



Current issues in pensions financial reporting

30 September 2024

Our latest update on pensions accounting looks at the issues affecting disclosures being prepared at **30 September 2024** and considers the outlook for schemes with 31 December year ends.



Our latest update on pensions accounting looks at the issues affecting disclosures being prepared at 30 September 2024. We cover a range of topics which will be of interest to those preparing and auditing pension disclosures under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and Accounting Standards ASC715 (US listed). These include:

- the impact of market movements on balance sheet positions and selection of discount rate assumptions;
- developments in mortality assumptions; and
- hot topics, including an upcoming review of FRS102, the impact of the Virgin Media case, and whether parent guarantees are caught by IFRS17.

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 increase, but balance sheet impact positive

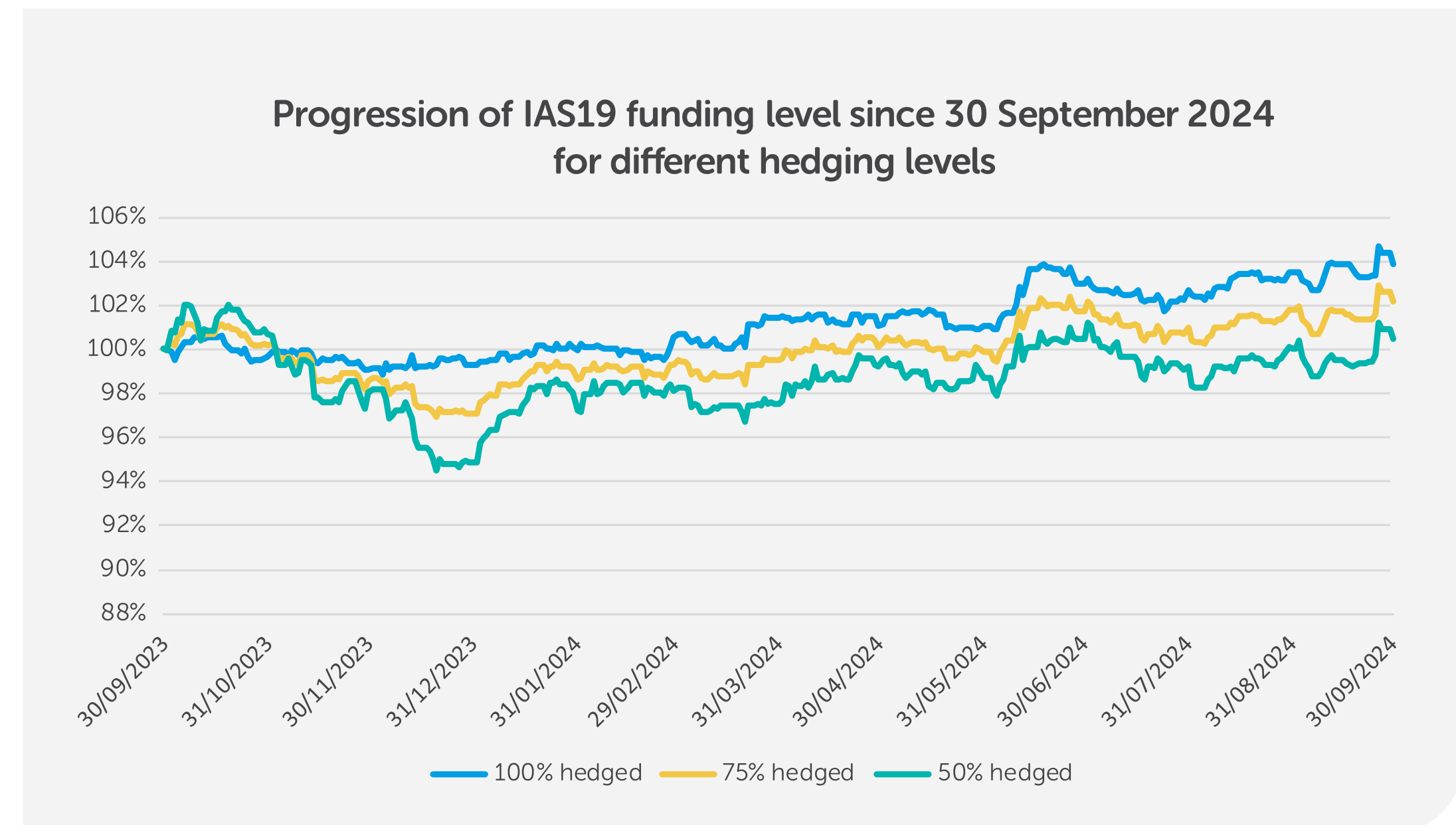
Since 30 September 2023, most schemes have seen the value of their IAS19 liabilities increase, with corporate bond yields falling by up to 0.5% p.a. at shorter durations and around 0.2% p.a. at longer durations.

While the decrease in discount rates and rise in liability values will not be welcome to corporate sponsors, the overall impact on the net balance sheet is likely to be positive due to strong asset returns over the period. The extent of the improvement in net balance sheet position is likely to depend on the balance between liability hedging assets and growth seeking assets in the scheme.

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

The chart demonstrates a drop in funding levels during the last quarter of 2023, with positions recovering throughout 2024 to date.

As such, the outlook for this year's financial statements for schemes with 31 December year ends is bright, with strong improvements in the net balance sheet position since 31 December 2023 expected based on market conditions to date. This is discussed in more detail below.



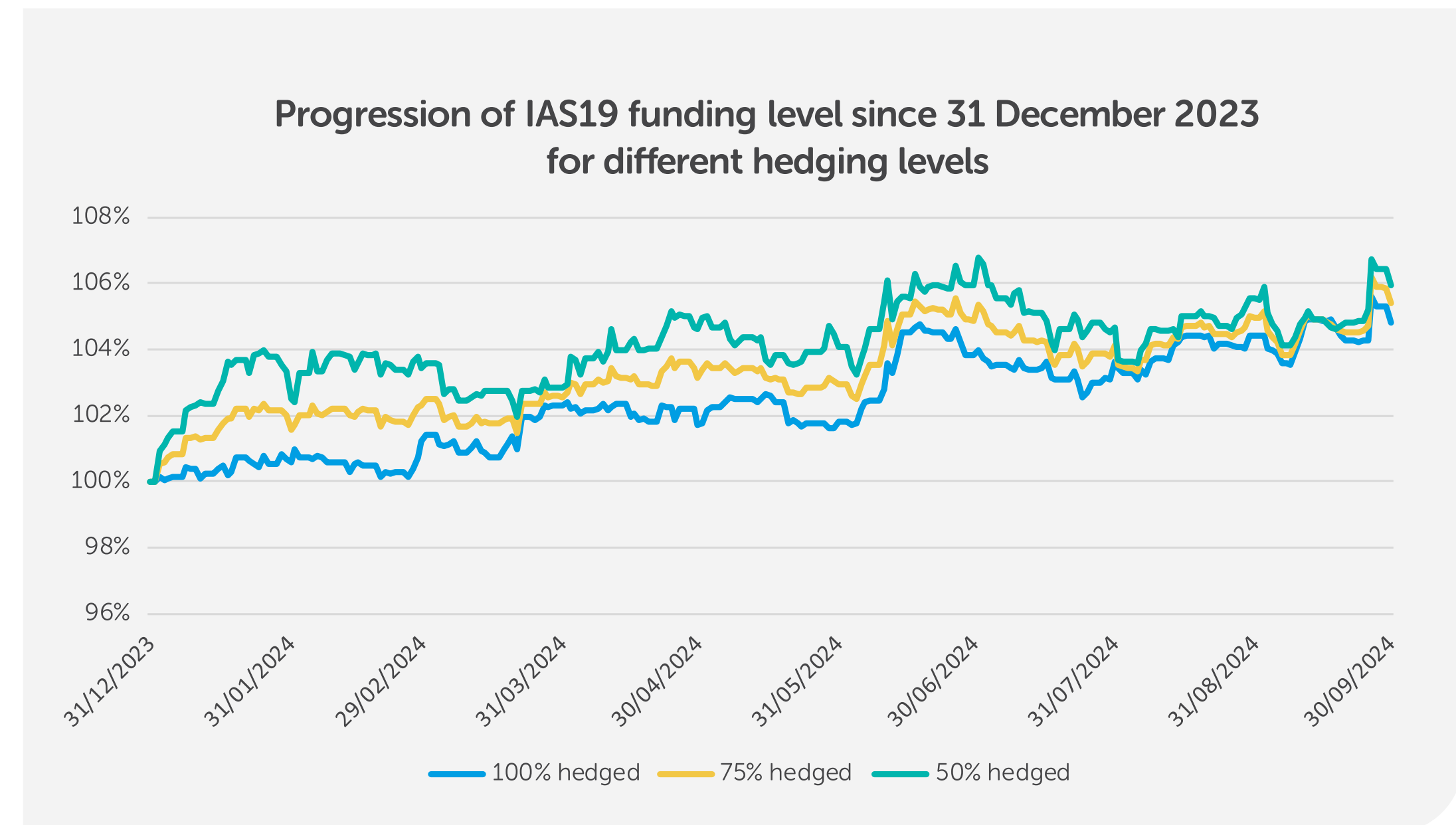
Source: Barnett Waddingham model

The picture since 31 December 2023

Since the start of the year, corporate bond yields have increased by between 0.5% p.a. and 0.75% p.a., depending on duration. Although there was a rise of around 0.1% p.a. in expectations for future inflation over the same period, most of these schemes will have seen the value of their IAS19 liabilities decrease.

Corporate sponsors are likely to see an improvement in their balance sheet position between 31 December 2023 and 30 September 2024, particularly if less well hedged, due to positive asset returns over the nine-month period.

The chart shows how the progression may have varied for three schemes with differing levels of interest rate and inflation hedging coverage.



Source: Barnett Waddingham model

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 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.

Click below for more information on each of the main standards:

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 before next year end – advice may be needed to establish the correct treatment. Please contact your usual Barnett Waddingham (BW) contact if you would like to discuss surpluses further.

Discount rate

The Accounting Standards require the discount rate to be based on yields of high quality (usually AA-rated) corporate bonds of appropriate currency, considering the term of the relevant pension scheme's liabilities.

Figure 2 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 30 September 2024.

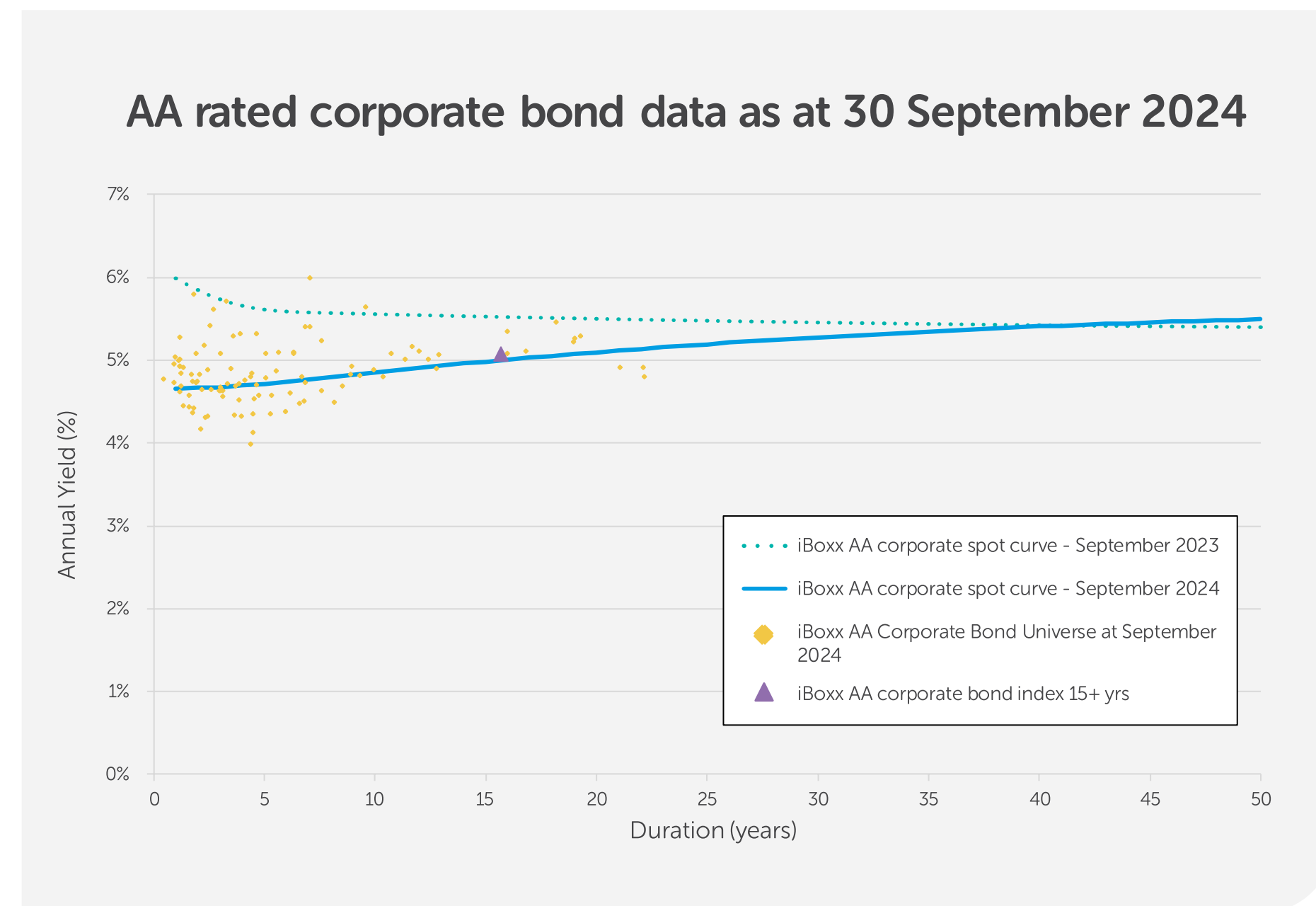
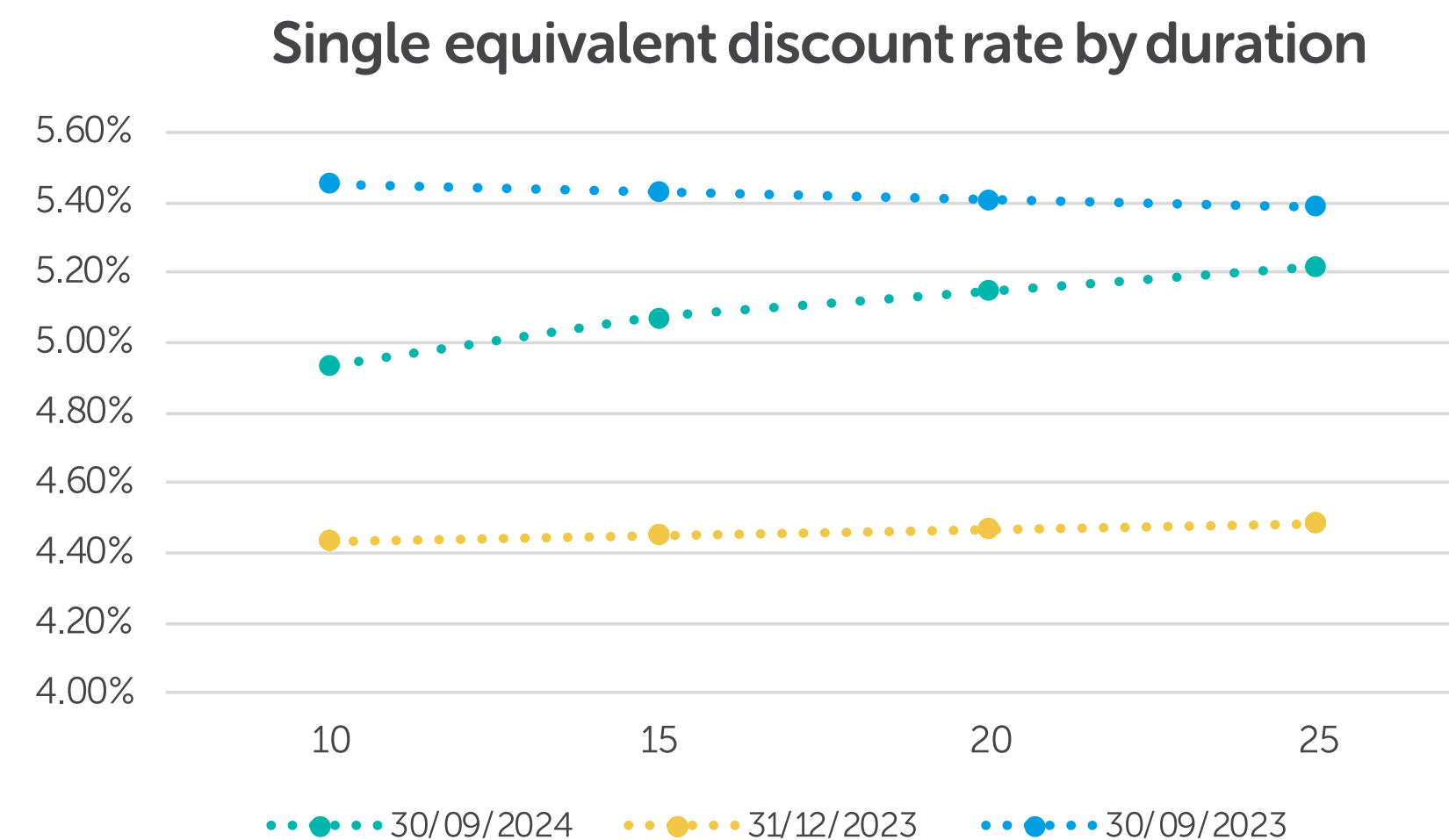


Figure 2: AA Corporate bond universe at 30 September 2024
Data Source: iBoxx

The variation in yield by term is different to a year ago, with the curve being upward sloping as terms rise compared to slightly downward sloping last year. This effect should be reflected in the choice of discount rate.

A common method to reflect the shape of the 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 the audit firms prefer this approach to be used.

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



Source: Barnett Waddingham model

Key factors for setting discount rates:

- **Choice of bond 'universe'** - 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 up to 0.35% per annum (pa) to the rate implied by the standard AA rated corporate bond data set is likely to be appropriate. Consideration will also be needed on whether to include all bonds. For example, there may be outliers in the data or 'pseudo public sector' bonds which could be excluded.

- **Curve fitting method** – the model chosen to fit the yield curve will need to be robust and a decision will be needed to on how to extrapolate the curve at longer durations, where there may be no, or very limited bond yield data available.

- **Duration** – the discount rate will vary by duration, so unless actual scheme cashflows are being used then the selected single equivalent discount rate from the model should be based on an equivalent duration to the scheme.



Inflation

Retail Prices Index (RPI)

As can be seen from the RPI inflation yield curve in Figure 3, market-implied future expectations vary depending on the term being considered. Consequently, inflation assumptions are normally set to be a single equivalent rate based on the full inflation curve. The key factors when setting the RPI inflation are:

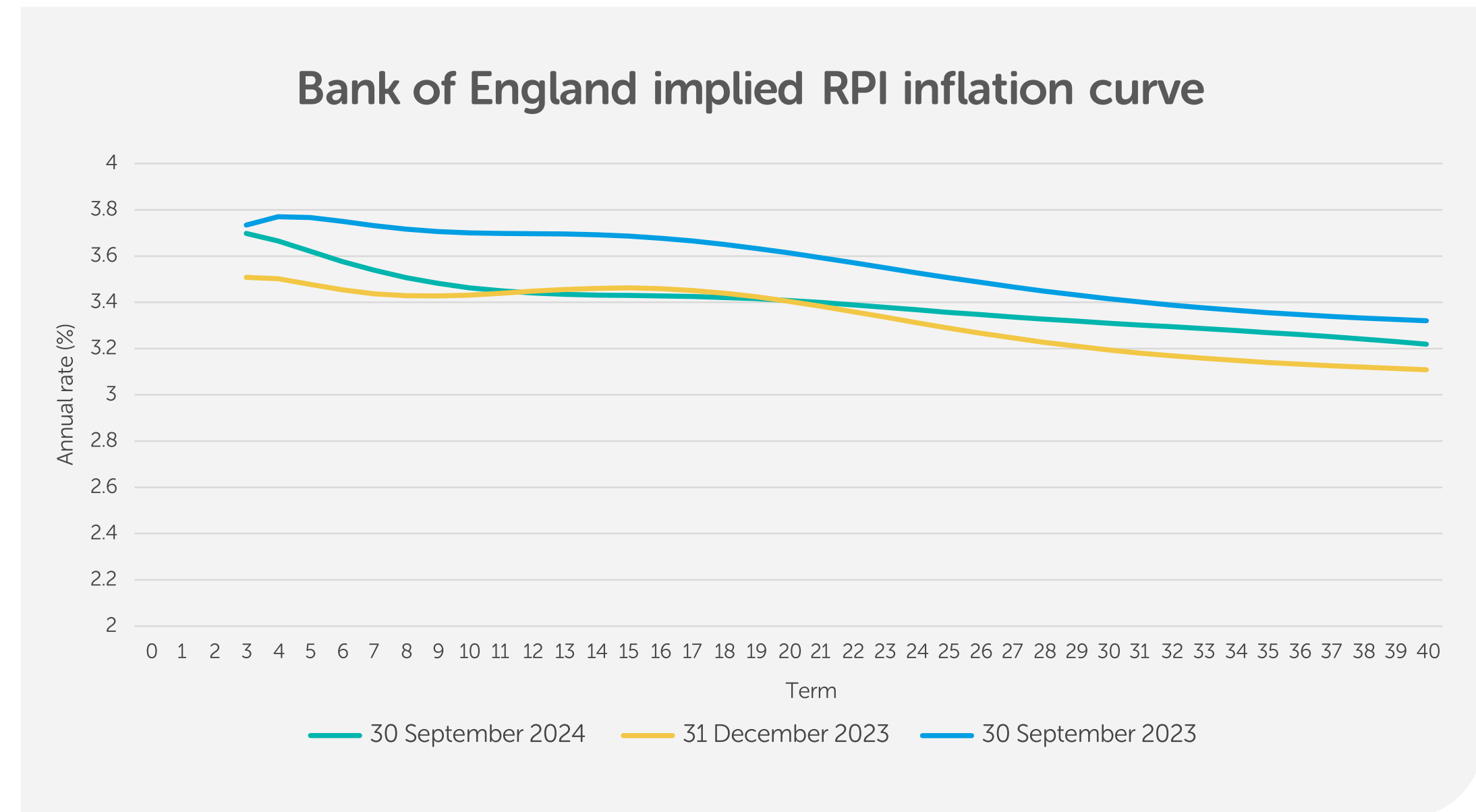
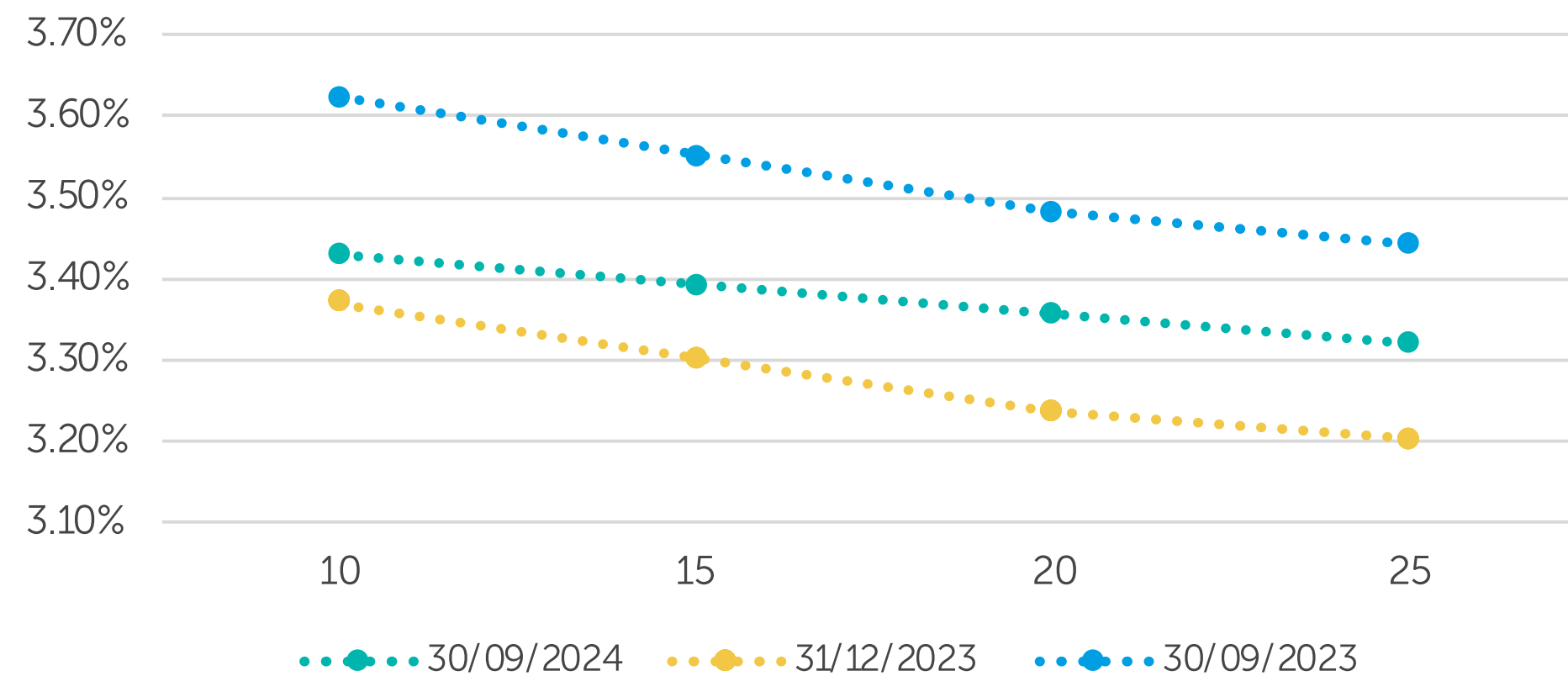


Figure 3: Spot inflation curves (annualised)
Data Source: Bank of England

The chart 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:

Single equivalent RPI inflation assumption by duration



Source: Barnett Waddingham model

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.
- 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.

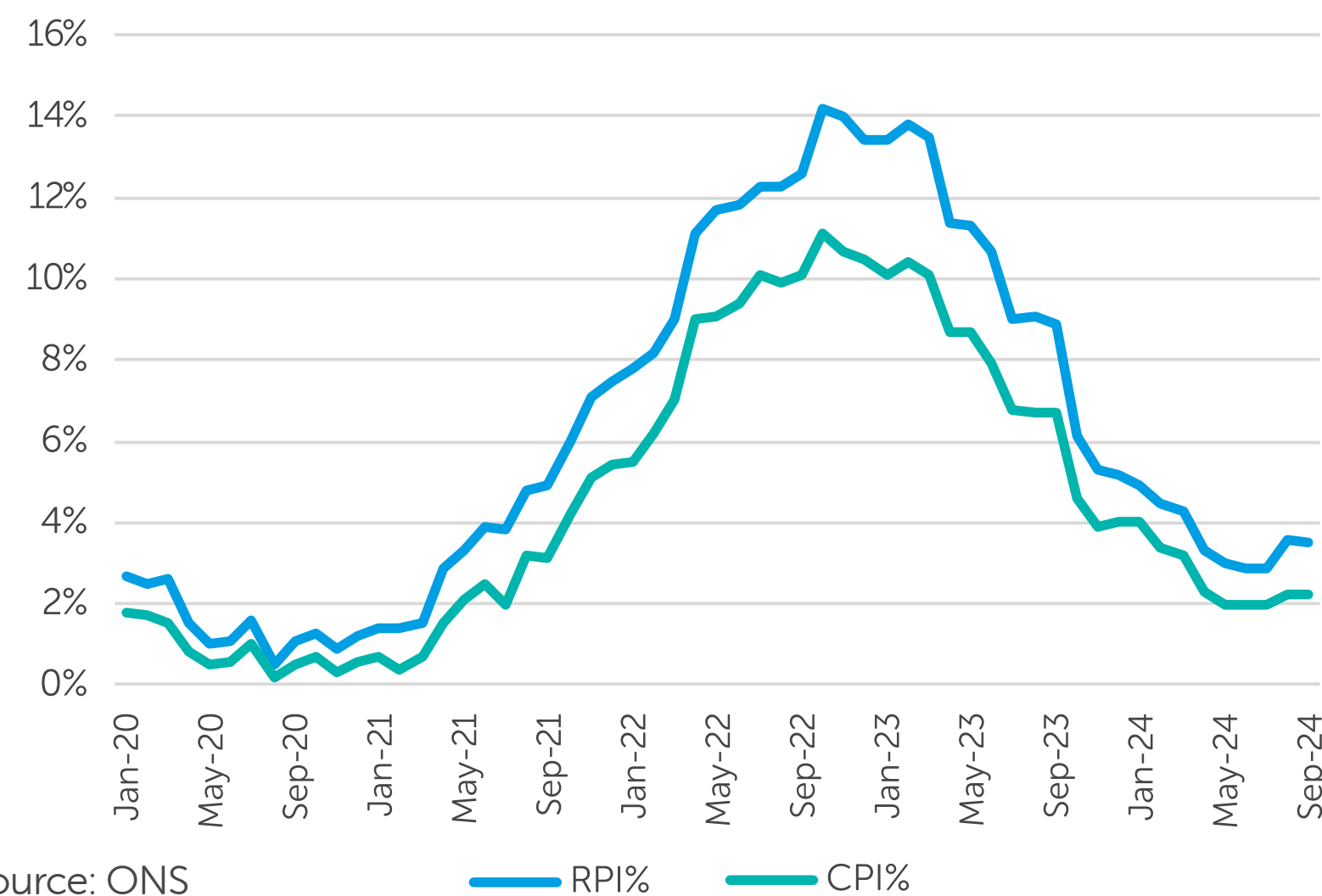
In December 2023, the ONS announced it is changing the way housing costs will be measured from February 2024 onwards. This results in a much stronger argument for there to be a slight difference between CPI and CPIH going forwards, of up to around 0.2% p.a.

An appropriate CPI assumption at 30 September 2024 is likely to be based on the gap remaining at around 1% p.a. 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 there is now expected to be difference between CPI and CPIH following the ONS announcement.

Allowing for recent high levels of inflation

The chart below shows the progression of inflation in the UK since 2020, with RPI and CPI respectively reaching as high as 14.2% and 11.1% in October 2022, although easing significantly since.

UK inflation measures since 2020



Source: ONS

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.

Current issues in pensions financial reporting

Mortality

Demographic assumptions used for accounting disclosures can have a significant impact on accounting figures – the most significant of these is mortality assumption. While 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.

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, 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.

BW 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.

The choice of weight parameters in CMI_2023 will depend on companies' views of future mortality in light of the pandemic. We expect 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).

Please read [this blog](#) from our longevity specialists for our current thinking on mortality assumptions.



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



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:

✉ employers@barnett-waddingham.co.uk

☎ 0333 11 11 222

www.barnett-waddingham.co.uk

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