

# Accounting for pension costs - FTSE100

Survey of assumptions used at 31 December 2014





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## I am pleased to present the results of our fourteenth annual survey of the pensions accounting disclosures made by FTSE100 companies.

The survey shows that despite making significant contributions and seeing falling long-term inflation expectations over 2014 many schemes have made little progress towards reducing deficits. In fact the overall deficit for the companies in the survey increased by nearly £5bn, as gains from contributions, asset returns and falling inflation expectations were entirely offset by increases in liabilities caused by reductions in discount rates resulting from plummeting corporate bond yields.

The survey also shows that while funding levels remain above the lows seen at the end of 2009 they remain some-way below the levels seen between 2006 and 2008.

Our survey showed that the average discount rate at the end of 2014 decreased by 0.9% p.a. when compared to 2013, which has been driven by the corresponding fall in bond yields. The increase in liabilities was mitigated to a limited extent by reduced long-term inflation expectations in the UK at the year end with the average assumption for inflation falling by 0.3% p.a.

In many cases, particularly where the scheme has significant holdings of gilts, bonds or other liability hedging strategies are in place, the damage to the balance sheet will have been tempered by the strong performance on the asset side. Although many schemes have retained significant shortfalls, overall funding levels are broadly comparable with 2013.

We hope that this analysis will be helpful to companies in formulating their own assumptions under IAS19 (or FRS17).

### **Martin Hooper**

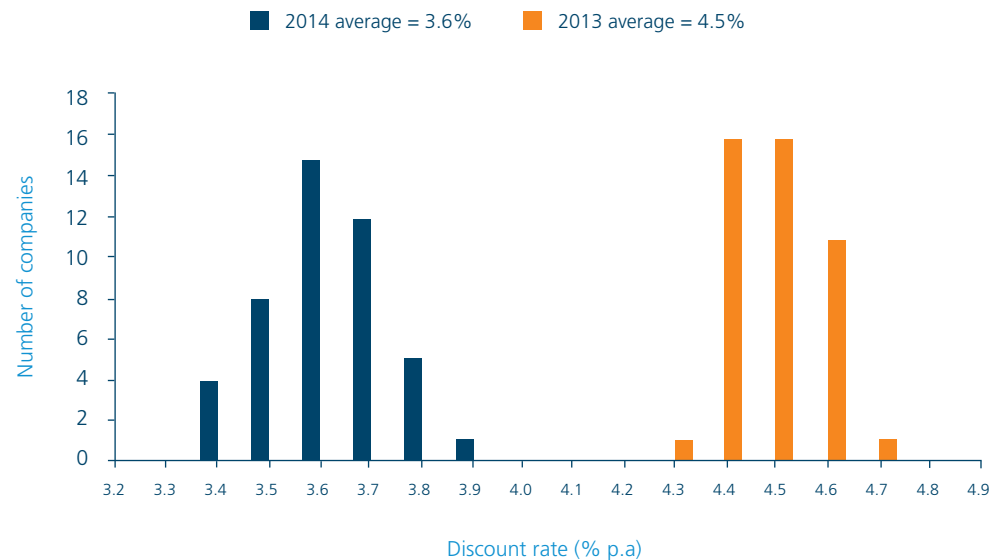
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## Discount rate

The discount rates used by the companies in our survey are set out below.

**Discount rate (% p.a.) - rounded to the nearest 0.1%**



At 31 December 2014, the yield on the iBoxx and Merrill Lynch over 15 year AA-rated corporate bond indices were 3.4% and 3.3% p.a., respectively (2013: both 4.4% p.a.).

Out of 45 companies, 44 disclosed a discount rate assumption between 3.3% p.a. and 3.8% p.a. in their pension liability calculations. This compares to a range between 4.4% and 4.6% seen for the majority of companies in 2013.

Year ending	iBoxx over 15 year AA-rated corporate bond index % p.a.	Merrill Lynch over 15 year AA-rated corporate bond index % p.a.	Average discount rate % p.a.
31 December 2014	3.4	3.3	3.6
31 December 2013	4.4	4.4	4.5

For a typical scheme with a duration of around 20 years, the year-on-year fall in the discount rate of 0.9% would add nearly 20% onto the liabilities with all other things being equal.

The majority of companies continue to choose a discount rate that is at least several tenths of a percent above the yields on the iBoxx and Merrill Lynch indices. As in previous years, this is likely to reflect the fact that most pension scheme liabilities have durations significantly longer than the bonds that make up the indices. As yields on corporate bonds continue to generally increase by term, companies are using discount rates above the index yield to account for the duration of their scheme's liabilities.

It may also reflect the adoption of 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.

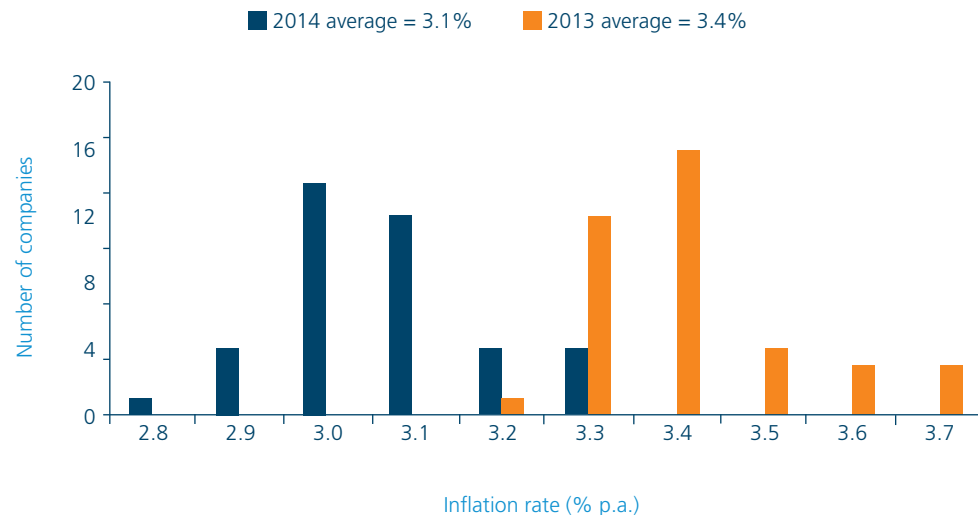
The trend of declining discount rates over the last few years has been a major contributor to increasing pension liabilities and the limited progress made in reducing deficits. If not already doing so, companies should carefully consider their approach in setting the discount rate, particularly where an index yield approach may be overstating their accounting liabilities. Taking specific account of the duration of a scheme's liabilities may lead to an alternative, more appropriate assumption being used, which may result in lower accounting obligations.

## Inflation rate

The Bank of England implied 'Retail Price Index (RPI) inflation spot rate' at 20 years (based on the difference between the yields on fixed interest gilts and index linked gilts) was 3.3% p.a. as at 31 December 2014 (2013: 3.7% p.a.). Most companies in the survey assumed that RPI inflation would be lower, with the average at 3.1% p.a.

Judging by the difference between the market and disclosed assumptions, it is likely that at least some allowance is being made for an 'inflation risk premium'. This is based on a view that investors are willing to pay more for index linked gilts because of the inflation protection they receive. If this is true, it would mean that the difference between fixed interest and index linked gilts is artificially large.

**RPI Inflation rate (% p.a.) - rounded to the nearest 0.1%**



Year ending	RPI inflation spot rate*	Average RPI inflation assumption % p.a.
31 December 2014	3.4	3.1
31 December 2013	3.7	3.4

\* Bank of England implied 'inflation spot rate' at 20 years

The market implied expectation for long-term RPI inflation has decreased from 3.7% p.a. in 2013 to 3.4% p.a. in 2014. The average RPI inflation assumption adopted by the companies in our survey has shown a similar decrease from 3.4% p.a. to 3.1% p.a. This fall in inflation expectations will have reduced liabilities, although the effect for individual schemes will depend on the proportion of benefits linked to inflation.

Many schemes now have benefits increasing with reference to the Consumer Prices Index (CPI), and over the last 20 years CPI has been 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 1.1% p.a. In 2015, the Office for Budget Responsibility (OBR) estimated the gap between RPI and CPI to be around 1.0% p.a., which is lower than their previous estimate in 2011 of 1.3% to 1.5% p.a.

Only a small number of companies in our survey disclosed both an RPI and CPI assumption. The average CPI assumption adopted as at 31 December 2014 was 2.1% p.a. (2013: 2.5% p.a.), around 1.0% p.a. lower than RPI. This is a slightly higher difference than the 0.9% p.a. that was observed in 2013. The RPI-CPI gap disclosed by a relative minority of companies at 31 December 2014 ranged from 0.7% to 1.1% (2013: 0.5% to 1.1%).

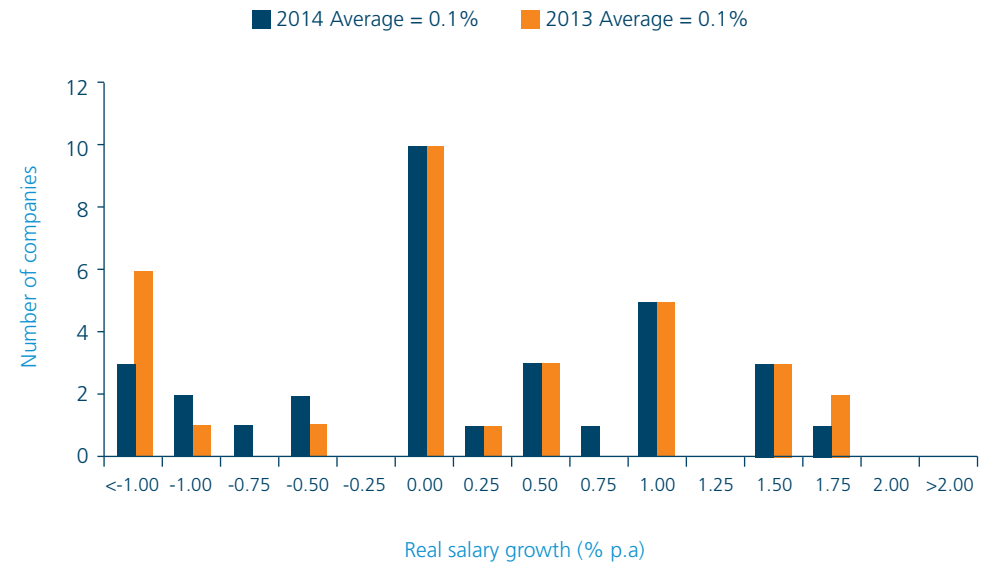
## Salary increases

Some companies may use a scale for promotional salary increases in addition to a general salary growth assumption and therefore a comparison of the disclosed salary increase rate assumptions may not be like-for-like in all cases.

We have nevertheless shown below the disclosed salary increase assumptions used relative to the assumed rate of RPI inflation (i.e. real salary growth). The average real salary growth assumption was 0.1% p.a. in 2014, which represents no overall change from 2013.

Some companies in the survey have pensionable salary growth assumptions below inflation, reflecting decisions to cap increases in pensionable salary at a level below the rate of inflation or where pensionable pay has been frozen altogether.

**Real Salary Growth (% p.a.) - rounded to the nearest 0.25%**

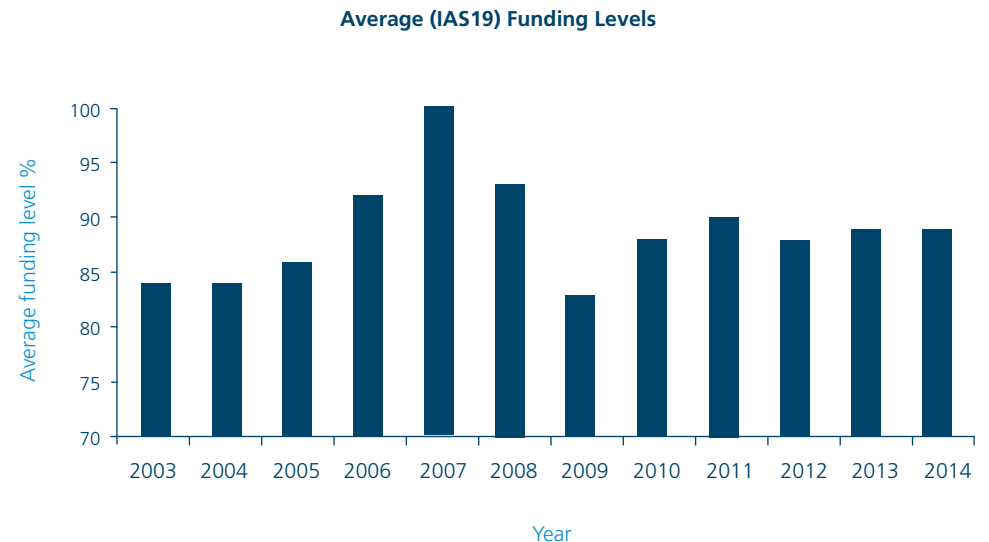
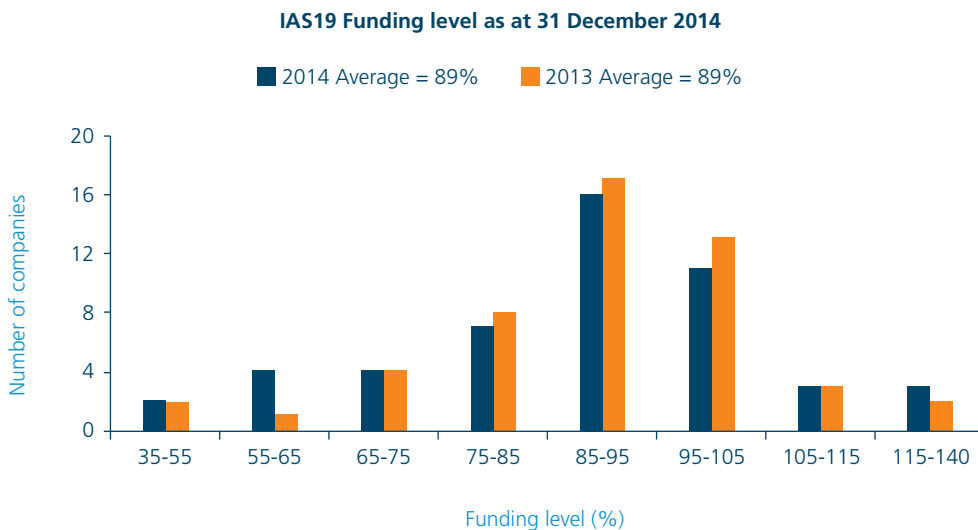


## Surplus/deficit

The (mean) average IAS19 funding level for the companies in our survey was approximately 89% in 2014 (2013: 89%). This result shows that the funding level for many companies has remained consistent compared with the previous year, despite the significant drop in discount rates.

The relative calm in IAS19 funding levels was brought about by a combination of contributions and scheme assets performing better than expected in the period to 31 December 2014 coupled with a not inconsiderable fall in the assumed level of future inflation.

The median funding level fell (from 91% to 89%) whilst the proportion of schemes that were greater than 95% funded also fell marginally from 36% to 34%, indicating that the 2014 year-end disclosures still made painful reading on the whole for finance directors, especially where the company had made significant deficit contributions.

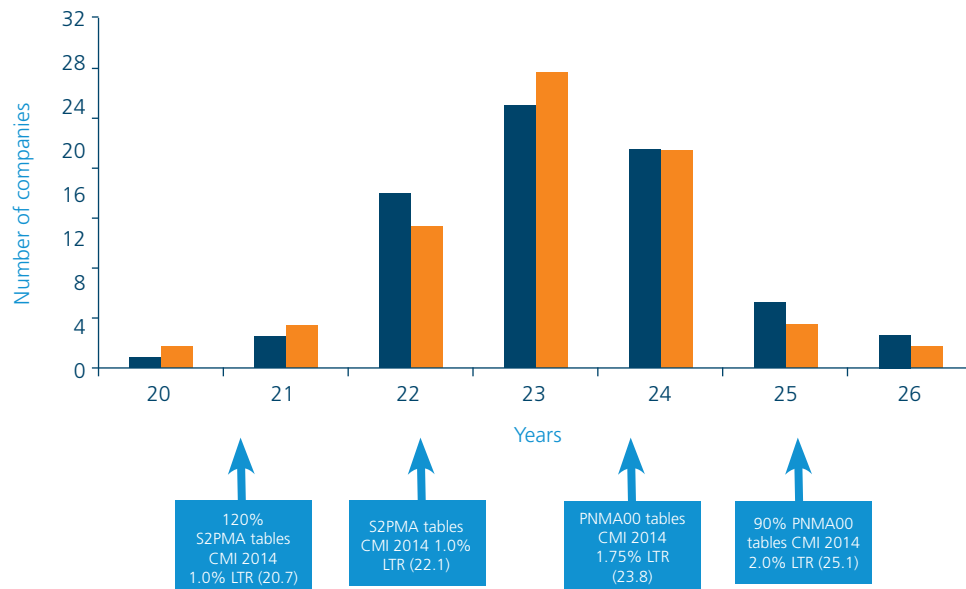


## Life expectancy

The majority of companies in this year's survey disclosed information on their life expectancy assumption, either by stating the assumed life expectancy or by referring to the mortality tables used for both this year and the previous year, allowing comparisons to be drawn. We have shown below the life expectancy assumptions for a male aged 65 and also indicated the life expectancies implied by some typical mortality tables.

### Life Expectancy - Male aged 65 (to the nearest year)

■ 2014 Average = 23.3    ■ 2013 Average = 23.2

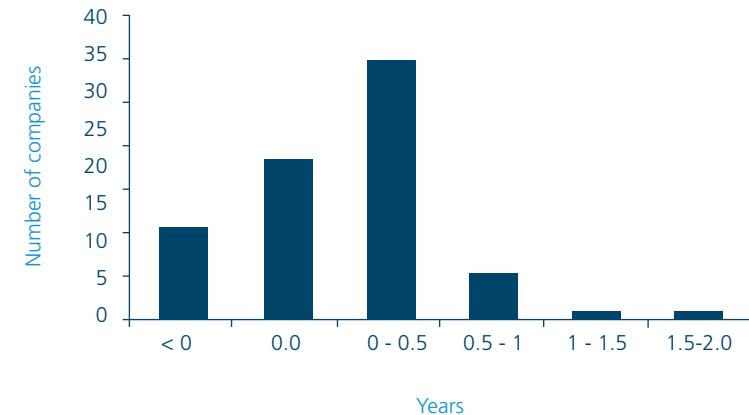


The following chart shows the changes to life expectancy assumptions from 2013 to 2014 for the 75 companies that stated a life expectancy assumption in their 2014 accounts (presented as the effect on the life expectancy for a male aged 65 at the year-end).

The average life expectancy assumption increased by 0.1 years in 2014 i.e. the average life expectancy in 2014 was 23.3 years compared to 23.2 years in 2013. This is a smaller improvement compared with the previous year and is probably in line with the longevity gains than would be expected solely due to improvements over the year.

### Change in Life Expectancy since 2013

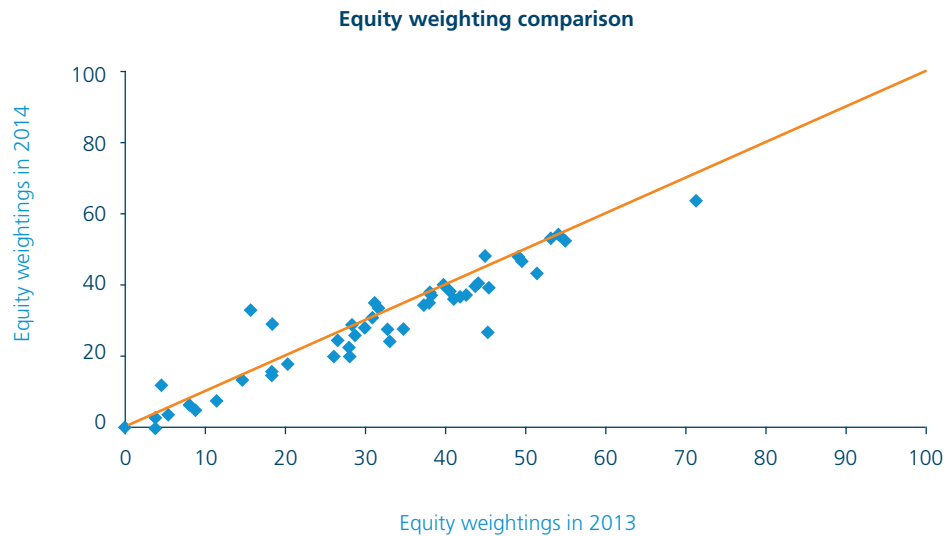
■ Average improvement, 0.1 years



## Asset allocation

The chart below shows the percentage of assets invested in equities for companies in the 2014 survey, compared with the percentage invested in equities by the same companies in the 2013 survey. The straight line represents an unchanged equity weighting from 2013 to 2014. Those companies that fall below the line have a lower equity weighting at the end of 2014, than at the end of 2013.

The majority of the 49 companies disclosing an asset allocation fall below the line, which is likely to be a natural consequence of strong returns on protection assets, with bonds yields falling markedly over 2014 although it will also reflect a general trend of schemes actively taking steps to reduce the risk in the scheme by moving to safer asset classes.



## How we 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/FRS102 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/FRS102, 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.




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Waddingham**  
a true partnership approach

## Impact of Pensions on UK Business Coming soon (July 2015)

**Look out for our 5th annual report examining the impact of pension schemes on businesses in the FTSE350.**

Once again, we will be taking a close look at the affect of DB schemes on different aspects of the business.

Our research aims to help stakeholders in understanding the challenges posed by DB schemes and provides the ideal opportunity to benchmark your company against the largest companies in the UK in terms of DB risk.



We hope that this analysis  
is helpful to companies  
in formulating their own  
assumptions under IAS19  
(or FRS17).

For further information, or to discuss any of these issues further, please contact your usual Barnett Waddingham consultant or the Corporate Consulting team on:

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