

Current issues in pensions financial reporting

31 March 2024

This note is for those involved in preparing and auditing pension disclosures under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (US listed) as at **31 March 2024**. It looks at topical issues, alongside considerations for company directors when setting assumptions, and for auditors in determining whether the assumptions are appropriate. Please note that this briefing should not be taken as a recommendation for a particular course of action – please seek advice appropriate to your own circumstances.

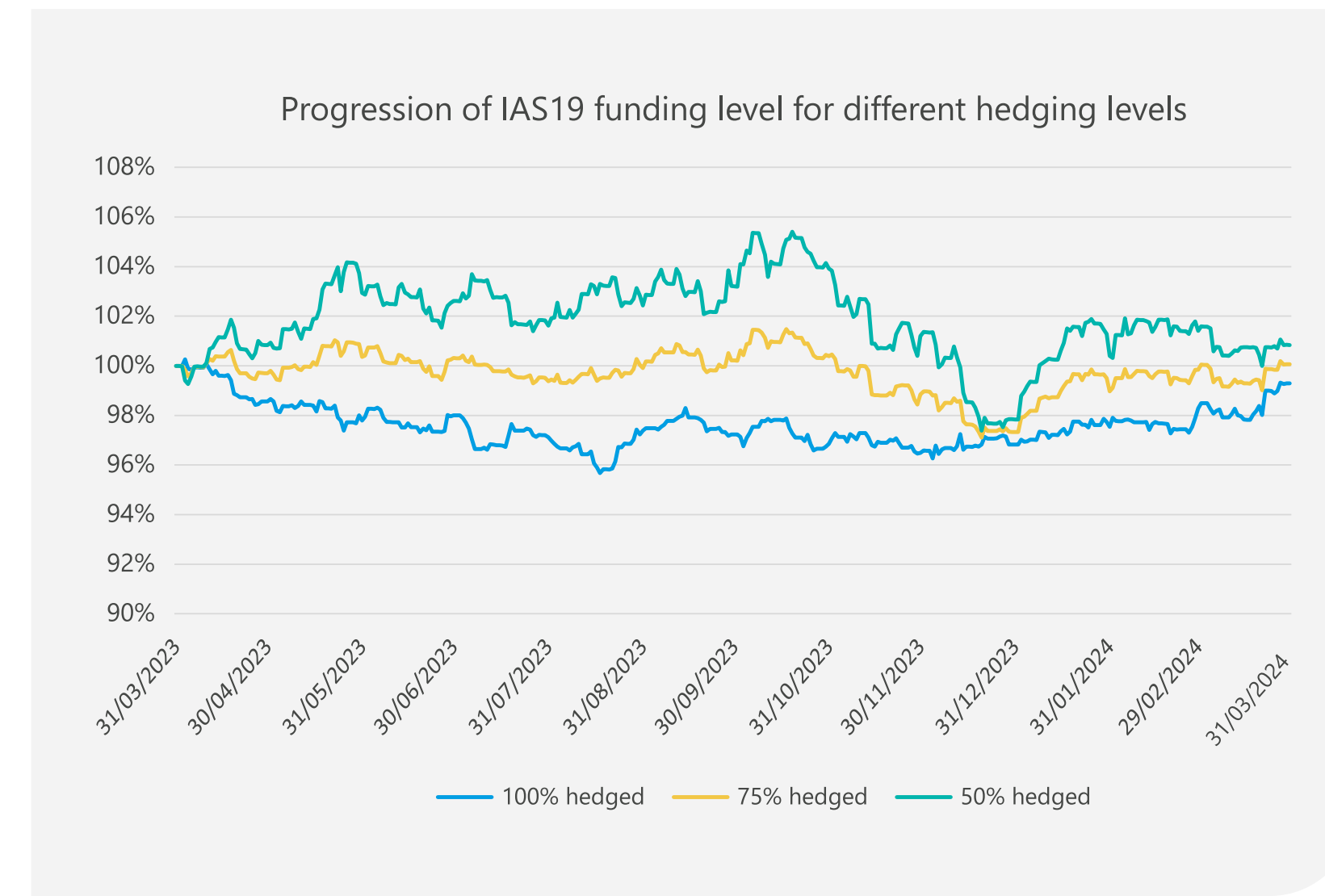


IAS19 liabilities hold steady, but balance sheet impact mixed

Since 31 March 2023, most schemes have seen the value of their IAS19 liabilities stay broadly consistent, with corporate bond yields remaining at similar levels to last year.

Whilst the stability on the liability value will be welcome to corporate sponsors, the outcome in terms of the net balance sheet position can vary for schemes, with the overall impact likely to depend on the balance between liability hedging assets and growth seeking assets in the scheme. Returns on most asset classes employed as part of return seeking elements of strategies were positive, but values of government bonds generally used as part of liability hedging fell over the period.

Generally, schemes with lower levels of hedging will have fared slightly better over the year (but this is by no means universal and such schemes will have experienced more volatility). The chart below shows how the progression may have varied for three schemes with differing levels of interest rate and inflation hedging coverage.



Conducting the same analysis over the three months to 31 March 2024, we see that most schemes should have seen a fall in their liabilities from 31 December 2023. This is due to corporate bond yields rising by roughly 0.3% per annum (pa) over the period.

Unlike the full-year scenario, corporate sponsors are likely to see a rise in balance sheet position over the three months, particularly if less well hedged, as asset values have also seen positive returns over the three-month period.

Surpluses, IFRIC14 and asset ceilings

The changes in funding levels mean many schemes may continue to find themselves with accounting surplus at the next balance sheet date. Some schemes may also find that the accounting position is materially better than the scheme funding position used to determine the last recovery plan contributions, increasing the chances of additional liabilities being required under IAS19 (even if a deficit remains).

Companies will need make a judgement as to whether it is appropriate to recognise the surplus and whether IFRIC14 creates any additional liabilities due to commitments made under a recovery plan. The key points for each of the main standards are:

- **IAS19: IFRIC14 applies** – where the company has an unconditional right to a refund of surplus this can be recognised in full. It is normally enough to be able to demonstrate the Company would have this right in the scenario where the scheme is run on until a point where all benefits have been paid out (gradual settlement). As long as the Company can (in theory at least) run the scheme on indefinitely and the rules allow them to receive a refund at the end of the life of the scheme, the surplus can be recognised.

Where the Company does not have an unconditional right to a future refund the surplus must be restricted to nil, and if there is a recovery plan in place, the present value of these contributions should be recognised as an additional liability on the balance sheet. If there is future accrual, the additional liability can be reduced if the service cost exceeds the contributions agree for future accrual.

- **FRS102: IFRIC14 does not apply.** The principles above are typically followed to determine whether to recognise a surplus or not, but there is no requirement under any circumstances to recognise an additional liability for recovery plan contributions. There is potentially more scope for management judgement to be applied when deciding on whether to recognise a surplus under UK GAAP.
- **US GAAP:** No restrictions apply on the surplus that can be recognised (and no additional liability will arise from any recovery plan).

Establishing whether an unconditional right exists can be a subjective judgement and can, in some cases, require legal interpretation of the scheme's rules if there is doubt over how they would operate. Where companies have yet to consider the asset ceiling, they may wish to do so ahead of the next year end as advice may be needed to establish the correct treatment.

Impact of Covid-19 on pension scheme demographics

When considering the impact of Covid-19, it is helpful to consider as two parts:

- The **historical** impact of the pandemic i.e. the increase in deaths over 2020 and 2021, and the impact that these increased deaths has on pension scheme liabilities (typically reflected in updated membership data between valuations); and
- The **future** impact of the pandemic i.e. how will the consequences of the pandemic affect future numbers of deaths of pension scheme members.



The historical impact of the pandemic

The Continuous Mortality Investigation (CMI) has estimated that there have been approximately 173,600 excess deaths in the UK than would have been expected between 2020 and 2023. Whilst this is an unprecedented number in recent times, it is unlikely to mean a significant reduction in pension scheme liabilities.

For example, 100,000 additional deaths equate to an approximate reduction of circa 0.8% in pensioner liabilities (based on a UK pensioner population of 12m), but the overall effect will be lower for most pension schemes, as non-pensioner liabilities will not have been significantly impacted and research from the CMI suggests pensioners were less affected than the general population.

In general, we would expect the reduction in liabilities due to excess mortality to be more pronounced for more mature schemes, although the impact is likely to be negligible compared to the likely impact on the accounting position from financial markets.

The future impact of the pandemic

The pandemic is also likely to affect deaths in the short and medium term and therefore have an impact on mortality projection assumptions. In particular, since the end of the second wave of the pandemic in Q2 of 2021 the number of deaths has been persistently and materially higher than expected (based on mortality in 2019).

It is difficult to know what is driving these 'excess' deaths, although reasons suggested include:

- an increase in heart-related deaths (possibly caused by missed diagnoses during the shutdown of healthcare services in the pandemic or there being a higher risk of heart-related deaths following infection by Covid-19);
- other missed diagnoses and treatments during the pandemic;
- a bad influenza season accompanied by a cold snap in Winter 2022/23; and
- pressures on the NHS (such as increased waiting lists and ambulance response times and strikes by medical staff).

It seems likely that these factors are likely to persist in the future, and therefore that mortality will be higher in the short and medium term compared to pre-pandemic expectations.

The latest version of the CMI model, CMI_2023, was published in April 2024. This model takes into consideration all the deaths which have occurred over 2020 to 2023, including those as a result of the pandemic. When incorporating this model into the demographic assumptions, entities will need to decide on how much weight to place on the pandemic experience in 2020 and 2021 as well as on the post-pandemic experience in 2022 and 2023. It is likely to be difficult to justify placing a large weighting on the experience in 2020 and 2021 due to the exceptional circumstances in those years. However, a relatively large weighting placed on the 2022 and 2023 mortality data (which had mortality similar to levels observed for 2016 to 2018) may be appropriate in recognising the fact that the pandemic may lead to a slowdown in life expectancy improvements compared to previous models.



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, considering the term of the relevant pension scheme’s liabilities.

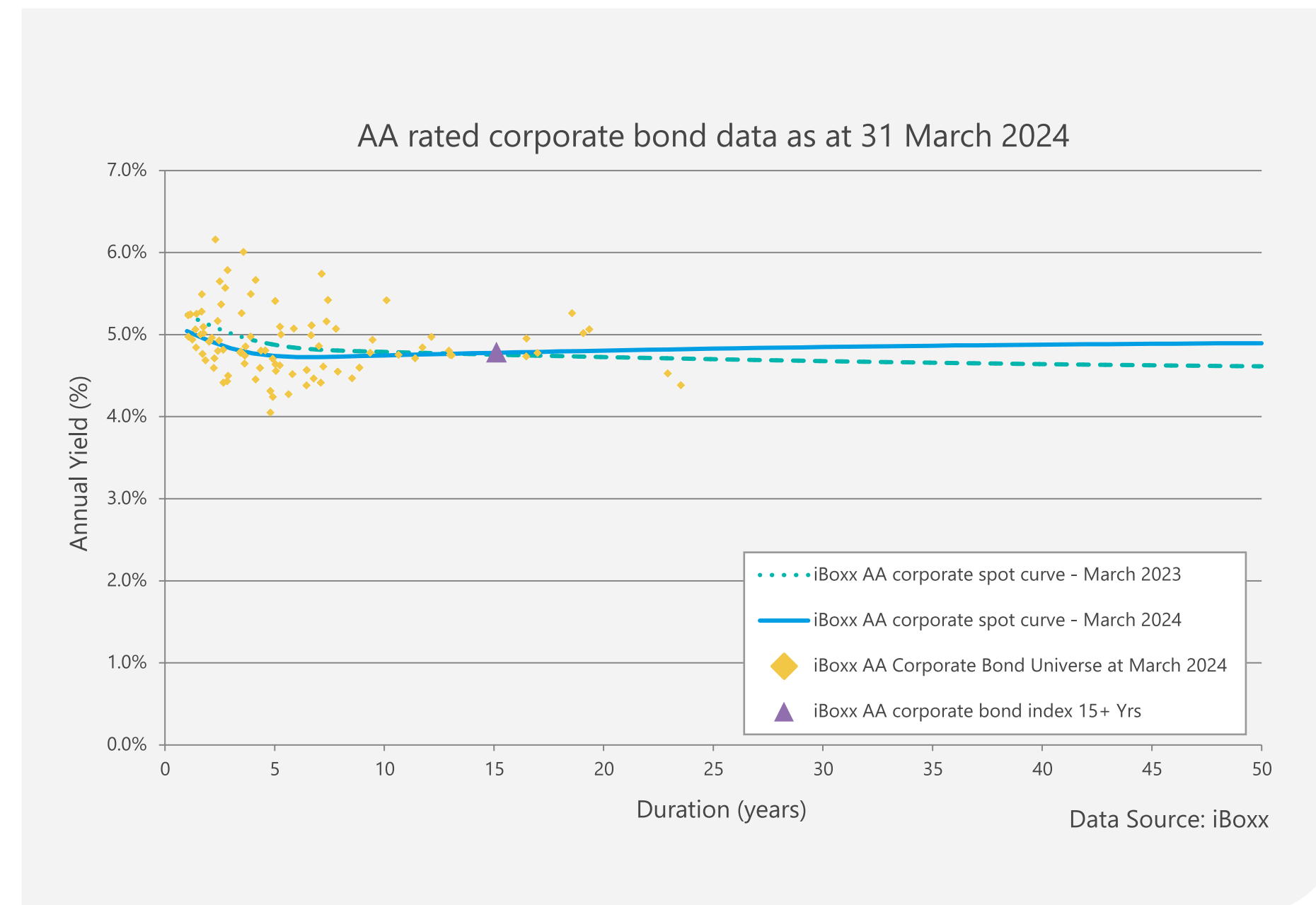


Figure 2: iBoxx AA Corporate bond universe at 31 March 2024

Figure 2 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 31 March 2024. The variation in yield by term is similar to a year ago, with the curve being slightly downward sloping as terms rise and then levels off. This effect should be reflected in the choice of discount rate.

A common method to reflect the shape of AA bond yield curve is to base the discount rate on a single equivalent rate rather than a single rate based on an index, and our experience is that the audit firms prefer this approach to be used.

The table below shows single equivalent discount rates (SEDR) using the iBoxx AA-rated corporate bond curve based on sample cashflows for a range of durations:

Approximate duration (years)	31 March 2024	31 December 2023	31 March 2023
10	4.75% pa	4.45% pa	4.70% pa
15	4.75% pa	4.45% pa	4.65% pa
20	4.80% pa	4.50% pa	4.65% pa
25	4.80% pa	4.50% pa	4.60% pa

At the end of Q1 2024, single equivalent discount rates on AA corporate bonds were higher when compared to 31 December 2023 and 31 March 2023 for all durations. The table above shows that discount rates for short durations derived from the iBoxx curve have decreased since 31 March 2023 by approximately 0.05% pa and discount rates for longer durations have increased by approximately 0.20%. This will result in higher discount rates being adopted for accounting purposes compared to last year and therefore a lower value being placed on the liabilities. Each 0.1% increase on the discount rate would translate to a decrease of approximately 2% in liability value for a scheme with a 20-year duration.

Where a single equivalent discount rate approach is used, care should be taken, 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 the full yield curve SEDR approach chosen in this analysis, 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. We extrapolate the curve beyond the duration of the longest AA rated bond through using the spot values predicted by the model up to 50 years and assuming a constant spot rate thereafter.

Generally, it will be possible to justify a higher discount rate by adopting 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 increase of 0.20% - 0.30% pa to the rate implied by the standard AA rated corporate bond data set is likely to be appropriate.



Inflation

Changes from Retail Price Index (RPI) to Consumer Prices Index including owner occupiers' housing costs (CPIH) in 2030

On 25 November 2020 the Government published its response to the RPI reform consultation. It is now widely expected that the change to the RPI inflation statistic to bring it in line with the CPIH index will take place in 2030. No compensation is likely to be given to index linked gilt holders, and RPI-linked pension increases will also cost less to provide, although CPI-linked pension liabilities will likely be largely unaffected.

CPIH became the UK's primary inflation measure in 2017 and essentially takes the Consumer Price Index (CPI) and includes a measure of owner-occupied housing. It also means that from 2030, index-linked gilt payments will implicitly be linked to CPIH due to the change of the makeup of the RPI statistic. When RPI is aligned with CPIH, RPI would be expected to be lower in future and, all else being equal, this would be reflected in market valuations of index linked gilts.

Following the publication of the consultation response, there was in fact a limited reaction from the market, whereas we might have expected a fall in long-dated index linked gilt prices, reflecting the expectation that pay-outs will be lower from 2030 onwards.

This suggests that either the market had already adjusted to expectations or supply and demand distortions mean the holders of index linked gilts (such as pension funds or insurance companies) are more concerned with the hedging of liabilities than the price of the instruments.

A judicial review into the reform of RPI instigated by a number of large pension funds began in June 2022. If this is successful it could mean the changes will need to be reconsidered (although may still go ahead), the changes could be reversed, or compensation could be required for holders of RPI index linked gilts adversely affected by the changes.

Retail Prices Index (RPI)

As can be seen from the inflation yield curve in Figure 3, market implied expectations for the future vary depending on the term being considered. Adopting a proxy, such as the Bank of England's inflation spot rate at a duration equivalent to the scheme's liabilities, does not reflect the variations in expected future inflation rate by term.

In particular, this does not reflect the fact that the curve is downward sloping at the long end, and so using a single-equivalent approach it should be possible to justify assumptions below the spot rate at the given duration for most schemes. In fact, our recent experience is that using a spot rate from the curve will generally be above the audit firms' usual range for RPI inflation assumptions. To this end, we recommend adopting a single-equivalent approach, particularly where this is also being used to derive the discount rate.

There may be other considerations to take into account when choosing inflation assumptions, such as whether to adjust for a possible inflation risk premium (IRP) that may be implicit in the Bank of England's figures or for any other external factors that the company directors feel should be considered in determining this assumption. Adjustments of up to 0.3% pa are typically used to reflect an IRP although it may be possible to justify adjustments above this level, particularly given the lack of market reaction to the expected reduction in RPI from 2030 onwards.

As shown in figure 3, inflation expectations in this quarter are generally higher compared to the previous quarter. Compared to inflation expectations as at 31 March 2023, expectations this quarter are higher at shorter durations and slightly lower at longer durations.

The table below shows single equivalent inflation rate assumptions based on the Bank of England inflation curve and sample cashflows for a range of durations, before any deduction for an inflation risk premium:

Approximate duration (years)	31 March 2024	31 December 2023	31 March 2023
10	3.55% pa	3.35% pa	3.55% pa
15	3.45% pa	3.30% pa	3.50% pa
20	3.40% pa	3.25% pa	3.45% pa
25	3.35% pa	3.20% pa	3.40% pa

Consumer Prices Index (CPI)

The figures above relate to inflation as measured by the RPI. Many schemes have benefits increasing with reference to the Consumer Prices Index (CPI) instead, and assumptions for CPI inflation are generally set with reference to the assumption for RPI inflation given the limited market for CPI-linked investments. The difference between RPI and CPI can be attributed to two things:

- the 'formula effect', resulting from technical differences in the way the two indices are calculated; and
- differences between the compositions of the two indices (i.e. the goods that are included in them).

Following the response to the consultation on RPI reform, there is now a much firmer expectation that RPI will be aligned with CPIH from 2030 onwards. In December 2023, the Office for National Statistics (ONS) announced that it is changing the way that housing costs will be measured from February 2024 onwards. This results in a much stronger argument for there to be a slight difference between CPI and CPIH going forwards, of up to around 0.2% pa.

An appropriate CPI assumption at 31 March 2024 is likely to be based on the gap remaining at around 1% pa up to 2030, but then only a small difference after that date. It should be possible to justify a small difference between RPI and CPI after 2030, on the grounds that there is now expected to be difference between CPI and CPIH following the ONS announcement.

Allowing for recent high levels of inflation

Since April 2021, inflation has been increasing with RPI and CPI respectively reaching as high as 14.2% and 11.1% in October 2022, although has eased significantly since. As a result, recent pension increases in payment and deferment may have been higher than the long-term assumption used in previous accounting disclosures. Auditors will also expect known future increases to be considered – for example, if the balance sheet date falls after the reference month for determining the increase, even if the increase will occur after the balance sheet date.

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. Whilst there is generally a wide range of assumptions adopted, we have seen reductions in mortality improvements over the past few years that have led to lower liability values for accounting purposes through the annual model released by the CMI.

For simplicity, company directors have in the past adopted the same mortality assumptions used by the scheme's trustees for the funding valuation. However, the Trustees are required to use prudent assumptions, whereas the assumptions for company accounting should be a best estimate. We would therefore expect margins for prudence within the mortality assumptions to be removed before being used for accounting purposes, and we are increasingly seeing audit firms picking up on this as well (often requesting evidence supporting the setting of the best estimate mortality assumptions, for example in a mortality analysis report).

Mortality base tables - S3 and S4

The CMI recently published the S4 tables in February 2024, their latest mortality base tables using pension scheme member data for the period 2014 to 2019 (with the CMI excluding data for 2020 and 2021 due to the abnormally high deaths in these years due to COVID-19).

Most schemes will currently be funding using the S3 tables, and typically will only move to using the S4 tables as part of their next triennial actuarial valuation. The adoption of the S4 tables is typically done using a mortality analysis, for example a socio-economic analysis that considers member postcodes and income and/or an analysis of actual mortality experience in the scheme over a recent period.

If companies move to S4 with the same loading as was previously used for the S3 tables, then this will result in a small decrease in liabilities. However, schemes using a mortality analysis to adopt S4 may see an increase or a decrease in liabilities, depending on the results of the analysis.

Barnett Waddingham has a specialist longevity tool (developed alongside our expert Longevity Consulting team) 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 or actual mortality experience over a historical period. To find out more about this please contact us using the details at the bottom of this note.

Mortality projections model

The CMI_2023 model was released in April 2024. The model includes 2020 and 2021 data, the period in which there were the two primary waves of the Covid-19 pandemic in the UK. The model also includes 2022 and 2023 data which the CMI believes can be relied on to an extent for the purposes of producing future mortality. As with the CMI_2020 to CMI_2022 models, “weight” parameters can be used to vary the weight placed on data for 2020 onwards; with the default parameters set to place no weight on experience for 2020 and 2021 and some weight on data for post-pandemic years. In CMI_2023, the default weight parameter for 2022 and 2023 data is set to be 15%. Although this weight value may seem low, it broadly allows for half the liability impact of placing full weight on data for 2022 and 2023.

As discussed on pages 4 and 5, the choice of weight parameters in CMI_2023 will depend on companies’ views of future mortality in light of the pandemic. We expect that a reasonable approach will be to either place no weight or a small weight on data for 2020 and 2021 and a small weighting for 2022 and 2023 data.

The overall liability impact changing from CMI_2022 to CMI_2023 is likely to be relatively small, although the change between CMI_2021 and CMI_2023 is likely to be larger (a c. 3% liability reduction).





Other assumptions

In the past, assumptions such as amounts commuted for cash at retirement and the proportion of cases where a pension is payable on death may have been set to align with 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 environments.

Companies should therefore review other assumptions from time to time to ensure they reflect a best estimate of future experience.



Hot Topics

Financial Reporting Council (FRC) Revision of UK and Ireland Accounting Standards

The FRC has issued comprehensive improvements to financial reporting standards that apply in the UK and Republic of Ireland. The amendments to the standards will in most cases be effective for the accounting periods beginning on or after 1 January 2026. The main amendment applicable to pension schemes is that where a surplus exists, the basis used to determine any limit on the recognition of that surplus must also be disclosed.

International Financial Reporting Standard (IFRS) 17

Where an entity reporting under IFRS has provided a guarantee to a UK pension fund (for example to support a funding plan or reduce PPF levies) this may need to be accounted for under IFRS17 for accounting periods beginning on or after 1 January 2023. Entities should investigate whether any such guarantees are in place and consider whether they will be required to account for them under IFRS17 going forward.

Many sponsors of UK pension plans will have obtained guarantees of certain obligations from entities within the corporate group. The purpose of this is normally to improve the covenant afforded to the pension scheme, thereby allowing more flexibility in funding arrangements, or to reduce the amount of a PPF levy due. These guarantees could be deemed to meet the definition of insurance contract under IFRS17 and could require a change in accounting practice for the entity providing the guarantee.

Companies will need to establish whether there are any guarantees in place provided by entities within the group that account under IFRS, and whether the terms are such that it is caught by the definition of insurance contract under IFRS17. We understand that there is no impact on group consolidated accounts, it is only the entity providing the guarantee that is potentially affected. If the guarantee is deemed to be a contract of insurance under IFRS17, the entity will need to decide how to account for this. The entity will need to consider whether the amounts involved are material, and it also has options on whether to account under IFRS17 or as a financial guarantee contract under IFRS9. The entity should also engage with its auditor to understand what their position is in relation to accounting for these guarantees.

High Court Ruling – Virgin Media vs NTL Trustees – Scheme amendments and Section 37 notices

The judge in the High Court case of Virgin Media vs NTL Trustees handed down her judgement last year, which could have material consequences for defined benefit (DB) schemes which previously contracted-out of the state pension system on the 'reference scheme test' method between 1997 and 2016.

The judge in this case ruled that, where benefit changes were made without a valid 'section 37' certificate from the Scheme Actuary, those changes could be considered void.

It may take some time for the industry to understand the impact of this ruling, and for the next stages of the legal process to become clear - an appeal is scheduled for later in 2024. Most schemes are unlikely to be in a position to assess the potential impact (if any) but auditors may want to understand what work has been undertaken.



Further information

Illuminate - Instant Scenario Testing

FTSE350 pensions: preparing for a transaction

Independent review of accounting disclosures

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

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

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