Barnett Waddingham
a true partnership approach

31 December 2016

Current Issues in Pensions

Financial Reporting

The key financial assumptions required for determining pension liabilities under the Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (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.

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)	31/12/2016	30/09/2016	31/12/2015
ML Sterling Non-Gilts AA Over 15 years	2.57%	2.17%	3.57%
ML Sterling Corporates AA Over 15 years	2.69%	2.29%	3.67%
iBoxx Sterling Corporates AA Over 15 years	2.62%	2.22%	3.68%
Over 15 Year Fixed Interest Gilts	1.77%	1.43%	2.59%

At the end of Q4 2016, yields on AA corporate bonds were significantly lower than they were at 31 December 2015. 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. A 100 bps fall in discount rate would translate to an increase of approximately 20% in liabilities for a scheme with a 20 year duration.

Figure 1 shows the individual yields on the bonds making up the iBoxx Corporate Bond universe as at 31 December 2016.

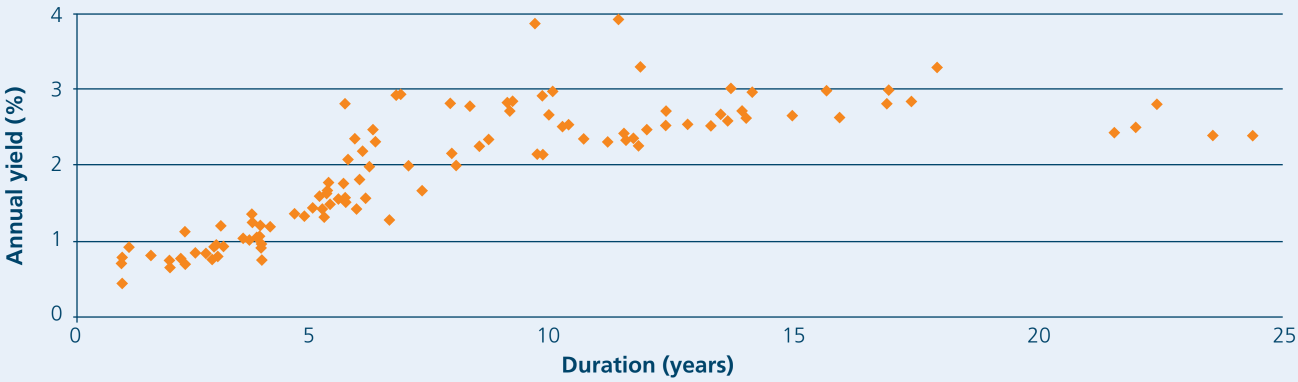
Markets have a great end to the year, but discount rates remain low

2016 saw a vote by the UK public to 'leave' the European Union and Donald Trump elected as the 45th president of the United States. Despite the uncertainty created by these significant political changes, the FTSE100 share index ended 2016 at an all-time high with FTSE100 companies finishing 19% up on the same time last year and 4% up over the quarter.

Discount rate assumptions under the accounting standards are based on yields of high corporate bonds and yields on all types of UK bonds have increased over the last quarter reversing the trend seen over the previous three quarters of 2016. Whilst the combined effect of market movements over the last quarter mean accounting positions at the year end will not be as bad as feared a few months ago, most schemes accounting positions are likely to have deteriorated materially over the year. Even with the movements in quarter 4, corporate bond yields remain around 100 bps lower at the end of 2016 compared to 2015.

FIGURE 1: IBOXX CORPORATE BOND UNIVERSE AS AT 31 DECEMBER 2016

Source: iBoxx



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 December 2016 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, but even by extrapolating beyond the yield on the longest duration AA bonds it is unlikely to be possible to justify a discount rate of above 3%, even for the most 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 becoming increasingly common to reflect the differences in yields at different terms by basing the discount rate on a single equivalent rate to 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 significant variations in individual rates and subsequently also in the liability figure derived. Even under this approach which, is argued by some to be the most accurate, a range of outcomes are possible depending on the dataset and method used to construct the curve and how this is extended to durations beyond the longest AA rated bond.

- It may be possible to adopt a 'single agency' approach where the discount rate is set by reference to 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) to be considered when setting the discount rate. Currently, an adjustment of no more than 0.05% pa to a rate derived from the standard AA rated corporate bond data set is likely to be appropriate which is broadly the same as a year ago.

Inflation

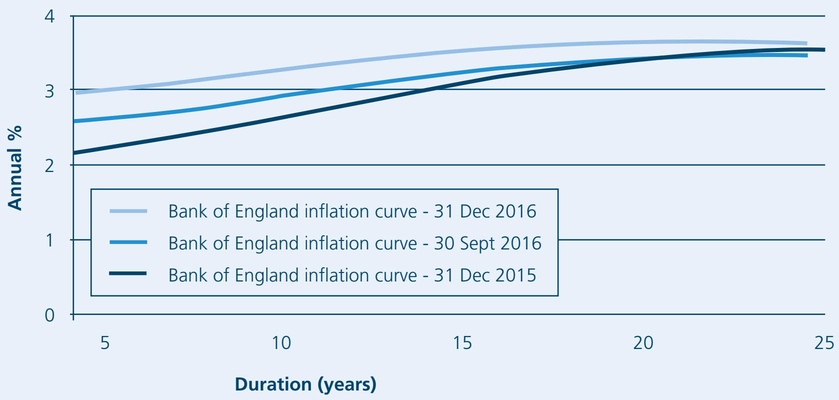
Retail Prices Index

The table below 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 the 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. In particular, the BoE curve indicates lower rates are appropriate at shorter terms and data from other sources (such as swap pricing and long dated gilt strips published by the Debt Management Office (DMO)) also indicate declining rates at longer terms. 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 of up to 0.3% pa are typically used to reflect this effect although it may be possible to justify adjustments above this level.

Index (annualised rate)	31/12/2016	30/09/2016	31/12/2015
Bank of England 20 year market implied inflation	3.66%	3.43%	3.44%
Bank of England 15 year market implied inflation	3.54%	3.24%	3.12%

FIGURE 2: SPOT INFLATION CURVES (ANNUALISED) Source: Bank of England



RESEARCH

Survey of assumptions used by the FTSE100 as at 31 December 2015

Our fifteenth annual survey of FTSE100 pensions accounting assumptions revealed an increase in IAS19 funding levels over the year to 31 December 2015.

Market movements over the year mean this improvement is likely to have been reversed, and deficits are are expected to be significantly higher at 31 December 2016.

The full survey is available on our website

Implied rates of future inflation are at higher levels compared to those observed at the previous quarter and of those of a year ago at all durations. For those schemes with inflation-linked liabilities, there will be an additional increase in liabilities along with that resulting from falls in discount rates.

Consumer Prices Index (CPI)

The figures above relate to inflation as measured by the Retail Prices Index (RPI). Many schemes now have benefits increasing with reference to the Consumer Prices Index (CPI) instead, and over 20 years to 2010 CPI was on average around 0.7% pa lower than RPI. Of this, 0.5% pa could be attributed to the 'formula effect' resulting from technical differences in the way the two indices are calculated, and the remaining 0.2% pa 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% pa and 1.0% pa.

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% pa and 1.5% pa. A more recent paper published by the OBR in March 2015 suggests the gap to be about 1.0% pa while the Bank of England central long-term estimate suggests 1.3% pa.

The current Government CPI inflation target is 2.0% pa.

HOW WE CAN HELP

Illuminate - instant scenario testing

Pension schemes can have a significant impact on a company's accounting position. We have added an interactive modelling tool to Illuminate to 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 tool allows an instant assessment of the sensitivity of the accounting results to the year-end assumptions so that the Finance Director can make a fully informed decision on the optimal approach.

FIND OUT MORE >

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.

HOW WE CAN HELP

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 end of this note.

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.

Other assumptions

In the past, assumptions such as amounts commuted for cash at retirement and proportion of cases where a pension is payable on death may have been set to be the same as used in the scheme funding valuation and may therefore contain an element of prudence. Individually such assumptions may not have a material effect on the liabilities but collectively can mean liabilities are overstated relative to a true best estimate. Any such overstatement will be exacerbated in low discount rate envrionments. Companies should therefore review other assumptions from time to time to ensure they reflect a best estimate of future experience.

RESEARCH

Impact of pensions on UK business

Our sixth annual report considers the impact that pension provision is having on UK business.

The survey offers a unique assessment of the financial impact of DB pension schemes within the context of the wider finances of FTSE350 companies.

The full report is available on our website.

The current UK framework

The Financial Reporting Council (FRC) UK accounting standards:

- FRS101: Reduced Disclosure Framework;
- FRS102: The Financial Reporting Standard;
- FRS104: Interim Financial Reporting and
- FRS105: The Financial Reporting Standard applicable to the Micro-entities Regime.

We look at each of these in more detail:

FRS101: Reduced Disclosure Framework

FRS101 sets out a reduced disclosure framework for qualifying entities. 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: The Financial Reporting Standard

FRS102 is a single reporting standard that has replaced the old UK Genrally Accepted Accounting Principles (GAAP) (comprises a number of Financial Reporting Standards, Statement of Standard Accounting Practice and Urgent Issue Task Force). The accounting standard addresses a specific area of accounting, including transitional provisions and specific requirements for specialised entities. Specific requirements for specialised entities is comprised with public benefit entities, retirement benefit schemes and financial institutions.

FRS102 makes it 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.

FRS104: Interim Financial Reporting

FRS104 does not in itself require any company to prepare an interim statement but may be used by companies which are required to produce interim financial statements under other rules (for example because they are listed). FRS104 is based on the interim reporting requirements of IAS34, which may be used by some entities instead of FRS104, and replaces the ASB Statement Half-yearly financial reports. The revision is intended to bring interim reporting into the new framework but does not make any changes to which entities are required to prepare interim reports.

Disclosure requirements under FRS104 are based on those under FRS102 for annual financial statements. For pensions, the FRC has stated:

- The cost of a DB plan for an interim period is calculated on a year-to-date basis
- The DB obligation can be approximated based on the latest actuarial valuation and adjusted for changes in member demographics

FRS104 became effective for interim periods beginning on or after 1 January 2015.

FRS105: The Financial Reporting Standard applicable to the Micro-entities Regime

FRS105 is an accounting standard intended for financial statements of companies which qualify for the micro-entities regime. It is based on FRS102 but its accounting requirements are adapted to satisfy the legal requirements applicable to micro-entities and to reflect the simpler nature and smaller size of micro-entities. FRS105 is effective for accounting periods beginning on or after 1 January 2016 though early application is permitted. The FRC will withdraw the Financial Reporting Standard for Smaller Entities (FRSSE) from 1 January 2016, with any companies previously subject to this regime who do not qualify for micro-entities regime being subject to FRS102 going forward.

HOW WE CAN HELP

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.

IFRIC14 and IAS19

The International Accounting Standards Board (IASB) consulted on further changes to IAS19 regarding scheme amendments and curtailments and the consultation closed for public comment on 19 October 2015. The IASB has now considered the response to this consultation and, subject to some amendments to the wording, is proposing that these are adopted.

One of 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.

The proposed amendments to IFRIC14 'IAS19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements' address how the powers of other parties, such as the trustees of the plan, affect an employer's right to a refund of a surplus from the plan.

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. settling liabilities in full, 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 treatment under FRS17. However, this restriction under FRS17 is relaxed under FRS102, and therefore such a change to IFRIC14 would once again lead to different treatment between FRS and IFRS.

These amendments are expected to come into force for accounting periods beginning on or after 1 January 2019.

Yield curve approach to accounting

A number of companies in the US are beginning to use a 'yield curve' approach to calculating interest cost and service cost components of the Net Periodic Benefit Cost for DB obligations under ASC715. By applying a term dependent spot rate to the present value of each future cashflow, it is possible to reduce these costs since the current shape of the yield curve would lead to a lower interest rate (when compared to the single equivalent discount rate) being used for the interest cost calculation. This approach would also lead to a reduction in the service cost as it would utilise the higher interest rates for longer duration liabilities. Note, under this alternative approach, the present value of future benefit cashflows at the measurement date, formally known as the 'Projected Benefit Obligation' will be unchanged from the current approach of using a single equivalent discount rate.

The Securities and Exchange Commission has responded by stating that they would not object to moving to this approach. However, they did state that once a company moved to this approach, they would not expect them to move back to using a single equivalent discount rate. They also noted that appropriate disclosures about the change, such as the effect it would have, would be required.

The IASB and ASB have not yet given any indication of whether this approach is acceptable under IFRS or UK GAAP but the net interest approach used for IAS19 / FRS102 means there is unlikely to be a significant benefit for UK schemes of moving (unless they are unfunded or very badly funded).

HOW WE CAN HELP

Training for those involved in Pensions Financial Reporting - IAS19, FRS101, FRS102 and ASC715

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. IAS19, FRS101, FRS102 and ASC715) 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 DB pension arrangements. We will provide background on the theory behind the main pension accounting standards – IAS19, FRS101, FRS102 and ASC715 – 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   0207 776 2200   www.barnett-waddingham.co.uk