Barnett Waddingham
a **true partnership** approach

Financial Reporting - 31 March 2015

Current Issues in Pensions

The key financial assumptions required for determining pension liabilities under the Accounting Standards FRS17 (UK non-listed), IAS19 (EU listed) and FAS158 (US listed) are the discount rate and the rate of future inflation.

There are a number of considerations for company directors to take into account when setting these assumptions and for auditors in determining whether the assumptions are appropriate. This note sets out some of the technical issues relevant to those involved in the preparation and the audit of pension disclosures.

Market update

Equities are generally at higher levels to this time last year with non-UK equities having performed particularly well. UK Government bond holdings will have seen strong returns but accounting liabilities are likely to be significantly higher.

The overall effect of market movements will differ for schemes depending on their asset allocation. Ignoring deficit contributions and scheme experience, schemes are likely to observe a deterioration in the accounting position unless they have been invested largely in matching assets such as bonds or gilts.

Discount rate

The Accounting Standards require the discount rate to be based on yields on high quality (usually AA-rated) corporate bonds of appropriate currency, taking into account the term of the relevant pension scheme's liabilities. Corporate bond indices are often used as a proxy to determine the discount rate.

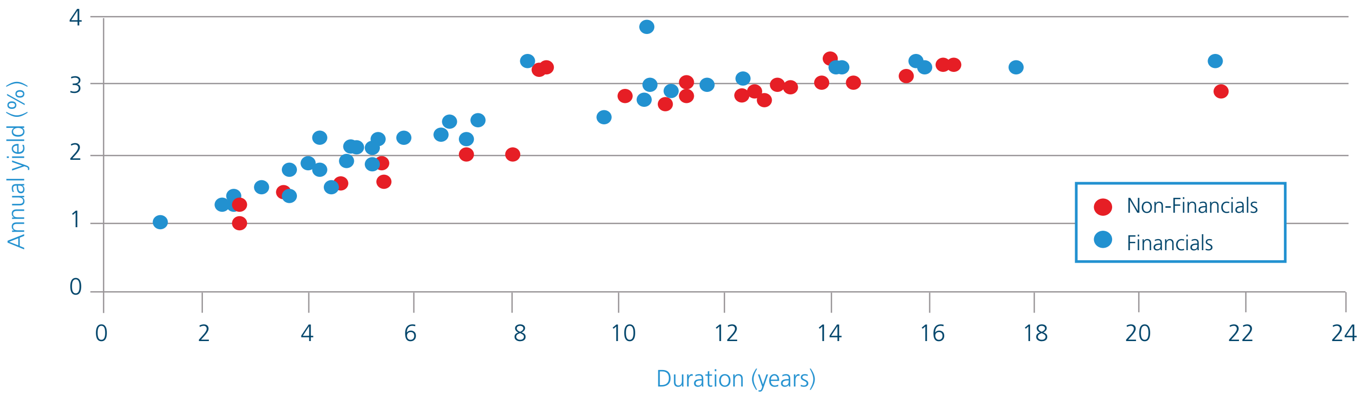
The table below shows some of the key market indices that could be taken into account when deriving the discount rate. The yield on Government bonds (gilts) is also shown for comparison:

Index (annualised yield)	31/03/2015	31/12/2014	31/03/2014
ML Sterling Non-Gilts AA Over 15 years	3.00%	3.29%	4.19%
ML Sterling Corporates AA Over 15 years	3.09%	3.39%	4.27%
iBoxx Sterling Corporates AA Over 15 years	3.10%	3.41%	4.29%
Over 15 Year Fixed Interest Gilts	2.24%	2.43%	3.46%

At the end of Q1 2015, the yields on bonds of all types were significantly lower than they were at 31 March 2014. This is likely to result in lower discount rates being adopted for accounting purposes compared to last year, although this may vary according to how companies have allowed for the duration of their scheme's liabilities when setting the discount rate. Whatever the method used, this is likely to translate into significantly higher liabilities.

Figure 1 overleaf shows the individual yields on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index as at 31 March 2015.

Figure 1: Individual yields as at 31 March 2015 on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index



Data Source: Markit Group

Other issues that should be noted when setting the discount rate include:

- The yields on individual AA bonds vary by duration, as shown on Figure 1. Taking into account the duration of a pension scheme's liabilities when setting the discount rate may result in a different discount rate than if a single index figure is used. Figure 1 illustrates that longer dated stocks generally had a higher yield.

  The duration of the iBoxx Sterling Corporates AA Over 15 years as at 31 March 2015 is approximately 15 years and this is generally shorter than the duration of most pension schemes' liabilities.

  As can be seen in Figure 1, the yields vary significantly in the short to mid durations, but flatten out at the longer durations.

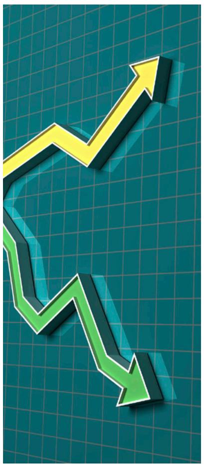
  In years where the yields vary significantly by term, the use of an index yield means the discount rate will not normally be appropriate for the duration of the scheme's liabilities. It is likely, therefore, to be appropriate to use a discount rate below the index yield if the duration of the scheme's liabilities is shorter than the index. For longer durations, yields are generally above the index and by extrapolating beyond the yield on the longest duration AA bonds it could be possible to justify discount rates of up to 3.5% p.a. for immature schemes. As ever, consistency with the approach adopted in previous years should be considered.

  We continue to see companies using a discount rate above the AA Corporate Bond index yield reflecting this consideration.

- It is possible to discount different tranches of liabilities at different rates, for example by using an AA bond yield curve rather than a single rate based on an index. Care should be taken, however, as AA bond yield curves can be derived in a variety of ways. The methodology chosen can lead to variations in individual rates and subsequently also in the liability figure derived.

- The yields on AA bonds issued by financial companies continue to be higher than comparable bonds issued by non-financials.

- It may be possible to adopt a 'single agency' approach whereby an index is constructed based on all bonds that are rated at AA by one or more of the three main rating agencies. This approach provides a larger universe of bonds (particularly at the longer durations). Using this approach, an adjustment of 0.2%-0.25% p.a. to the index could be appropriate for schemes with longer durations.



Inflation

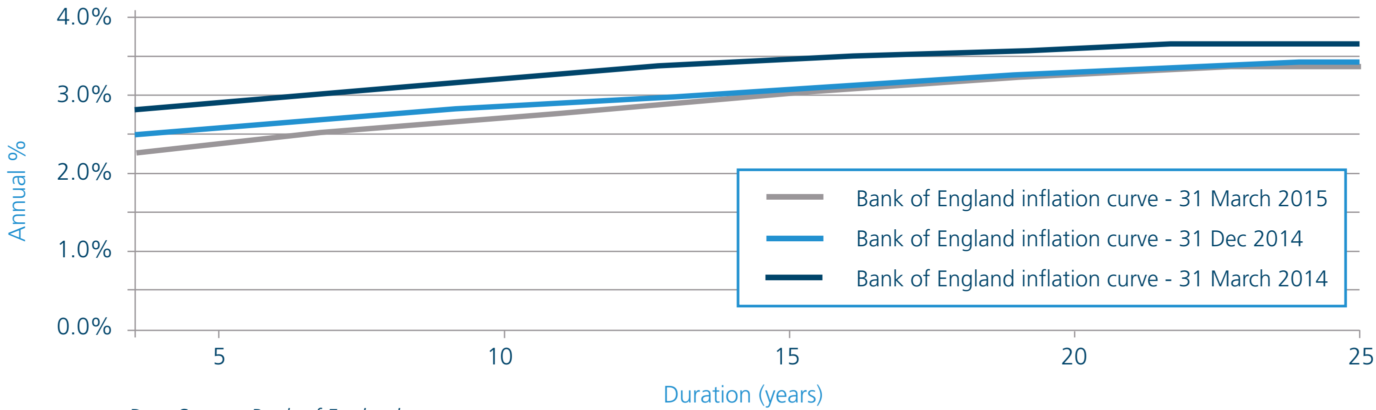
Retail Prices Index (RPI)

The table overleaf shows a sample of market implied long-term inflation rates. As can be seen from the inflation yield curve in Figure 2, market implied expectations for future vary considerably depending on the term being considered. It may, therefore, be appropriate to adopt an inflation assumption appropriate to the characteristics of each specific scheme rather than merely adopting a proxy such as the Bank of England's 20 year rate, particularly if the duration is significantly different to 20 years. Consistency with the approach adopted to derive the discount rate is important.

There may be other considerations to take into account when choosing inflation assumptions, such as whether to adjust for a possible inflation risk premium that may be implicit in the Bank of England's figures or for any other external factors that the company directors feel should be taken into account in determining this assumption. Adjustments in the region of 0%-0.3% p.a. are typically used to reflect this effect.

Index (annualised rate)	31/03/2015	31/12/2014	31/03/2014
Bank of England 20 year market implied inflation	3.28%	3.32%	3.63%
Bank of England 15 year market implied inflation	3.03%	3.11%	3.46%

Figure 2: Spot inflation curves (annualised)



Data Source: Bank of England

Implied rates of future inflation are at lower levels to those observed at the previous quarter as well as those of a year ago. For schemes with significant proportions of benefits linked to inflation this may provide some degree of mitigation against the increase in liabilities resulting from lower discount rates.

Consumer Prices Index (CPI)

The figures above relate to inflation as measured by the RPI. Many schemes now have benefits increasing with reference to the CPI instead, and over 20 years to 2010 CPI was on average around 0.7% p.a. lower than RPI. Of this, 0.5% p.a. could be attributed to the 'formula effect' resulting from technical differences in the way the two indices are calculated, and the remaining 0.2% p.a. could be attributed to differences between the compositions of the two indices. In 2010 a change was made to the way the indices were calculated and at the time this was expected to increase the difference between CPI and RPI going forward. The 'formula effect' since 2010 has been observed to be between 0.8% p.a. and 1.0% p.a.

Towards the end of 2011, the Office for Budget Responsibility (OBR) published a paper on the gap between RPI and CPI which suggested that the other factors mean the gap could be between 1.3% p.a. and 1.5% p.a. However, this assumes that the constituent effect will continue unchanged, and there is no guarantee that this will be the case over the long-term.

The current government CPI inflation target is 2.0% p.a.

Mortality

Demographic assumptions used for accounting disclosures can have a significant impact on the accounting figures. The most significant of these is the mortality assumption. Barnett Waddingham's survey of assumptions used by FTSE100 companies showed a difference of up to six years in the life expectancy assumptions adopted. Each additional year of life expectancy can add around 3% to the value of pension scheme liabilities and hence the chosen assumption can have a big impact on the results.

For simplicity, company directors have often adopted the same mortality assumptions used by the scheme's trustees for the funding valuation. As pension costs have increased there has been an increasing tendency to adopt different assumptions. Trustees are required to use prudent assumptions whereas the assumptions for company accounting should be a best estimate. Entities should consider reviewing their mortality assumptions to ensure these are not overly prudent and that their pension liabilities are not being overstated.

Barnett Waddingham has developed a tool to help companies analyse the appropriateness of their mortality assumptions by looking at scheme-specific factors such as the socio-economic make-up of the membership. To find out more about this please contact us using the details at the bottom of this page.

FRS to move towards an IFRS-based framework

The Financial Reporting Council Board (FRC) has formally approved the new UK accounting standards:

- FRS101: Reduced Disclosure Framework, and
- FRS102: The Financial Reporting Standard.

We look at each of these in more detail:

FRS101

FRS101 sets out a reduced disclosure framework for qualifying entities for accounting periods beginning on or after 1 January 2015. A qualifying entity is a member of a group where the parent of that group prepares publicly available consolidated financial statements and where that member is included in the consolidation, but other criteria must also be met.

This effectively means that subsidiaries of groups preparing accounts in line with IFRS can apply consistent accounting policies with those group accounts, but can also take advantage of disclosure exemptions to reduce the time and cost of preparing accounts.

There are some restrictions; charities may not be qualifying entities, and qualifying entities who prepare consolidated financial statements, either because they are required to do so or they do so voluntarily, may not apply FRS101.

FRS102

With regard to accounting for pension schemes, FRS102 will replace the current FRS17 and will have implications for pensions accounting disclosures. For the majority of entities, FRS102 will be compulsory for accounting periods beginning on or after 1 January 2015. The main change is that the 'expected return on assets' will cease to be used, and the finance cost will be replaced by a 'net interest' entry, calculated using the discount rate applying at the start of the period. There are other changes affecting, for example, the way surpluses are restricted which may give companies freedom to recognise surpluses where they were prohibited from doing so under FRS17.

It may also be more difficult to account for group plans (with more than one participating employer where these are under common control) as defined contribution (DC) schemes in future, as at least one group company will need to account for the scheme on a defined benefit (DB) basis.

It is only possible to account for multi-employer plans on a DC basis (with more than one participating employer where these are not under common control) if there is insufficient information to use DB accounting methods. Further, if such an entity wishes to use DC accounting and has agreed contributions to fund a deficit it will need to reflect the present value of these on its balance sheet and the impact of any revisions as an expense.

IFRIC14

The International Accounting Standards Board (IASB) is planning to consult on amendments to IFRIC14, which deals with whether companies are able to recognise an accounting surplus under IAS19 and whether additional liabilities should be recognised in respect of future agreed contributions to meet a funding deficit.

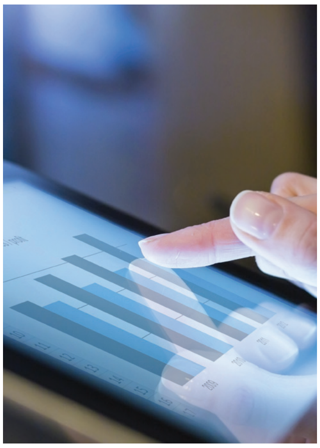
Broadly, these proposed amendments change the circumstances where an entity could be deemed to have an 'unconditional right' to a surplus, and require restriction of the amount recognised if the trustees of the scheme have a unilateral power (in the scheme rules) to use a surplus for other purposes (e.g. making benefit improvements or by triggering a wind-up).

For example, this could result in some schemes which are closed to future benefit accrual no longer being able to recognise a surplus in line with the current treatment under FRS17. However, this restriction under FRS17 will be relaxed under FRS102, and therefore such a change to IFRIC14 would once again lead to different treatment between FRS and IFRS.

IAS19

The IASB is also planning to consult on further changes to IAS19 regarding scheme amendments and curtailments. The proposed changes would require profit and loss items to be recalculated to allow for remeasurement of assets and liabilities at the date such an event occurs, which could be significant for those that rely on profit and loss charges being fixed at the start of the year. These amendments may not come into force until 2017.

How we can help



Pension Scheme Accounting Modeller – Instant Scenario Testing

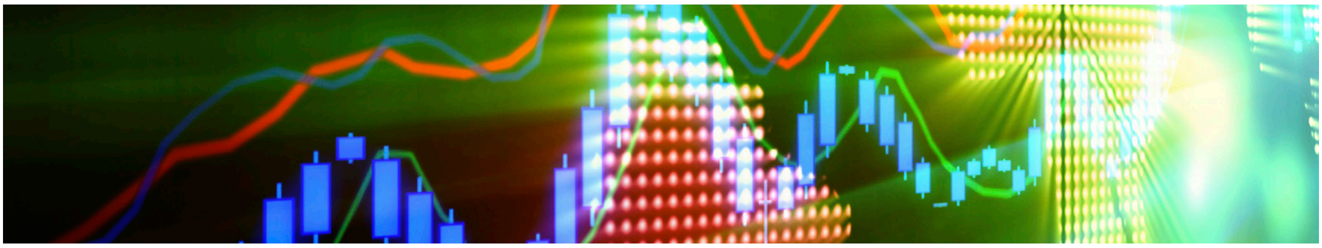
Pension schemes can have a significant impact on a company's accounting position. Our interactive modelling tool can help Finance Directors understand and quantify the factors influencing the financial position of the scheme so that they can be linked into the company's own internal plans for its core business.

The software allows an instant assessment of the sensitivity of the accounts to the year end assumptions so that the Finance Director can make a fully informed decision on the optimal approach.

It also allows companies reporting under IAS19 to view the impact of the changes to IAS19 on their accounting figures.

Independent review of accounting disclosures

The pension disclosures set out in a company's accounts need to be accepted by its auditors. We can support audit firms without the benefit of a specialist pension team to understand the assumptions and disclosures prepared by companies that they audit. The required scope of such a review varies and will provide auditors with the level of comfort they require to sign off the accounts.



Training for those involved in Pensions Financial Reporting - FRS17 and IAS19

There have been several recent and forthcoming changes to the pensions requirements under UK and International Accounting Standards. Our specialist consultants at Barnett Waddingham have extensive experience of advising on the assumptions and preparing the pensions disclosures for inclusion in company accounts under the different accounting standards (e.g. FRS17, IAS19 and FAS158) as well as supporting audit firms without the benefit of a specialist pension team to understand the assumptions and disclosures prepared by companies that they audit.

Our specialist consultants can provide interactive workshops focussing on accounting for defined benefit pension arrangements. We will provide background on the theory behind the main pension accounting standards – FRS17 and IAS19 – and will explore some of the current market factors influencing the disclosures and how these have changed over the last year or so.

For more information please email corporateconsulting@barnett-waddingham.co.uk.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

corporateconsulting@barnett-waddingham.co.uk   020 7776 2200

3522042
April 2015