

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.

### 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:

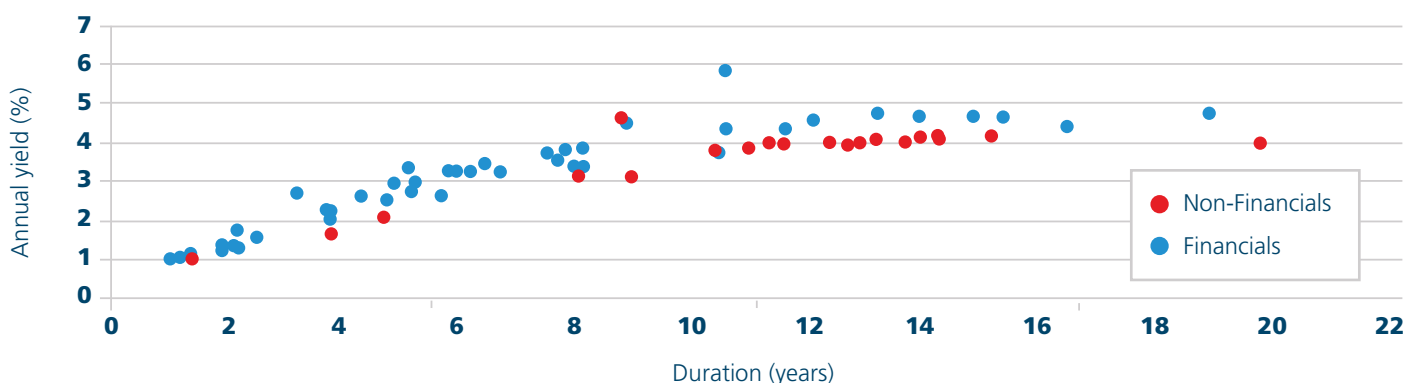
Index (annualised yield)	30/09/2013	30/06/2013	30/09/2012
ML Sterling Non-Gilts AA over 15 years	4.20%	4.27%	4.07%
ML Sterling Corporates AA over 15 years	4.28%	4.46%	4.06%
iBoxx Sterling Corporates AA over 15 years	4.32%	4.52%	4.02%
Over 15 Year Fixed Interest Gilts	3.44%	3.46%	2.92%

At the end of Q3 2013, the yields on bonds of all types were lower than those at the end of Q2 2013. However, the yields are higher now than they were at 30 September 2012. This is likely to result in slightly higher discount rates being adopted for accounting purposes to those adopted last year.

The difference between the yield on the over 15 year AA-rated non-gilts index and the over 15 year AA-rated corporates only index reduced over the quarter, mainly due to the issuance of lower yielding corporate bonds.

Figure 1 shows the individual yields on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index as at 30 September 2013.

**Figure 1:** Individual yields as at 30 September 2013 on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index



## 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 30 September 2013 is approximately 14 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 have flattened out at the longer durations. This is a slight change to the trend observed over the previous few quarters where the curve continued to slope upwards even at longer terms.

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 above the index yield if the duration of the scheme's liabilities is longer than the index. Based on Figure 1 and extrapolating beyond the yield on the longest duration AA bonds, it could be possible to justify discount rates of 4.5%-5% p.a. for immature schemes. As ever, consistency with the approach adopted in previous years should be considered.

We have seen an increasing number of 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. Since last year there was a trend of narrowing credit spreads and this continued over the quarter, arguably suggesting greater confidence in the corporate bond markets. During the year a number of financial companies were downgraded by the ratings agencies, which means that there is now less weight to that sector in the index.

## Inflation

### Retail Prices Index

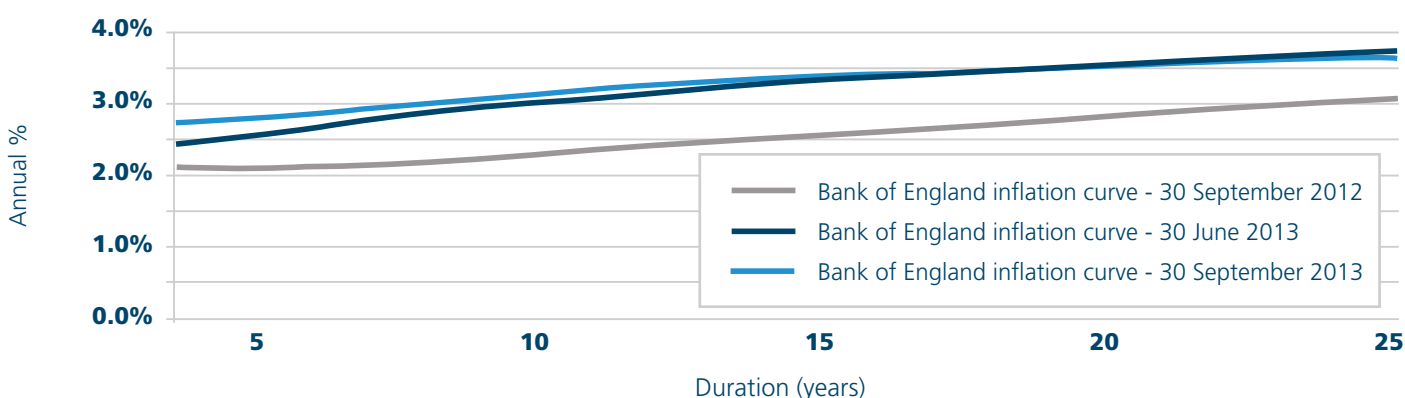
The table below shows a sample of market implied long-term inflation rates. As can be seen from the inflation yield curve in Figure 2, market implied inflation varies considerably depending on the term being considered. It may, therefore, be appropriate to adopt an inflation assumption appropriate to 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. The justification for including an inflation risk premium is arguably less strong under current market conditions due to the high level of demand for fixed interest gilts.

Index (annualised rate)	30/09/2013	30/06/2013	30/09/2012
Bank of England 20 year market implied inflation	3.54%	3.56%	2.81%
Bank of England 15 year market implied inflation	3.38%	3.33%	2.54%

Figure 2: Spot inflation curves (annualised)



Implied rates of future inflation have remained largely unchanged during Q3 2013, especially at the longer durations, but are significantly higher than those of a year ago. Allowing for a higher implied inflation rate would in isolation result in higher pension scheme liabilities (to the extent that benefits are linked to inflation).

## 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 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 1.0% p.a.

Towards the end of 2011, the Office for Budget Responsibility 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 FTSE 100 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 note.*

## IAS19 standard

The International Accounting Standards Board (IASB) published a revised IAS19 standard in June 2011 which is intended to simplify and improve the quality of disclosures made about employee benefits plans. It will also have a real impact on the disclosed profits of companies with defined benefit (DB) plans. The new standard was formally endorsed by the EU in June 2012 and is effective for accounting periods beginning on or after 1 January 2013, although early adoption is encouraged.

The key changes to the standard were summarised in our [30 June 2012 Current Issues in Pensions Financial Reporting](#) and further detail was provided in our [31 December 2012 Current Issues in Pensions Financial Reporting](#).

Entities may be required to disclose information about the potential impact of the changes to their accounts for the period ending on the current review date and, following adoption of the revised standard, the effect on the accounts in the period of adoption (and any prior periods presented in the accounts).

## Financial Reporting Council issues FRS102

On 5 March 2013, the Financial Reporting Council Board formally approved the new UK accounting standard, FRS102. With regard to accounting for pension schemes, this 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, and early adoption is permitted for periods ending on or after 31 December 2012.

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 and how group and multi-employer plans must account for their pension arrangements.

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 schemes in future, and it is only possible to take this approach for multi-employer plans (with more than one participating employer where these are not under common control) if there is insufficient information to use DB accounting methods. It is likely that entities will need to make disclosures as to the impact of the changes during the transition.

## Directors pension disclosures from 1 October 2013

On 20 June 2012, the Secretary of State for Business, Innovation and Skills announced a package of measures to address failings in the corporate governance framework for directors' remuneration. A consultation ran from 27 June 2012 to 26 September 2012, seeking views on the draft regulations.

The basic principle of the new Companies Act is to disclose a single figure for directors' remuneration from year to year, together with supporting additional information. The value of pension benefits earned over the year will be calculated in a similar way to that used to assess the liability for tax under the Annual Allowance rules, rather than reflecting the change in Cash Equivalent Transfer Value (CETV). The new regulations apply for accounting periods ending from 1 October 2013.

UK listed companies (or at least those with a "premium" listing) are also required to comply with the Listing Rules for accounting disclosures, which are currently based around the CETV approach.

The Financial Conduct Authority (FCA) is therefore committed to reviewing the Listing Rules and has published a consultation on its proposed changes (closing on 9 October 2013) where UK listed companies will only need to comply with the Companies Act requirements in relation to remuneration reports. However, any changes will not take effect until 1 January 2014.

It seems that any UK listed companies with year end dates between 1 October 2013 and 1 January 2014 will need to comply with the existing Listing Rules in addition to the new Companies Act requirements.

## Other Pension Accounting Issues

### Recent Market Volatility

Equities are generally at a much higher level than they were at this time last year, although accounting liabilities are also likely to be higher for those schemes with a significant proportion of benefits linked to inflation.

The overall effect of market movements will differ for schemes depending on their asset allocation. Schemes with a significant proportion of their assets invested in equities are likely to see improvements in their accounting positions (over the 12 months to 30 September 2013), especially if a higher discount rate is adopted. However, ignoring deficit contributions and scheme experience, the improvement in the accounting position for many schemes (particularly those with a significant portion of benefits linked to inflation) are likely to be offset by higher inflation assumptions being adopted.

### 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 forthcoming changes to IAS19 on their accounting figures.

### Survey of assumptions used by the FTSE100 as at 31 December 2012

Our twelfth annual survey of FTSE100 pensions accounting assumptions has revealed that 96% of companies increased their IAS19 discount rate at 31 December 2012 relative to the yield on a long-term AA bond index.

The survey focuses on the assumptions adopted by FTSE100 companies for determining the value of their pension liabilities for accounting purposes. FTSE100 companies will be disappointed that despite £12bn being paid into DB schemes during 2012 there has been no improvement in IAS19 funding levels. The full survey is available on our [website](#).

### 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 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 DB 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.

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](mailto:corporateconsulting@barnett-waddingham.co.uk)

+44 (0) 20 7776 2200

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OCTOBER 2013  
BWT089

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