fabian, NBC Actauries and Jacques Malan.

- *Transnet Pension Fund Annual Reports*

  These are annual reports covering the ten-year period from 1990/91 to 1999/2000. These reports contained the chairman's report, fund management report, Principal Officer's report, report of the independent auditors, actuarial report and annual financial statements. The annual financial statements include statement of funds and net assets as at the end of the financial year, revenue account for the financial period covered and notes to the annual financial statements,

- *Transnet Second Defined Pension Fund and Transnet Retirement Fund and Transnet Pension Fund annual reports*

  These reports cover 2000/2001 financial year. They also contain information detailed in the Transnet Pension Fund Annual Report above.

- *Transnet Limited annual reports*

  These reports cover ten financial years from 1990/91 to 2000/2001. More attention is paid on the retirement benefits funds related matters detailed in:

  - The Chairman's statements;
  - The Managing Directors Report;
  - Pension Fund financial performance highlights;
  - Report of the independent auditors;
  - Accounting policies regarding accounting for post retirement benefits;
  - Post retirement benefits treatment, including accounting for surplus/deficit, and disclosure in terms of GAAP statement AC 116.

- *An Accelerated Agenda Towards the Restructuring of State Owned Enterprises: Policy Framework*

  This document is aimed at detailing a coherent framework that is intended to guide the government of the restructuring process of the state owned enterprises. This document identified Transnet debt as impacting on the overall restructuring of this parastatal. Complicating Transnet debt restructuring was T 011 Debentures issued by Transnet to Transnet Pension Fund to address the pension fund deficit inherited from the South African Transport Services (SATS).

- *Pensions World – South Africa web site*

  This web site contains various articles dealing with the retirement benefits. These articles include investment strategies, various funds performances, legal issues, labour relations matters, corporate governance issues, amendments to the Pension Funds Act 1956 and communications strategies among others.

- *Financial Services Board (FSB)*

  FSB bulletins and journals containing information regarding various activities in the Financial Services Sector, including retirement benefit funds.

- *Retirement Fund Governance in South Africa*

  This document is based on the research conducted by Deloitte & Touché Financial Institutions Services Team on retirement fund governance in South Africa. Detailed findings in this report cover the overall governance assessment, fund administration, Trustees/Board of Management, the audit, legal compliance, investment matters and member investment choices.

- *Mergers & Acquisitions – a review of activities for the year 2001*

  This is an annual edition by Ernst & Young Corporate Finance department. It deals with major corporate restructuring activities in South Africa covering transaction values and volumes, transaction trends, international developments, sector analysis review, pricing statistics, and transaction characteristics among others.

3.2.2 Primary data

Primary data has been obtained through informal interviews held with the Principal Officer, Operations Executive, Member of the Board of Trustees appointed by the Managing Director of Transnet Limited, the employer company. These interviews have been held primarily to obtain information regarding corporate governance practices (refer Chapter 2 paragraph 2.3 above). Other methods of data gathering such as surveys, observations and questionnaires have not been conducted due to the fact that this research is case study based.

3.3 Verification of data validity

Secondary data was obtainable from credible sources such as the local Pension Funds web site whose articles have been written by registered actuaries, published literature, audited annual reports, documents that have been authenticated by parliament such as the Pension Funds Act, the Companies Act etc. Other sources have been originated by persons who are members of accredited professional bodies (e.g. the Pension Funds Story document produced by Ian Smith, the Principal Officer, who is a Chartered Accountant (SA)). On this basis the secondary data is valid.

Persons interviewed to obtain primary data are people of high integrity who were appointed to the Board of Trustees based on their competencies. Information obtained has been verified by obtaining confirmation from other Trustees Board Members.

3.4 Methods of data analysis and presentation

Data analysis and presentation has been detailed in Chapter 4 below.

The primary sources of data for analysis purposes are the annual reports of the Transnet Pension Fund covering the financial years ended 31 March 1991 to 31 March 2001 and the annual reports of Transnet Limited, the employer company covering the financial years ended 31 March 1991 to 31 March 2001. These annual reports will be analysed with reference to the literature review detailed in Chapter 2 above with a view to obtaining information regarding compliance or non-compliance therewith. Internal and external auditors reports covering both Transnet Limited and the Pension Funds and Audit Committee documents have also been analysed.

In presenting the findings, reference was made to research questions and the objectives of the study. Presentation has been prepared to communicate the results of the case study regarding the outcome of the restructuring activities that have been pursued over the past decade, that is whether the intended objectives of the restructuring were achieved. This is followed by recommendations of strategies that can be implemented by both the Board of Transnet Limited and the Board of Trustees of the Pension Funds taking into account the present financial positions and performances of these organisations as well as the overall Government restructuring initiatives of the company.

CHAPTER 4

Analysis and presentation of data

4.1 Analysis of Annual Reports for financial year ended 31 March 1991

Detailed analysis of these reports is critical due to the fact that they (for both Transnet Limited as an incorporated entity and Transnet Pension Fund) contain the first strategic direction taken by management of both entities regarding the restructuring of the Transnet Pension Fund. During the1990/91 financial year the company inherited more than R 17billion Pension Fund deficit.

Transnet Limited Annual Report - 31 March 1991

When the Board of Directors assumed control of Transnet Limited on the 1 April 1990, the status of the balance sheet was as follows:

	R million
CAPITAL EMPLOYED	
Ordinary shares	14 002
Long term liabilities	10 011
Provisions	15 273
Deferred income	63
	----------
	39 349
	======

EMPLOYMENT OF CAPITAL

Fixed assets	34 691
Investments	1 583
Loans and advances	2 577
Net operating assets	498
	----------
	39 349
	======

The breakdown of provisions was as follows:

Pension Fund	10 394
Transmed (medical aid provision)	2 900
Accumulated leave	769
Other provisions	1 210
	----------
	15 273
	======

The total actuarial deficit of the Pension Fund as at the date of incorporation of the company on the 1 April 1990 amounted to R 17.1billion made up of a statutory deficit of R 6.8billion and a social deficit of R 10.3billion.

The social deficit of R 10.3billion was fully provided for by the company in its first balance sheet on the 1 April 1990 as shown above. During 1990/91 financial year the company issued R 4.8million T 011 Debentures in favour of the Pension Fund to partly reduce the deficit. This was after an increase in provision for the Pension Fund deficit of R 0.4million. This resulted in the net deficit of R 5.9billion as at 31 March 1991 as shown below:

	R billion
Provision acquired (social deficit)	10.3
Add: Increase in provision	0.4
Less: Converted to T 011 Pension Fund Debentures	(4.8)

Net provision made	5.9
	====

Provision in the books of the company in respect of the Pension Fund deficit was in accordance with AC 116: Employee Benefits, which requires employer companies to make full provision of the pension fund deficits in their balance sheets. In terms of Transnet Pension Fund Act and the agreements relating to the establishment of the Fund, Transnet Limited underwrites the Fund's obligations with the State acting as an ultimate guarantor.

However, the statutory deficit of R 6.8billion was not provided for. This was to be funded by increased company contributions to the Fund and lump sum payments out of profits of the company.

In his statement as Chairman of Transnet Limited in the 1990/91 Annual Report, Dr Marius de Waal said: *"Due to the fact that the Pension Fund invested surplus monies in Government and semi-Government bonds with the Public Investment Commissioners and that this type of investment yielded a lower return than could have been obtained in growth assets, a deficit arose in the Fund. The Pension Fund Act has since been amended and the Fund currently invests in growth assets such as shares and property. One of the most urgent duties of the Board of Directors was to formulate a strategy to address this shortfall. The Board decided not to fund the deficit in full, but to follow a three-fold strategy:*

- *partial funding by the issue of stock;*
- *an increase in the contribution rate by the company from 9% to 12%; and*
- *an allocation from profits.*

The statement by Dr Marius de Waal marked the first strategic initiative in the restructuring of Transnet Pension Fund in order to address the deficit. However, this strategy had the following notable short comings:

- The industry to be targeted for the proposed issue of stock was not mentioned. Even though stock is perceived to be a growth asset, S&P 500 has shown that stocks are riskier than bonds or Treasury Bills. It also indicated that stocks have earned returns lower than Treasury Bills for extended period of time. Risk was not mentioned as a factor in the proposed diversification strategy. The main focus was on growth.

- No mention was made of investments in other securities such as real estate, fixed income securities or liquid funds. Diversification of investment portfolio is a critical risk strategy. Also in a Fund, which had more than 90 000 pensioners, it was not a good investment strategy not to include liquid funds in the investment portfolio. During the financial year under review, R 4million in cash was paid out to pensioners every working day. This amounted to more than R 1billion per annum. Therefore a portion of the assets of the Pension Fund should have been allocated to liquid funds.

- Allocation from profits required the resolution of the shareholder as this would amount to the appropriation of funds other than a dividend payout. A dividend policy needed to be implemented, stating that dividends would only be paid after a portion of profits has been allocate to the Pension Fund.

- Gearing policy needed to be implemented, clearly stating the company's targeted gearing ratio. This would assist in capping the amount of profits to be allocated to the Pension Fund and the amount to be declared as dividends to the shareholder.

- These strategies needed to be incorporated into the broader company strategies.

- It was also not mentioned whether the proposed increase in the company contribution rate was based on the advice of a qualified actuary or was based on the Board of the Directors gut feel. However, such increases were welcome under the circumstances.

A clearer funding strategy was outlined in another section of the Annual Report dealing with the analysis of the company business units and its support services. In outlining the Pension Fund strategy, an actuarial valuation of the Fund would be undertaken annually in order to monitor whether the strategy to address the shortfall is achieving the desired results. As at 31 March 1991, the total Pension Funds assets amounted to R 10billion. Of this amount, 22% was invested in shares, 2% in property, and the balance in cash and stock. The objective behind this asset allocation was to gain better exposure in growth assets. The targeted allocation was 65% shares, 15% property and 20% interest-bearing securities. Also investments in liquid funds were not mentioned. During 1990/91 financial year R 4million in cash was paid out to pensioners per working day. Also this targeted allocation strategy was not compared with other asset allocation strategies with similar objectives to assess its reasonability and acceptability.

Transnet Pension Fund Annual Report - 31 March 1991

The Acting Chairman of the Pension Fund, Dr E Kruger, outlined strategies to be adopted after consideration by the Board of Trustees of the Pension Fund, the Board of Directors of the company and the actuaries as follows:

- the amount of R 10.3billion has been transferred to the Pension Fund, and is funded through the issuing of Transnet Limited stock to the Pension Fund;

- the remaining portion of the shortfall, namely R 6.8billion would be funded over the next ten years through greater contributions by the company and through the lump sum payments to be paid from company profits to the Pension Fund.

The fact that the entire R 10.3billion was transferred to the Pension Fund, and is funded through the issuing of Transnet Limited stock to the Pension Fund was inconsistent with the how this deficit was accounted for in the company books. The Pension Fund also reflected R 5.9billion as an asset raised in its books as a result of the issuance of the T 011 Debentures in its favour. This figure was overstated by R 1.1billion in the books of the Pension Fund. This overstatement failed to satisfy the definition of an asset in terms of AC 000 of GAAP. This resulted in incorrect financial information reported by the Transnet Pension Fund. The financial statements of the Pension Fund for the year ended 31 March 1991 did not achieve fair presentation in terms of AC 101 of GAAP.

In terms of Transnet Pension Funds Act, the Pension Fund was restricted to invest all surplus funds in government bonds with the Public Investment Commissioners. As part of restructuring initiatives, the Act was amended, enabling the Fund to invest in growth assets and to establish a balanced portfolio. The target asset allocation was set at 65% for share portfolio, 15% in property portfolio and the remaining balance of 20% was to be invested in money-market instruments. This allocation proposal was in line with the company Chairman's proposal except that he stated that the remaining 20% was to be invested in fixed income securities. This therefore served as a solution to concerns regarding lack of liquidity on the proposed asset allocation raised above. This allocation model compares favourably to conservative for growth and moderate risk asset allocation model proposed by Merrill Lynch (The Wall Street Journal, July 2, 1990). By September 1991 a move towards the proposed asset allocation improved returns on equity from 2% during the financial year to 31 March 1991 to 20.9% over the six months period to 30 September 1991. This was an impressive performance given that industry returns on equity investments over the 30 year period to 30 September 1991 averaged 22%.

Transnet increased contribution rates from 9.9% of pensionable emoluments to 12%. This was above the actuarially assumed inflation linked increase in pensionable emoluments of 11% per annum, an indication of a commitment on the part of the company management and the Board of Trustees of the Pension Fund to reduce this deficit.

4.2 Analysis of Annual Reports for financial years ended 31 March 1992, 31 March 1993, 31 March 1994, 31 March 1995, 31 March 1996, 31 March 1997, 31 March 1998, 31 March 1999 and 31 March 2000.

During the seven financial years to 31 March 1998 the Pension Fund continued to reflect shortfalls that were partly reduced by the issuance of the T 011 Debentures to the Pension Fund. These debentures were specifically designed to resolve the shortfall. Innovative investments strategies, increases in company contributions to the Pension Fund, reduction of benefits to retired members and their spouses, as well as the company's rationalisation programme also contributed to the reduction of the shortfall. 1998/9 and 1999/2000 financial years recorded actuarial surplus of R 88million and R 2.4billion respectively, for the first time in the history of this Fund.

In this section the annual reports of both the Pension Fund and the company are critically analysed with reference to the following:

- Actuarial deficit trends;
- Investments and funding strategies adopted by both the Board of Trustees and the Board of Directors of the company;
- Impact of T 011 Debentures on Transnet restructuring initiatives; and
- Overall financial statements presentation covering both the Pension Fund and the company.

In analysing the above factors comparisons are made to theoretical, statutory and regulatory framework, as well as the acceptable practices and literature. Financial information is evaluated for accuracy, reasonableness, consistency, validity and compliance with GAAP, the Companies Act, the PFMA, Transnet Pension Funds Act 1990, and the Pension Funds Act 1956.

The actuarial deficit trends

The remaining balance of R 5.9billion of the Pension Fund social deficit provided for in the company's books at 31 March 1991 was converted into T 011 Debentures. At 31 March 1992 the balance of these debentures amounted to R 9.1billion, after adjusting for decrease in provision of R 1.6billion.

The statutory deficit increased by 53% from R 6.8billion as at 31 March 1991 to R 10.5billion as at 31 March 1992. This increase was due to the following:

- A 13% discount rate with which the shortage would grow until it is redeemed;
- Contributions which were perceived to be too low;
- More deaths than anticipated;
- Less than expected Pension Fund investments performance; and
- Pensioners increased from approximately 90 000 to more than 92 000 within one year.

This deficit, however, showed a decreasing trend over the six-year period to 31 March 1998. As at the end of these financial periods, the actuarial deficits were stated in the books of the company as follows:

Figure 1

Actuarial deficits of the Transnet Pension Fund (statutory deficit)

31 March	*R'billion*	*% decrease*
1992	10.5	53
1993	6.4	39
1994	4.6	28
1995	4.2	9
1996	3.2	24
1997	3.2	-
1998	3.0	6
1999	(0.9)	130
2000	(2.4)	167

The rate of decrease of these deficits was significant during 1991/2, 1992/3, 1993/4 and 1995/6 financial years. The main reasons for these improvements, per the Pension Fund Chairmen, during these years, were higher returns flowing from improved investment strategies, especially with a bias towards equity portfolio and increased in the market assets values of the fund. On the other hand, the decrease in the rate of reduction of these deficits during 1994/5, 1996/7 and 1997/8 financial years is mainly attributable to the general poor performance of the bond markets during these years, coupled with the collapse of the economy in the emerging markets, which resulted in high interest rates and the weakening of the South African Rand against hard currencies. 1998/9 and 1999/2000 financial years experienced actuarial surpluses for the first time in the history of the Pension Fund. This improvement is attributable to improved investments strategies, which resulted in good returns, increased market value of investments portfolio, reduction of liabilities without changing benefits as a result of reduction in pension increases.

The shortfalls relating to the Pension Fund statutory deficits experienced during the seven financial years to 31 March 1998 had not been provided for in the books of the company on the basis that the actuarial shortfall as determined on the 1 April 1990, plus interest of at least 12 percent per annum, was guaranteed by the Government of the Republic of South Africa. The guarantee obligation of the Government shall reduce as the company funds the shortfall and shall lapse when it is fully funded. In terms of the old AC 116, which was applicable during that period, it was not mandatory to make provision in the employer company books for retirement benefit fund shortfall. Paragraph .48 of that statement, as it was then applicable, only required an employer company to disclose the fact that the fund is financially unsound and to disclosed strategies as to how the shortfall would be funded. This information was adequately disclosed in terms of the statement. This statement was superseded by the new AC 116, which became effective during the financial periods commencing on or after 1 January 2001. This statement made it mandatory to make provision for post-retirement obligation, including post-retirement medical aid benefit for both retired and active employees.

However, not withstanding the fact that provision for the shortfall was not mandatory in the employer company's books in terms of the old AC 116, it would be prudent to make provisions for these Pension Funds shortfalls as, even though they were guaranteed by the Government, the company had an obligation to fund them either by increased contributions or the appropriation of profits, both requiring the payment of cash or assets with monetary values. In terms of paragraph 37 of AC 000, prudence is defined as the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities and expenses are not understated. Therefore, based on this statement, the exclusion of these shortfalls in the balance sheets and the income statements of the company amounted to an understatement of both liabilities and expenses.

However, the fact that these shortfalls were not provided for did not compromised fair presentation of the company financial information as this provision was not mandatory in terms of the old AC 116.

The actuarial surpluses experienced during 1998/9 and 1999/2000 financial years was not capitalised in the books of the company as no decision had been made by the Government and the company as to whom the surplus belong. In the absence of anything to the contrary, surplus could only be capitalised in the balance sheet of the company as at the end of these financial years if the company was not prohibited from so doing in terms of the Pension Fund Act and provided this surplus meets the recognition criteria of an element of the financial statement in terms of AC 000. In terms of the Pension Fund Amendment Act (which was gazetted subsequent the financial years concerned) the employer company could include this surplus in its income statement and capitalise it as an asset in its balance sheet under certain circumstances. In its 2002 Annual Report, Edgars Consolidated Stores Limited (Edcon) capitalised a portion of its pension fund surplus in its balance sheet.

Proposals were submitted to the authorities to offer pensioners an enhanced pension in exchange for them assuming all their medical aid liabilities. Similarly, a portion of the surplus will be utilised to pay lump sums to medical aid member's provident fund accounts to meet the company's existing post-retirement medical aid liability for services rendered to date. The surplus is adequate to cover enhanced pensions plus all post-retirement medical aid liabilities and the balance of the surplus of approximately R 240million will be available to meet claims of former members in terms of the Pension Funds Second Amendment Act. The Financial Services Board has confirmed that the allocation of the actuarial surplus to fund post-retirement medical aid obligations is not an improper use of the actuarial surplus. It is expected that the surplus will be distributed from the pension fund in the next twelve months (Edcon 2002 Annual Report, p70, 2002). Note 5 (Retirement fund) to the financial statements for the year ended 31 March 2002 was as follows:

The funded status of the Edcon Pension Fund determined in terms of AC 116 and IAS 19 is as follows:

	2000 R' 000
Benefit obligations	283 358
Fair value of assets	684 232
	------------
	400 874
To be utilised to fund the post-retirement medical aid obligation (note 17)	80 900

Unrecognised asset	319 974
	=======

Investments and funding strategies adopted by both the Board of Trustees of the Pension Fund and the Board of Directors of the company.

To address the shortfall, the following investments and funding strategies were adopted:

- ***Issuance of T 011 Debentures***

  These debentures were issued to the Pension Fund to partly address the Pension Fund deficit and were issued in two trenches. Amounts of R 4.9billion and R 5.1billion were issued to the Pension Fund during 1990/91 and 1991/92 financial years respectively. These debentures were not tradable/marketable and therefore illiquid.

  Non-tradability of these debentures created another challenge to the Pension Fund and the company. As these debentures did not have outside market, they could only be re-acquired by the company should there be immediate cash requirements by the Pension Fund. This could further strain the company's already fragile cash position. Refer Figure 2 below: *The Effects of T 011 Debentures on Cash Flow.* A number of factors could lead to the need for liquid funds at the Pension Fund. Some of these are:

  - *Group restructuring initiatives.*

    Restructuring leads to retrenchments and voluntary employment terminations. These require cash resources to meet retirement benefits obligations.

  - *The existing and potential retirees.*

    As stated above, from 1 April 1991 to 31 March 1992 the number of pensioners increased from 90 000 to 92 000, an average increase of 2%. Cash is needed to meet benefit obligations of these pensioners.

These challenge called for a changed mindset on the part of both the Board of Directors of the company and the Board of Trustees of the Pension Fund regarding new fund assets investments strategies, and new and innovative funding strategies to reduce the shortfall. As mentioned by the Chairman of the Pension Fund in the Annual Report for the year ended 31 March 1991, R 4million cash payout is made to the pensioners every working day. This translates to about cash requirement in excess of R 1billion per annum.

The effect of these debentures on the group funding levels is demonstrated in Figure 2 below:

Figure 2

Effects of T 011 Debentures on group funding

	1992 R'bn	*1993 R'bn*	*1994 R'bn*	*1995 R'bn*	*1996 R'bn*	*1997 R'bn*	*1998 R'bn*	*1999 R'bn*	*2000 R'bn*
Interest bearing debt (excl. T 011 Debntures)	9.7	15.2	14.6	14.1	12.6	16.7	16.3	20.2	18.9
T 011 Debentures	9.1	8.8	8.8	8.6	8.5	8.5	8.5	8.5	8.5
Total interest bearing debt (incl. T 011 Debentures)	18.8	24.0	23.4	22.7	21.1	25.2	24.8	28.7	27.4
Total equity	13.9	12.1	11.9	12.0	11.8	11.6	11.9	12.9	15.5
Total interest bearing debt and equity	32.7	36.1	35.3	34.7	32.9	36.8	36.7	41.6	42.9
T 011 Debentures as a percentage of total interest bearing debt	48%	37%	38%	38%	40%	34%	34%	30%	31%

Total interest bearing debt as a percentage of total interest bearing debt and equity (gearing)	57%	66%	66%	65%	64%	68%	68%	69%	64%

Interest bearing debt (excluding T 011 Debentures) consists of unsecured stocks and bonds, and secured obligations, both local and foreign. Secured obligations are secured by finance lease aircraft, rolling stock, pipeline network and port facilities. Total equity consists of issued capital and reserves (both accumulated losses and non-distributable). Non-distributable reserves consist of revaluation reserves arising from the revaluation of pipeline networks and port facilities. The group never achieved accumulated surpluses since inception, even though in some years it achieve marginal annual profits.

During the period under review, T 011 Debentures as a percentage of the total interest bearing debt averaged about 38%. This means that a significant portion of the company's borrowing capacity has been reduced by these debentures. This has a major impact on the planned capital expenditure programme to improve income generation capacity of the group and to enhance the value of its assets for restructuring purposes.

Gearing ratio (total interest bearing debt as a percentage of the interest bearing debt plus equity) averages 65% (i.e. 65:35). This ratio is not a true reflection of the group gearing due to the fact that the company's assets were overstated, particularly rail assets and underground cables, whose exact values could not be determined. The majority of these assets, especially property and rail infrastructure that had substantial carrying values in the balance sheet could not be located. Off balance sheet obligations, including operating lease obligation of aircraft are not taken into account in the determination of the total group exposure. However, this ratio is still unacceptably high compared to the industry levels of 60%. Again this ratio is considered too high considering the R 40billion capital rollout management of the company have committed to over a ten-year period. With a high proportion of cash generated from operating activities being utilised (about R 1.3billion) to service T 011 Debentures and other post retirement benefit obligations of SATS pensioners (such medical aid benefits), this planned capital rollout would only be funded using borrowed funds. These unacceptably high debt burdens also adversely affected the company's international credit rating.

Another challenge of this debt burden is how it would be allocated when cash generating business units are sold as part of restructuring initiatives.

T 011 Debentures carry a coupon rate of 16.5% per annum. This meant that these debts cost the company approximately R 1.4billion per annum, in finance charges and additional contributions. This accounted for approximately 8% of the average turnover over the nine financial years under review. The company sustained the highest loss of R 1.7billion during 1992/3 and achieved the highest profit of R 779million during 1999/2000. This profit was mainly due to the sale of SAA (Pty) Ltd aircraft under a sale and lease back arrangements. As at the 31 March 2000 the balance of accumulated losses in the balance sheet amounted to R 2.6billion.

The effect of the company performance during this period is illustrated in Figure 3 below:

Figure 3

Effects of retirement benefit costs on the performance of the group

	1992 R'm	**1993 R'm**	**1994 R'm**	**1995 R'm**	**1996 R'm**	**1997 R'm**	**1998 R'm**	**1999 R'm**	**2000 R'm**
Net profit after tax before ret. benefit costs	889	278	1,775	2,033	1,735	1,905	2,140	1,339	2,599
Additional ret. benefit costs	(979)	(1,458)	(1,458)	(1,494)	(1,563)	(1,397)	(1,397)	(1,397)	(1,401)

Additional co. contr.	-	-	-	(67)	(159)	-	-	-	-
Interest paid on T 011 Debentures	(979)	(1,458)	(1,458)	(1,427)	(1,404)	(1,397)	(1,397)	(1,397)	(1,401)
Net profit after tax after additional ret. costs	(90)	(1,180)	317	539	172	508	743	(58)	1,198
Other medical aid related post ret. benefit costs	-	(569)	(596)	(421)	(425)	(678)	(465)	(418)	(419)
Acc. profit /(loss) for year	(90)	(1,749)	(279)	118	(253)	(170)	278	(476)	779

The above performance adversely affect the company gearing and technical insolvency due to additional retirement benefit costs. This also implies that to meet capital expansion programme, the company has to borrow more money, thereby worsening the gearing situation. Profits achieved during 1999/2000 financial year are not sustainable profits. They have been derived mainly from the sale of SAA (Pty) Ltd aircraft and buildings as part of assets rationalisation programme.

The Board of Directors of the company were concerned about the impact this debt had on the group's performance.

The Pension Fund deficit is still the main inhibiting factor on the group's financial results and this will remain the case for the *foreseeable future* (Dr M. de Waal: Chairman of Transnet Limited, 1994 Annual Report).

The interest paid on debentures issued to the Pension Fund and additional contributions towards the Pension Fund and Medical Aid Fund continue to impact negatively on the Group results (Prof L. Tager: Chairman of Transnet Limited, 1996 Annual Report).

The effects of T 011 Debentures on the group cash flows are illustrated in Figure 4 below:

Figure 4

Effects of ret. benefits costs on the group cash flows	*1992 R'bn*	*1993 R'bn*	*1994 R'bn*	*1995 R'bn*	*1996 R'bn*	*1997 R'bn*	*1998 R'bn*	*1999 R'bn*	*2000 R'bn*
Net cash flows from operations before retirement benefits of Transnet employees	2.3	3.1	2.4	5.2	4.5	4.2	4.3	5.0	3.8
Additional retirement benefit costs	(1.0)	(1.6)	(1.6)	(1.5)	(1.6)	(1.6)	(1.4)	(1.4)	(1.4)
Additional co. contr.	-	(0.2)	(0.2)	(0.1)	(0.2)	(0.2)	-	-	-
Interest paid on T 011 Debntures	(1.0)	(1.5)	(1.5)	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)	(1.4)

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Other retirement related costs including medical aid lump sum payments	(0.4)	(0.9)	(0.3)	(0.4)	(0.4)	(0.5)	(0.4)	(0.4)	(0.4)
Net cash available for invest activities	1.0	0.6	0.5	3.4	2.5	2.1	2.5	3.2	2.0
Cash flows from investing activities	(1.3)	(0.9)	(0.3)	(1.0)	(2.1)	(1.6)	(3.0)	(5.1)	0.4
Cash flows from financing activities	1.9	2.2	(1.4)	(1.9)	0.2	(1.2)	0.2	3.8	(3.4)
Net increase/ (decrease) in cash	1.6	1.9	(1.3)	0.5	0.5	(0.7)	(0.3)	1.8	(1.0)

It is demonstrated from Figure 4 above that approximately 81%, 81%, 36%, 44%, 50%, 42%, 36% and 47% of net cash flows from operations before additional retirement funding costs were used to fund additional retirement benefits and other retirement related costs (including SATS pensioners medical costs) during the 1992/3, 1993/4, 1994/5, 1995/6, 1996/7, 1997/98, 1998/9 and 1999/2000 financial years respectively. This left insufficient or no cash to be utilised to finance capital expenditure and other investments. Capital projects are therefore mainly financed by borrowed funds. This further leads to higher finance costs, unacceptably high gearing levels, liquidity problems and solvency problems.

- ***Transnet Pension Fund investment strategies***

During this period the Board of Trustees formulated the following investments objectives (which are outlined in the Annual Reports):

- To earn at least 4% real return per annum measured over rolling six-year periods;
- Maintenance of a relatively low risk profile;

- Protection of pensions against inflation by ensuring that in the long-run pensions are maintained at least at 70% of their original purchasing power;
- Combination of the optimal risk/return with suitable asset allocation policy to ensure long-term, consistent out performance of the benchmark.

Unlike the early 1990's, which was characterised by lack of strategic vision, the latter part of the decade was characterised by brilliant strategies. These included the formation of the Investment Policy Framework. An Investment Committee was formed to formulate a re-modelled investment policy framework. The objective of this framework was to clearly define and determine key fundamentals such as the investment objectives, mandates, benchmarks, risk parameters and asset/liability model. This policy was based on an overseas model and Transnet Pension Fund was one of the first entities in the country to give it a consideration. Another shift in focus was the introduction of offshore investment strategy. This offshore investment yielded a 43% return. In comparison, the international benchmark (MSCI) recorded a 36.8% return over the same period. However, even though offshore exposure is limited to 15% in terms of the Pension Funds Act 1956, the Board of Trustees decided to cap this exposure to 5%.

These are sound investment objectives in that they are supported by proven theories. Formulating an Investment Policy Framework is a very good starting point. This has been alluded to in Chapter 2 above. In paragraph 2.4 it is stated that to be able to achieve optimal asset allocation (and therefore a good risk/return combination), Frank K. Reilly and Keith C. Brown (1997) recommends that investors should implement a portfolio management process. In the implementation of this process, the first step is the construction of a policy statement, which should incorporate investment objectives and goals.

Formulation of objectives for investment purposes is also supported in the pension funds journals. *An important aspect that trustees need to be acutely aware of is the risk versus return. While there are different types of risks associated with the pension fund investments, investment risk can be described as the possibility that a desired level of investment return will not materialise. There is a direct relationship between the amount of risk associated with an investment and the expected investment return. It is a well-known fact that the higher the level of risk associated with a particular investment, the higher the expected investment return will be. Trustees seeking higher returns will usually invest in portfolio's* *that have greater exposure to equities. On the other hand trustees who seek lower returns and lower risk will invest in portfolio's that have greater exposure to fixed income securities, real estate securities, gilts, and government bonds.* (Pension World – South Africa, March 1998).

Asset allocation strategies of a retirement benefit fund depend on the age of members, the industry in which the employer company operates, risk levels of members – this will mainly be a function of age and levels of literacy etc. Proper assets allocation should generate higher returns at acceptable risks levels. *Under defined benefit plan, the company carries the risk of paying future pension benefits to retirees; should the investment performance be poor, or should the company not be able to make adequate contributions to the plan, the shortfall will have to be made up in future years. Poor investment performance means the actual return on the plan assets fell below the assumed actuarial rate of return.* (Frank K. Reilly and Keith C. Brown, p 52, 1997).

The following is the asset allocation structure of Transnet Pension Fund over a nine-year period to 31 March 2000:

Figure 5

Asset allocation

	Mar 1992 %	**Mar 1993 %**	**Mar 1994 %**	**Mar 1995 %**	**Mar 1996 %**	**Mar 1997 %**	**Mar 1998 %**	**Mar 1999 %**	**Mar 2000 %**
Equity	24	35	39	38	54	58	59	52	56
Property	2	3	5	7	6	7	7	9	9
Gilts/cash	74	62	56	55	40	35	34	39	35
	100	100	100	100	100	100	100	100	100

There is no mention of these allocations being benchmarked against portfolios of similar nature. Figure 5 shows that asset allocation was biased towards equity. The reasons being that they are perceived to be high growth investments. This is one of the investment strategies the Board of Trustees alluded to in the early 1990's. *The ultimate objective over the longer term is still to*

increase the Fund's exposure to investments in growth assets such as shares and property to 55% and 10% respectively of the total investment portfolio since the above investments avenues have beaten inflation comfortably over the longer term (Dr A. Moolman: Chairman of the Transnet Pension Fund, 1991/92 Annual Report, 1992).
However, S&P 500 has shown that stocks are riskier than bonds or Treasury Bills. It also indicated that stocks have earned returns lower than Treasury Bills for extended periods of time.

Although equities did not perform well during the early nineties, it started picking up in the mid nineties, recording 26% returns on the total assets and 39.6% return on the equity portfolio alone, a commendable achievement compared to industry performance. The reason for this upward swing is attributable to exceptional achievement in the Stock Market. During the late nineties the Fund continued to perform well with return on total assets of 17.3% and return on equity portfolio of 18.4% compared to the All Share Index and All Bond Index, which recorded a low of 9.5% and 16.7% respectively during 1997/98 financial year.

Figure 5 also shows a steady shift away from gilts and cash, reducing allocation on these portfolio from 74% in 1991/2 to 35% during 1999/2000 financial year. This category consists mainly of Government stocks and bonds, as well as T 011 Debentures and short term liquid assets such as bank acceptances, fixed and term deposits, call accounts etc. This category is a low risk low return asset type, with the exception of T 011 Debentures, which are low risk high to moderate returns at 16.5% coupon rate. Higher gilts and liquid funds and lower equity portfolio's is a conservative investment policy. *The world economies are also in a serious descending phase but prospects for gradual improvement in the growth of some of the most important foreign economies create medium-term possibilities for South Africa, particularly with regard to exports. Therefore the Pension Fund is still following a very conservative investment policy at this stage, and will continue in order to limit risk as possible* (Dr A. Moolman: Chairman of the Transnet Pension Fund, 1991/92 Annual Report, 1992).

Figure 5 also shows a steady growth in the property portfolio, from a low 2% during 1991/2 financial year to high 9% in 1999/2000. The target allocation as determined by the Board of Trustees is 8% of the total portfolio. There are two main causes of the excess. Firstly property market values increased over the book values over the years. Secondly, during the latter part of the century, equity portfolio's performed poorly due to the Asian crisis, which resulted in a severe decline among world markets. The Asian contagion and the debt default in Russia affected the emerging markets, including South Africa. JSE plummeted by almost 50% and interest rates and local currency weakened substantially. The total return (net income and capital appreciation) earned by the Fund on its property portfolio averaged 14.4%, compared to a benchmark of an average return of 12% as measured by the SAPIX property index.

Future property strategies included the restructuring of the Fund's interest in the V&A Waterfront. This entails selling the V&A Waterfront to V&A Waterfront Property Holdings (Pty) Ltd and acquiring a 74% stake in this company, the remaining stake being held by Transnet. Other strategies involved the selling off of unproductive properties back to Transnet at a combined value of R 71million.

This allocation is still suffering from the following deficiencies:

- A greater portion of the plan assets (mainly gilts) consists of non-tradable and illiquid T 011 Debentures.

- The restructuring direction of the employer company was not clear, making it difficult for the Trustees to make informed investments strategic decisions.

The performance of the funds assets has been commendable over the nine-year period under review and has contributed positively in the reduction of the deficit and converting it to surplus at the end of 1999/2000 financial years.

Impact of T 011 Debentures on Transnet restructuring initiatives

As stated in Chapter 1 above, the Pension Fund debt was the main concern in the Government restructuring initiative of Transnet. Various restructuring strategies were debated upon but the remaining problem was to come up with a lasting solution to deal with this Pension Fund burden. This concern equally affected the Government as the shareholder, the Board of Directors of the company and the Board of Trustees of the Fund.

The Government has in its budget strategies other priorities and cannot meet this (the Pension Fund deficit) obligation. However, it has accepted the inevitable consequences, namely that highly profitable divisions such as Portnet must remain within the Group, that tariffs cannot be lowered and that for many years dividend will be scant (Dr M. de Waal: Chairman of Transnet Limited, 1994 Annual Report).

In the context of the restructuring of state assets and the transformation process at Transnet it has become necessary for the company to re-examine its post-retirement remuneration philosophy and policies. Such re-examination will have an impact on both the Pension Fund and the Medical Aid Fund. The state is investigating, through the Department of Finance, ways and means of handling the pension fund burden of all State Owned Enterprises with particular reference to Transnet. Decisions that will be made after this investigation will have a great impact on Transnet and its business units (Mr S. Macozoma: Managing Director of Transnet Limited, 1996 Annual Report).

The most challenging issue about the Pension Fund debt burden was how this debt would be dealt with when significant cash generating business units such as Portnet, Spoornet and Petronet were privatised and sold. Another challenge was how Transtel (Transnet telecommunications business unit) would compete in acquiring the second license when Telkom exclusivity period expires in 2002 if it is allocated a share of the Pension Fund debt.

Some of these concerns were addressed when the Pension Fund was further restructured and split into three separate funds. This restructuring initiative and its consequences will be dealt with in detail in the next section of this report.

4.3 The impact of the split of Transnet Pension Fund into three separate funds and the consequences of these restructuring initiatives on both the New Pension Funds and Transnet Limited

During 1997/98 financial year, the Board of Trustees of Transnet Pension Fund recognised the changing needs of Transnet and the Funds members and pensioners. During 1998/99 financial year an agreement was reached for the establishment of two additional retirement funds. It was clear that an optimisation process for the pensioner portion of the Pension Fund was needed. Given the fact that this portion of the Fund had out flows (benefits payments), it was agreed that the best way to ring fence this portion was to transfer it to a separate fund. This gave rise to the establishing of two additional Funds, which meant that the Fund was to be split into three separate funds as follows:

Transnet Second Defined Benefit Fund

This is the SATS pensioner portion of the then existing Transnet Pension Fund. The transfer of this portion of the Transnet Pension Fund to a separate fund was motivated by the fact that this portion would only have cash outflows (pension payments). This Fund was also closed to new members. This means that its survival is entirely depended on the performance of its planned assets.

This Fund was formed on 1 November 2000 in terms of an amendment to the Transnet Pension Fund Act, 62 of 1990. The Fund became entitled to its assets and liabilities, as Gazetted, on 15 December 2000, as authorised by the amended Act. Members have, however, been entitled to receive their benefits as if the assets and liabilities had vested on 1 November 2000. It was always the intention of the transferor and an employer that this Fund would commence from 1 November 2000. The first financial statements of this Fund cover the five months to 31 March 2001.

Transnet Retirement Fund

This fund is structured as a Defined Contribution Fund. The portion of the existing company employees in November 2000 (current employees) was transferred to this fund. The company committed R 700millions as a conversion incentive to encourage active members to convert to this fund. Only those members who converted would be allocated their share, with the remaining balance retained by the company.

This Fund was formed on 1 December 2000 by notice of the Government Gazette as authorised by the Pension Fund Amendment Act , 2000. The Fund became entitled to its assets on this day as authorised by amended Act. Members have, however, been entitled to receive their benefits as if the assets had vested on 1 November 2000. The first set of financial statements therefore cover five months period to 31 March 2001.

Transnet Pension Fund

This fund is the existing Transnet Pension Fund. This Fund is also closed to new members with effect from 1 November 2000. Members are current employees of the company as of November 2000 who elected not to convert to Transnet Retirement Fund. It continued to be a defined benefit fund. This is a contributory fund. Transnet Pension Fund established in 1990 to the date of the split in November 2000 will be referred to as the Old Transnet Pension Fund in order to distinguish it from this Fund for identification purposes, even though it is one and the same fund.

According to the 1999/2000 Annual Report the Old Transnet Pension Fund had 190 631 members consisting of 88 984 active members and 101 647 pensioners. The restructuring of this Fund and the splitting of the Fund into three different Funds posed significant challenges to company

Board of Directors and management, and the Board of Trustees of the Funds and its management. Equally affected by these challenges are Transnet Internal Auditors, the Independent Auditors of these Funds, the Government of the Republic of South Africa as sole shareholder of the company and a guarantor of the deficits of the Defined Benefit Funds, as well as the Actuaries of these Funds. These challenges involved administrative requirements, staffing problems, systems of accounting and internal controls, legislative and regulatory matters, communication, and time and financial resources. These challenges are analysed in detail below:

- ***Lack of skilled personnel***

  This was an area of great concern. Before the split was effected, the Board of Trustees omitted to form a task team to do resource audits. From 1 April 2000 to 31 March 2002 numerous problems were identified which are indicative of the serious lack of skilled finance and accounting personnel as well as personnel who have specialised retirement fund industry knowledge. The following examples were specifically identified to substantiate this fact.

  Incorrect accounting for events and transactions

  As stated above the Transnet Second Defined Benefit Fund was established on the 1 November 2000. Approximately 102 000 pensioners were transferred from the Old Transnet Pension Fund into this Fund. However, due to lack of communication and skilled personnel, the preparation of the accounting records for the financial year ended 31 March 2001 failed to account for this transfer properly. They were prepared as if the effective date of transfer was 1 April 2000. This caused significant delays in the finalisation of the audited financial statements and more resources, including external consultants, were hired to reverse all incorrect accounting entries and effect corrective actions.

  On the 1 June 2000, the Property Trust was formed. The purpose of this Trust was to transfer all property portfolio from the Old Transnet Pension Fund to this Trust, with the three Funds after the split being beneficiaries. However, these property portfolio's were never transferred to the Property Trust but were reflected in the three funds' accounting records at 31 March 2001. Again management, with the help of the outside consultants to effect corrective actions, made significant effort to correctly allocate property portfolio to this trust.

Assets contra accounts

The Funds had asset contra accounts that were not analysed and reconciled, resulting in the net debit of R 24million at 31 March 2001 across the Funds. This balance comprise the gross debits and gross credit entries as illustrated in Figure 6 blow:

Figure 6

Assets contra accounts

	Debits Rand million	*Credit Rand million*	*Net Amount Rand million*
Transnet Second Defined Benefit Fund	3,373	(3,355)	18
Transnet Pension Fund	64,181	(64,218)	(36)
Transnet Defined Contribution Fund	71,039	(70,997)	42
	138,593	(138,570)	24

These gross debits and gross credits could not be analysed by the Administrator as at 31 March 2001, the Funds year-end. Net debits of R 18million and R 42million were fully provided for in the books of Transnet Second Defined Benefit Fund and Transnet Defined Contribution Fund respectively. No entry was raised regarding the net credit of R 36million in the books of Transnet Pension Fund. This is prudent accounting treatment and is in compliance with AC 000.

The fact that these amounts could not be identified meant that all the figures included in the balance sheet of the Funds at the cut-off date and figures included in the income statements of these Funds during the accounting period concerned are suspects. Because of materiality of these figures, fair presentation of the financial information in the financial statements of the Pension Funds was compromised.

The company's financial statements, which was required in terms of AC 116 to provide for the deficit of R 3.6billion of Transnet Second Defined Benefit, are also not fairly presented as these unexplained material debits and credits in the Funds accounting records are also determinants of this figure. This is contrary to the requirements of AC 000, AC 101, section 286(1) of the Companies Act as well as section 40(3) of the Public Finance Management Act which all require that financial statements of the company should be fairly presented.

Lack of high level controls

There was serious lack of controls in the areas of major accounts reconciliations. Reconciliations were either not done at all or significant reconciling items not identified. Examples are as follows:

- Significant reconciling items between HiPortfolio, the custodians and the asset managers were not identified and resolved.

- Reconciling items in inter-fund accounts reconciliations were not be identified and resolved. Unidentified net balance amounted to R 26million.

- The reconciliations between the Property Trust Account and the Pension Funds were not done, resulting in major unexplained net difference of R 11million.

- Some of the bank reconciliations were either not done or contained significant unidentified reconciling items. For example, bank reconciliations as at 31 March 2001 showed an outstanding uncleared net reconciling item of R 9.6million.

When two or more accounting records fail to reconcile, the big question is which numbers are correct. Lack of high level controls such as these compromise fair presentation in both the company and the Pension Funds.

Split of pooled investments

The pooled investment assets shared by all three funds were physically split into three funds during the period 1 November 2000 and 31 January 2001. Due to the fact that this is a large exercise and that the investment system does not have the correct investment cost values recorded for the two new funds as at 1

November 2000, the funds administrator was required to perform numerous monthly manual adjustments to profit/loss on sale transactions. This splitting process was outsourced to outside consultants. The consequence of this outsourcing was that the administrator could not explain major differences. Critical information link was therefore compromised.

Non-compliance with the statement of GAAP

Property in V&A Properties (Pty) Ltd are currently valued at cost and not in terms of AC 135: Investment Properties. In terms of this statement, investment properties should be valued at fair values or at cost if the company elects to use the cost model. If the cost model is adopted, the fair values of such property should be disclosed by way of a note to the financial statements. Lack of compliance with this statement of GAAP results in fair presentation being compromised.

The above events are some of problem areas that indicated that there was no project management plan, supervision and monitoring by senior management to ensure that the accounting records were prepared in terms of the intentions and events that transpired in the Pension Funds during restructuring. They were also indicative of serious lack of financial disciplines, lack of skilled personnel, understaffing, lack of policies and procedures, lack of proper supervisory function and/or inadequate accounting systems required to handle the sophistication and complexities of the transactions involved.

- ***Corporate Governance issues***

This area was adequately managed. Critical corporate governance structures were put in place for all three funds after the split. These include the following:

Composition of the Board of Trustees and its objects:

The Boards of Trustees of the Transnet Defined Contribution Fund and Transnet Defined Benefit Fund were properly composed in accordance with the Pension Funds Act, 1956 and Transnet Pension Funds Act 1990. The Board of Trustees of the Transnet Second Defined Benefit Fund was properly constituted in terms of the Amended Transnet Pension Fund Act, 2000.

Amendment to the Rules of the Funds

All amendments to the Rules of the Transnet Defined Contribution Fund and Transnet Pension Fund were registered with the Financial Services Board (FSB) in terms of these Acts. All amendments to the Rules of the Transnet Second Defined Benefit Fund were registered with the Minister of Finance (now Minister of National Treasury) in terms of this Act.

Board meetings

The Board of Trustees meetings of all three Funds are held at least quarterly. Special meetings are held as and when required.

Board competency

Membership of the Boards of Trustees of the three Funds includes CA's (SA), advocates, directors of companies, Chartered Financial Analysts, and retired actuaries. The Chairman of the Board is usually the Group Finance Director of Transnet Limited. The Audit Committees, which are sub committees of the main Board are all chaired by Dr L Konar PhD CA (SA) who is a director of many financial institutions including a number of the JSE Securities listed entities. He is a former Professor of Accounting. The Principal Officer of the Funds is Mr Ian Smith CA (SA).

Minutes of the Board of Trustees meetings

Minutes of all Board meetings are recorded and kept in hard copy formats, electronically and in the Transnet Limited and in all Pension Funds web sites. Access is restricted.

Disclosure

All critical decisions taken at Board meetings that directly affect members are communicated to the members, either via Pension Fund bulletins/journals or meetings are held with member representatives. Communication is effective in that there is a 24-hour hot line set up to resolve any queries. The availability of these facilities are adequately communicated to members.

Investment objectives and strategies

At the beginning of 1998/9 financial year, an Investment Committee started with the formulation of a remodelled investment policy framework. The intention of formulating this document was to clearly define and determine key fundamentals such as investment objectives, mandates, benchmarks, risk parameters and asset/liability models. The implementation of this document would be optimised during the next financial years. However, this implementation was delayed by long and daunting restructuring tasks that was initiated immediately thereafter.

The trustees started a process to compile an Investment Policy Framework document to guide its investment process into the future. At a meeting held in June 2001, the trustees approved many of the aspects of this document, including the new specialised equity and bond mandates. These mandates were implemented during October 2001 to January 2002. A key factor that still remains to be worked on is the continuation of the immunisation strategy. Lots of work in this regard has already been done and the trustees will be addressing this later this year (Ian Smith: Principal Officer of the three Transnet Pension Fund, Audit Committee Executive Summary, p 1of2, 2002).

Risk management

During 2000/1 financial year the formation of the Risk Management and Compliance Committee was approved at the Transnet Pension Fund and Transnet Second Defined Benefit Fund Audit Committees and recommended for approval at the Board of Trustees meeting. The Transnet Defined Contribution Fund's Risk Management and Compliance Committee was not approved as it contained a few issues that needed to be resolved. The Funds risk coverage analysis is as follows:

Figure 7

Risk Coverage Analysis

Risk category	***Areas covered***	***Risk level***
Delegated authority	Disposal of death benefits	N/A
Mandates	Asset managers Asset allocations Global exposure Management fees	H H H H
Service Level Agreements	Board of Trustees Transnet business units	N/A N/A

Report structure	Exceptional reports Contributions Payments	N/A N/A N/A
Credit risk	Cash limits	N/A
Guidelines	Prudent investment guidelines (Reg 28) PF circulars SARS circulars Adjudicator	E N/A N/A N/A
Rules	Fund rules	N/A
Act	Transnet Pension Fund Act 1990 Pension Funds Act 1956	N/A N/A
SARS	PAYE SITE Lump sum tax VAT Pension Fund Tax	N/A N/A N/A N/A N/A

Legend:	N/A	Not rated yet
	H	High risk
	E	Extremely high risk

One of the investment objectives of the Funds incorporates the maintenance of a relatively low risk profile.

Unfair discrimination

The Pension Funds comply with all labour laws, including the Amended Labour Relations Act, 1995. They are also in compliance with the Constitution of the Republic of South Africa.

However, the following Corporate Governance issues had not been addressed. The management of the Pension Funds are working towards resolving these few lack of compliance.

Administration services agreements

Even though Service Levels Agreements have been included in the Risk Coverage Analysis in Figure 7 above, its implementation is not complete. The Service Level Agreement between the three Pension Funds and the Administrator has not been done. At present, no contractual relationship exists between the Administrator and the three Funds.

This could lead to disputes being difficult to resolve. This could also result in difficulties should a legal dispute arise.

Transnet Treasury acting as an asset manager

Monies belonging to the three Funds as well as the Property Trust are given to the Transnet Treasury to manage on behalf of the Funds and Property Trust. The mandate entered into between the Administrator and Transnet Treasury requires that Transnet Treasury comply with both the Transnet Pension Funds Act, 1990 as well as the Pension Funds Act, 1956. The Transnet Pension Funds Act requires that all asset managers who manage Pension Funds monies be registered with the FSB. Transnet Treasury is not registered with the FSB.

This is a breach of the Rules of the Funds as well as the mandate between the Funds and the Transnet Treasury.

Government guarantee of the deficit

In terms of the Transnet Pension Funds Act, the company and the Government guarantee the deficit that may arise in the defined benefit funds. As part of the conditions for agreeing to the cancellation of the T 011 Debentures (refer "Cancellation of T 011 Debentures below) the trustees of the Transnet Second Defined Benefit Fund requested that both the company and the Government confirm, in writing, their guarantee of the deficit. This guarantee had not been obtained from the Government. The granting of this document by the Government is important to enable the trustees to demonstrate that the governance processes have been completed and that they have fulfilled their fiduciary duties.

- ***Taxation legislation***

The Transnet Second Defined Benefit Fund became entitled to its assets and liabilities, and therefore gross interest and net rental income, as Gazetted, on the 15 December 2000, as authorised by the amended Act. Members have, however, been entitled to receive their benefits as if the assets and liabilities had vested on 1 November 2000. This is in terms of the transfer arrangements entered into between the members and the trustees. The Administrator calculated tax on all three funds on the basis of each Fund being entitled to the gross interest and net rental income from the 1 November 2000, in line with asset entitlement arrangement explained above. The Commissioner at SARS is of the view that the Transnet Second Defined Benefit Fund only came into existence on the 15 December 2000, in accordance with the authority of the amended Act. All gross interest and net rental income earned by this Fund for the period 1 November 2000 to 15

December 2000 is to be taxed in the hands of Transnet Pension Fund and should not be treated as pensioner income, exempt from tax. The total amount of potential tax liability amounts to R 22million.

The Administrator has disputed the ruling of SARS and has taken legal action to defend its position. A contingent liability note has been disclosed in the financial statements of Transnet Pension Fund for 2000/1 financial period. The company, as the guarantor of the deficit of the defined benefit funds has also disclosed this fact as a contingent liability.

This treatment is in line with the requirements of AC 107 (revised).

- ***Part cancellation and part redemption of T 011 Debentures***

  The resolution of Transnet inherited pension fund debt problem represents one of the major achievements of the past year in which the Transnet Pension Fund was comprehensively restructured through an Act of Parliament. The Transnet Pension Fund was divided into three separate funds:

  - *A Defined Benefit Fund for employees;*
  - *The Second Defined Benefit Fund for existing pensioners; and*
  - *A Defined Contribution Fund for current employees.*

  This restructuring contributed to consolidate the excellent progress made in recent years to deal with the R 17billion pension fund deficit inherited by Transnet at the time of its incorporation in 1990. Most significant was the freeing of the funds from high-interest bearing debentures known as T 011's, originally issued in 1992 to deal with the statutory deficit and bolster the Fund's cash flow. The financial position of the three new funds, supported by the continued guarantee of both Transnet and Government, allowed the Trustees of the three funds to agree to part cancellation and part redemption of these debentures. The Second Defined Benefit Fund for existing pensioners, however, had a net actuarial deficit of R 3.6billion at the end of the period under review. This was due to poor market performance, decreases in interest and discount rates, changes in mortality assumptions, and the cancellation of the T 011 Debentures. In keeping with the South African Accounting Standards, this deficit has been fully provided for in the Transnet results for the year under review. Details of these transactions may be found in the Report of the Directors (Prof L. Tager: Chairman of Transnet Limited, Transnet Limited Annual Report, 2001)

The above statement made by Prof. Louise Tager, the Chairman of the Transnet Limited Board of Directors sums the whole part cancellation and part redemption of the T 011 Debentures. Such transactions marked the end of this debt, which has been the main stumbling block in the company restructuring progress that adversely affected the company cash flow gearing levels, performance and technical solvency.

As part of the restructuring initiatives of the Pension Funds, the trustees of the Transnet Second Defined Benefit Fund agreed to the outright cancellation of their portion of the T 011's. At that date the T 011 Debentures were structured as follows:

	Rand million
Transnet Second Defined Benefit Fund	4 316
Transnet Pension Fund	3 000
Other	1 155

Balance at 31 March 2000	8 471
	=====

Cancellation of R 4 316million portion of the Second Defined Benefit Fund resulted in a net gain of R 109million analysed as follows:

Figure 8

Net gain on T 011 Debenture cancellation

	Rand million
Benefit arising on cancellation of pension fund debentures	4 316
Recognition of past service cost	(276)
Cost of M-Cell Ltd shares transferred to The Transnet M-Cell Limited Trust	(299)
Provision for the deficit in the Transnet Second Defined Benefit Fund	(3 632)

Net gain on T 011 part cancellation	109
	=====

An amount of R 4 316million is the Transnet Second Defined Benefit Fund portion of the T 011 Debentures.

Recognition of past service cost of R 276 refers to payments made in recognition of the past service entitlement of those employees who were ineligible in terms of the then existing rules to join the Pension Fund prior to 1981.

As part of T 011 Debentures cancellation deal, the Board of Directors agreed to cede part of the company's investment in M-Cell Limited to the Second Defined Benefit Fund. To facilitate this cession 75million M-Cell Ltd shares held by the company were transferred to Transnet M-Cell Limited Trust at their market values. This trust was formed specifically for this cession. In terms of the Trust Deed, the Transnet Second Defined Benefit is a beneficiary of this trust only to the extent of the deficit. This means that if there is a surplus or there is no deficit in any particular year, this Pension Fund ceases to be a beneficiary. The company then becomes a beneficiary.

An amount of R 1 395million in respect of the market value of these shares was capitalised in the balance sheet of Transnet Second Defined Benefit Fund at 31 March 2001. Note 7 to the Financial Statements of the fund reads as follows: *The fund is the beneficiary of the capital within the trust to the extent of any actuarial deficit in the Fund prior to recognising the entitlement to the value of the shares held by the M-Cell Trust. The capital consist of 75million M-Cell shares valued on the 30 day volume weighted share price prior to 31 March each year.*

In terms of the shareholder's agreement between the company and M-Cell Limited, the company is the beneficial owner of these shares. This brings the question of legality of this transaction. The Trust entitlement to these shares therefore did not enjoy recognition of the shareholders' agreement as this agreement was not amended to accommodate this arrangement. Also bringing in the shares into the books of the Pension Fund at market value without recognising profit on sale in the books of the company is also an incorrect accounting treatment. Also, recognition in the balance sheet of the Fund of the value of these shares without legal title to them is not in compliance with the recognition requirements of AC 000 as the Fund does not have control over these assets.

The financial statements of the Transnet Second Defined Benefit Fund for the year ended 31 March 2001 did not therefore achieve fair presentation. Similarly, the financial statements of the company for the year ended 31 March 2001 did failed to achieve fair presentation.

The deficit of R 3 632million of the Transnet Second Defined Benefit Fund was fully provided for in the company's balance sheet at 31 March 2001. (Refer Figure 8 above)

The composition of this figure is as follows

Figure 9

Transnet Second Defined Benefit Fund Deficit

	Rand million
Present value of obligations	(20 140)
Fair value of plan assets	16 508

Liability recognised in the balance sheet of the company at 31 March 2001	(3 632)
	=======

Net benefit liability is made up as follows:

Mortality increase cost	734
Interest cost	1 441
Pension increase moratorium	87
Capital appreciation	(285)
Investment income	(802)
Fair value cancellation of T 011 Debentures	4 870
Market value of M-Cell Limited shares	(1 395)
Other fund expenses	(45)
Pension benefits paid	(973)

Net benefit liability	3 632
	=====

As shown above this deficit was fully provided for in the books of the company as at 31 March 2001. This is the correct accounting treatment in terms of AC 116 (revised).

Now the question is whether the cancellation of T 011 Debentures and the formation of Transnet Limited M-Cell Trust provided a lasting solution to pension fund deficit burden. If it did not, what actions need to be taken by the Board of Directors of the company and Board of Trustees to solve these problems. Alternative courses of action that can be followed to resolve this problem will be touched on in the section dealing with recommendations below.

The redemption of R 3 000million portion of the Transnet Pension Fund resulted in a net loss of R 622million analysed as follows:

Figure 10

Loss on the cancellation of Transnet Pension Fund portion of the T 011 Debentures

	Rand million
Nominal value of T 011 Debentures redeemed	3 000
Market value of T 011 Debentures redeemed	(3 389)
Premium paid on redemption	(389)
Additional incentive to encourage conversion to Transnet Defined Contribution Fund	(563)
Share of the company Pension Fund surplus	330
Loss on redemption	622

Premium paid on redemption resulted from the fact that the market value of debentures paid to the Transnet Pension Fund was in excess of the nominal value at which these debentures were recorded in the books of the company.

To encourage active members to convert to the Transnet Defined Contribution Fund, their benefits were increased by R 563million, being part of the total R 700million incentive the company committed to alluded to above.

The actuarial surplus attributable to continuing employees at the time of conversion was in terms of a negotiated agreement shared with the employees in the ratio of employees 60% and the company 40%. The company has accordingly received a payment of R 330million being its share of surplus. This benefit would be used at the Managing Director's discretion to alleviate hardship and has therefore been transferred to non-distributable reserves.

Transnet Pension Fund recorded an actuarial surplus of R 153million. This surplus had not been recognised in the financial statements of the company as it was not known whom it belonged to. The company could not raise it as an asset in the balance sheet as it did not meet all the asset recognition requirements in terms of AC 000.

4.4 Recommended Actions

In this section recommended actions to resolve problems highlighted in the case study are outlined.

4.4.1 Skills requirement

The successful implementation of strategic initiatives is dependent on the availability of competent personnel to drive them. Most importantly with these three funds the successful implementation of Investment Policy Framework and the Risk and Compliance strategy is dependent on the quality of personnel the administrator hires. This will entail the overhaul of the entire Human Resource strategy to ensure that:

- Suitably qualified personnel with a good track record in the retirement fund industry and the Financial Services sector is hired.

- Set up of proper remuneration structures bearing in mind that this skill comes at a higher price. Proper bonus schemes should be set up to ensure that individual performances are recognised and rewarded.

- Proper training and development strategies should be in place to ensure that employees are up to date with the new developments in the industry.

- Staff retention strategies should be put in place such as job advancement strategies, promotions, recognition of individual input, encouragement of participation from the lower levels etc.

4.4.2 Installation of proper accounting systems

The combined membership of the three funds is approximately 200 000 of which more than 50% are retired members. These funds have a combined total asset value of more than R 35billion. To effectively manage the day-to-day activities of these funds will require the implementation of one of the highly sophisticated computer facilities. Computer personnel should be among the top in the country and the world.

4.4.3 Investment Policy Framework

Progress towards the implementation of this framework should be speeded up. The successful performance of these funds is dependent on the successful implementation of this framework. This framework requires regular update to ensure that only the world best investment strategies are adopted.

Referring to the proposed Investment Policy Framework in the 1998/9 Transnet Pension Fund Annual Report, the Chairman, Mr Saki Macozoma said: "*The significance of this policy document is understated in our market, while our foreign counterparts have proven its necessity".*

4.4.4 Risk Management and Compliance Strategy

As stated above the formation of these strategic initiatives have been given a go ahead by the Audit Committee of both the Transnet Pension Fund and Transnet Second Defined Benefit Fund. What should be speeded up now is the progress towards its implementation.

It was also stated in the Audit Committee document for the Transnet Defined Contribution Fund that this proposal was rejected due to the fact that it is good for the defined benefit funds. This means that this strategy document requires fine-tuning to ensure compatibility with this fund.

4.4.5 Corporate governance issues

The above analysis highlighted several areas of non-compliance with the corporate governance. The areas of non-compliance highlighted above are not exhaustive, but are areas, which are perceived to be significant.

The administrator should make sure that Service Levels Agreements between them and the three Pension Funds are signed.

The administrator should obtain written guarantees from the government regarding the guarantee of the defined benefit fund's deficits. The granting of this document by the Government is important to enable the trustees to demonstrate that the governance processes have been completed and that they have fulfilled their fiduciary duties.

4.4.6 *Transnet Treasury acting as an asset manager*

Transnet Treasury should comply with both the Transnet Pension Fund Act, 1990 and the Pension Funds Act,1956 in terms of the mandate entered into between the Pension Funds and Transnet Treasury. In order for Transnet Treasury to enjoy the status of being the asset managers of the Pension Funds, it should register with the FSB, failing which this relationship should be terminated.

4.4.7 *Funding strategies*

Transnet Second Defined Benefit Fund

The strategy to be adopted to minimise the extent of the deficit is as follows:

- Because of its influence and potential privatisation, the company should set an example on the financial discipline and follow the best international practices for a private sector employer, and therefore funding should start immediately.

- Further it should be considered whether this deficit should be burden of the company or should be transferred to the Government outright. This should be deliberated with the shareholder.

- During the 2000/2001 financial year, the company sold 75million M-Cell Limited shares (unrelated to the transfer of 75million shares to the Transnet M-Cell Limited Trust mentioned above). This sale realised a profit of R 2.3billion. Of this profit a dividend of R 1.8billion was paid to the government after deducting R 0.2billion in STC. Again during January 2002, the company warehoused the entire M-Cell Limited shareholding in Ice, an international passive investment vehicle. This transaction earned the company R 5.7billion of which the entire amount less costs, but excluding costs of acquiring these shares, will be remitted to the government. Based on this it is recommended that the government does not enforce its right to these dividends, but should be used, instead, to address the pension fund burden.

  Transnet Pension Fund

  As this fund is 100% funded as at 31 March 2002 (according to 2000/1 Transnet Annual Report), the company should only contribute to this fund at a minimum rate recommended by the actuaries. Since this fund is closed to new members, the funding basis was changed from the accrual basis to an attained age basis. This basis is appropriate for closed funds.

CHAPTER 5

Summary and conclusion

When the company was incorporated in 1990, it inherited Transnet Pension Fund from the old SATS. On that date this fund had a deficit of more than R 17billion. That inheritance marked the beginning of financial troubles for the company as, together with the government guaranteed this deficit. The first step the Board of Directors of the company took in an attempt to rescue the situation was the creation of non-marketable, illiquid debentures called the T 011 Debentures. These debentures were issued to the Pension Fund at a coupon rate of 16.5%. This was a double benefit to the Pension fund. Firstly the inclusion of an investment in its balance sheet worth more than R 8billion improved the asset base of the fund. Secondly annuity income was guaranteed in the form of interest income, which was in excess of R 1.2billion per annum.

The Pension Funds assets performed poorly during the early part of the last decade due to poor investments strategies adopted by the trustees and poor economic performance caused mainly by violence and political unrest leading up to the first democratic elections in 1994.

The issue of T 011 Debentures to the Pension Fund had adverse effects to the company. This resulted in high gearing levels, poor cash flows, poor performance, narrowing of borrowing capacity, poor credit rating, a threat of insolvency and the overall group restructuring problems.

The late 1990's marked the turning point in the strategic thinking on the part of both the management of the company and the Pension Fund's trustees. A new investment strategy was implemented by the formulation of Investment Policy document. This thinking was in line with the international trends. Despite poor economic performance as a result of the collapse of the economy in the Asian markets, which affected the rest of the developing nations, assets of the Pension Fund outperformed the industry performance. This new thinking led to the splitting of the Pension Fund into three funds. They consisted of two benefit funds and one contribution fund. This also led to part cancellation and part redemption of the T 011 Debentures.

The restructuring of the Transnet Pension Fund from the early 1990's to the early 2000's was analysed in this case study in comparison to theoretical framework, regulatory and statutory framework, accepted practices and to other entities of similar nature. This analysis revealed the following:

* Most of the statutory and regulatory requirements were met with exception of a few non-compliance instances. Several corporate governance requirements were neglected. These include failure to formulate service level agreements between the funds and the administrator, non-availability of a written government guarantee which was one of the instruments used to induce the trustees of the Second Defined Benefit Fund to agree to the cancellation of their portion of the T 011 Debentures.

  Other non-compliance with the corporate governance requirements involved using Transnet Treasury as asset managers without registration with the FSB. There were also questionable legal and accounting issues surrounding the formation of Transnet Limited M-Cell Trust created for the benefit of the Second Defined Benefit Fund. Questionable issues include the way the Trust Deed was drafted, particularly when the beneficiaries of the Trust was decided. In terms of the Trust Deed, the pensioner fund was a beneficiary to the Trust ***only*** if the fund was in deficit, otherwise the beneficiary was the company. The market value of M-Cell Limited shares held in the Trust was capitalised in the books of the Fund. This is an incorrect accounting treatment as the entitlement to these shares was conditional. Control, as one of the recognition criteria in terms of AC 000 was not transferred to the fund. Worst still is that this capitalisation was effected before the financial statements of the Trust were approved by its trustees

  Other areas of non-compliance with the corporate governance included a slow progress in the implementation of the Investment and Risk Management Framework.

* During the early part of the 1990's there was no investment strategy. This was in contrast to many Financial Management literatures, which recommended that retirement benefit funds should implement investment strategy in order to boost their assets performances. More investments were biased towards equity and real estate securities. This was not completely acceptable as experience has proven that in the long run, treasury bills outperform equity. This was based on the FSE 500 research findings. On the other hand Frank K. Reilly and Keith C. Brown in their book, Investment Analysis and Portfolio Management, Fifth Edition, state that real estate securities are low return low risk investments. They are mainly for the conservative investors.

* Staffing and the lack of skilled work force was another problem facing this restructuring. Basic accounting controls were either neglected or incorrectly implemented. This specifically refers to lack of bookkeeping knowledge, lack of accounting conventions knowledge, and lack of supervision and project management.

After all the efforts made over the decade to resolve the pension fund deficit, the Transnet Second Defined Benefit Fund remain in deficit. In this case study, it is recommended that the following be resolved as a matter of urgency:

- A proper funding strategy is required. This could be in the form of
- increased contributions;
- Transfer of investments by the company (non-core assets) to the pension fund;
- Influence the government not to appropriate profits in the form of dividends; or
- Influence the government to take over the pension fund burden.

Even though the road to success was not easy, management of both the pension funds and the company implemented a lot of strategic thinking in resolving the Pension Fund burden.

CHAPTER 6

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CHAPTER 7

Definitions of concepts

- **Old Transnet Pension Fund**

  This refers to the old combined pension fund before the split into three funds.

- **New Funds**

  This refers to all three funds after the split into three funds,

- **GAAP**

  This refers to the Generally Accepted Accounting Practice of the South African Institute of Chartered Accountant.

- **PFMA**

  The Public Finance Management Act.

- **FSB**

  Financial Services Board.

- **SATS**

  South African Transport Services.

- **Company**

  Refers to Transnet Group (Transnet Limited, its divisions, business units, subsidiaries, associate companies and support services).

- **SARS**

  South African Revenue Services.