Briefing | 30 September 2019

Current issues in pensions financial reporting

RISK | PENSIONS | INVESTMENT | INSURANCE

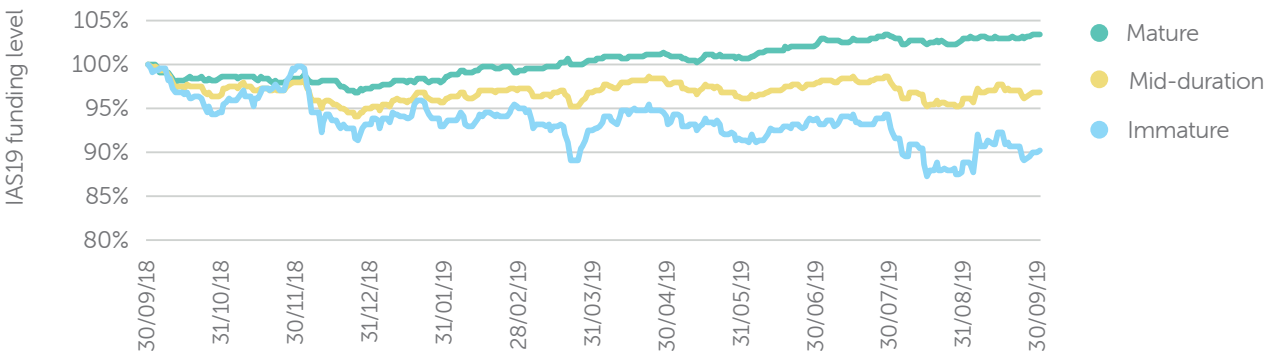
This note is for those who will be involved in preparing and auditing pension disclosure under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (US listed) as at 30 September 2019.

We look at the current topical issues as well as the considerations for company directors when setting assumptions, and for auditors in determining whether the assumptions are appropriate.

A mixed picture for funding levels

The movement in funding level over the period will depend on the investment strategy adopted by the pension scheme and the chart below shows how this may have developed for three typical schemes.

PROGRESSION OF IAS19 FUNDING LEVEL FOR TYPICAL SCHEMES



Source: Barnett Waddingham model

For companies reporting at 30 September 2019 the chart shows that there is likely to be a wide variety of outcomes. For mature schemes, who are likely to have hedged the majority of their interest rate risk and have a low level of exposure to equity markets the funding position may have improved. For less mature schemes, who are still taking significant levels of investment risk, increases in liabilities will not have been matched by growth in asset values.

For those companies reporting half-year figures, the position is slightly more positive, with mid-duration schemes seeing little change since 31 March 2019 and the more mature scheme seeing a slight improvement. Immature schemes however might still be expected to see a significant fall in the funding level. These conclusions are similar for those companies with reporting dates of 31 December 2018 who will currently be looking ahead to the year-end.

There may also be a further small reduction in liabilities from moving to the latest version of the mortality projection models, which continues to show slowing improvements in life expectancy resulting in lower life expectations.

Proposed changes from RPI to CPIH in 2030

The Government has recently proposed changing the RPI inflation statistics to bring RPI in line with the "CPIH" index. Currently there are three main measures of consumer price inflation in the UK: the Retail Price Index ('RPI'), the Consumer Price Index ('CPI') and CPIH. CPIH became the UK's primary inflation measure in 2017 and essentially takes CPI and adds a measure of owner occupied housing. If the changes go ahead then, from 2030, index-linked gilt payments will implicitly be linked to CPIH due to the change of the makeup of the RPI statistic. If RPI is aligned with CPIH then RPI would be expected to be lower in future and, all else being equal, the value of index-linked gilts would fall and real yields would likely rise.

Following the news of the proposal there appears to have been a c. 0.3% pa fall in the market's expectations, as measured by the difference in prices between fixed and index-linked gilts, for post 2030 RPI (this is the total combined fall on 4 September 2019 following the recent announcement, and on 17 January 2019 following the original House of Lords report on RPI that has led to this issue). The expected difference between RPI and CPIH over the long-term is around 1% pa so the market does not appear to be allowing for the full impact of the potential change at present.

If the changes do go ahead (and the Chancellor's letter suggests that the changes will go ahead) this would significantly reduce the value of long-dated index-linked gilts, unless compensation is given to holders. RPI-linked pension liabilities would also fall in value, but CPI-linked pension liabilities would likely be largely unaffected.

In relation to accounting assumptions, companies will need to review the methods used for setting both RPI and CPI assumptions going forward in light of the market's reaction to the proposed changes.

Changes to IAS19

For reporting periods beginning on or after 1 January 2019 there is a change to the requirements of IAS19 where either a plan amendment, curtailment or settlement event has occurred during the period.

At present, companies are required to remeasure the assets and liabilities to assess the impact of the event on profit and loss (P&L), but other items in the P&L are unaffected. Going forward, however, the current service cost and net interest cost will need to be recalculated for the remainder of the accounting period based on the remeasured position.

This creates the possibility that relatively modest augmentations that are accounted for as a plan amendment will have a more significant effect on the P&L charge if, for example, the deficit has increased significantly since the previous year end.

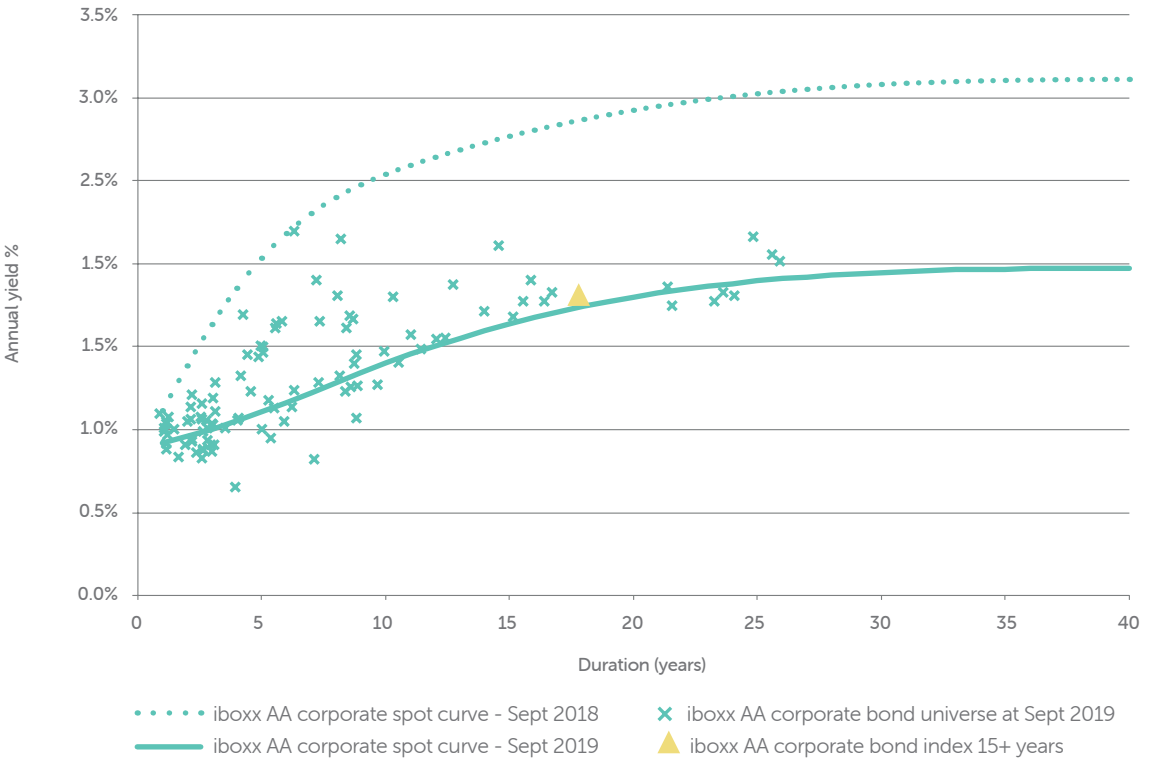
Companies who have already had events qualifying as a plan amendment, curtailment or settlement will need to ensure they understand the impact of this change to IAS19 on their P&L figures for the period. The impact of future actions should also be borne in mind, and companies should seek to establish with their advisers and auditors whether the impact of actions is likely to be considered material enough to require remeasurement of P&L items. It may also be possible to agree trigger levels, meaning that more minor events can be ignored for this purpose.

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. Figure 1 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 30 September 2019.

FIGURE 1: IBOXX AA CORPORATE BOND UNIVERSE AT 30 SEPTEMBER 2019

Data Source: iBoxx



As can be seen in Figure 1, the yields vary significantly in the short to mid durations, but flatten out at the longer durations. 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. Figure 1 highlights how much bond yields have fallen over the year and how the spot curve has flattened.

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)	SEDR 30 September 2019	SEDR 30 June 2019	SEDR 30 September 2018
10	1.60% pa	2.05% pa	2.65% pa
15	1.75% pa	2.25% pa	2.85% pa
20	1.85% pa	2.35% pa	2.95% pa
25	1.90% pa	2.40% pa	3.00% pa

At the end of Q3 2019, single equivalent discount rates on AA corporate bonds were significantly lower in contrast to last quarter and 30 September 2018. Corporate bond yields have fallen by around 1.0% p.a. since 30 September 2018, with the a significant part of this fall in yields occuring in August 2019. This reduction in yields will result in lower discount rates being adopted for accounting purposes, compared to last year, resulting in a higher value being placed on the liabilities. Each 0.1% decrease on the discount rate would translate to an increase of approximately 2% in liabilities 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 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.

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 adjustment of 0.10% pa for shorter durations (up to around 15 years) and no more than 0.05% pa in excess of 15 years to a rate derived from the standard AA rated corporate bond data set is likely to be appropriate, which is broadly the same as last quarter.

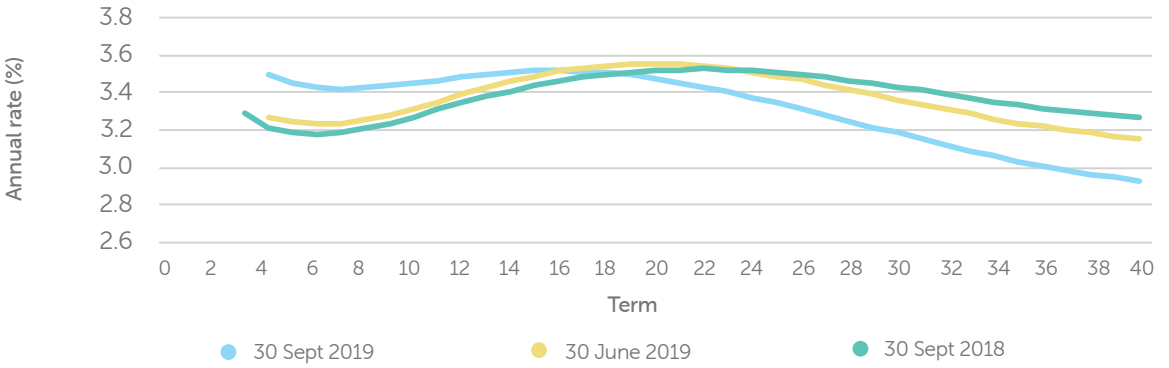
Inflation

Retail Prices Index (RPI)

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. Adopting a proxy such as the Bank of England's (BoE'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, the BoE curve indicates lower rates are appropriate at shorter terms and also declining rates at longer terms so it should be possible to justify assumptions below the spot rate at the given duration for most schemes. 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 (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 taken into account 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.

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



As shown in figure 2, for durations less than term 16, the implied rates of future inflation are higher than those observed at the previous year-end. For these shorter to mid-duration terms, schemes reporting at 30 September 2019 with inflation-linked liabilities will experience a slight increase in liability value. However, for longer durations, schemes reporting at 30 September 2019 with inflation-linked liabilities will experience a more marked decrease in liability value.

The table below shows single equivalent inflation rate (SEIR) 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)	SEIR 30 September 2019	SEIR 30 June 2019	SEIR 30 September 2018
10	3.50% pa	3.45% pa	3.45% pa
15	3.35% pa	3.45% pa	3.45% pa
20	3.25% pa	3.40% pa	3.45% pa
25	3.20% pa	3.35% pa	3.40% pa

Consumer Prices Index (CPI)

The figures above relate to inflation as measured by the 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 median 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.

Given the recent announcement about potential changes to the calculation of RPI, companies will need to review their methodology for setting the CPI assumption, especially if this is derived from market implied RPI inflation.

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.

The analysis showed a fall in average assumed life expectancy of 0.3 years between 2016 and 2017, which equates to a fall of 1.2% in the value of liabilities. This is likely to have been driven by recent evidence indicating life expectancy may not be rising as fast as previously predicted.

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.

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.

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.

Impact of pensions on UK business

Our eighth annual report considers the impact that pension provision is having on UK business over the period to 31 December 2017.

The survey offers a unique assessment of the financial impact of defined benefit pension schemes within the context of the wider finances of FTSE 350 companies. Some of the key highlights of our research are the £7 billion reduction of pension deficit of UK plc companies in 2017, and the £14 billion value of transfer payments to defined contribution schemes in 2017.

The full report 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 - FRS102, FRS101, IAS19 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. FRS102, FRS101, IAS19 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 – FRS102, FRS101, IAS19 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 employers@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 get in touch via the following:

employers@barnett-waddingham.co.uk 0333 11 11 222

www.barnett-waddingham.co.uk