Briefing

Current Issues in Pensions Financial Reporting

30 SEPTEMBER 2018

The key financial assumptions required for determining pension liabilities under the Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (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.

Funding levels have improved, but significant risks remain

Companies due to report at 31 December 2018 are likely to show some improvement in pension funding position on those positions reported both at the prior year end and at 30 June for the half year position. Despite a continued mixed picture for asset returns in 2018, meaning that asset values are likely to see little increase over the year, there has been a rise in AA corporate bond yields, which will serve to increase discount rates and reduce liability values. However, for schemes with significant amount of inflation linked liabilities this gain will be partially offset by rises in inflation expectations.

For those companies with a year-end reporting date of 30 September, the position is likely to be improved on last year as the flat asset returns of 2018 were boosted by the better than expected returns in Q4 of 2017. These companies will also see some movement in liability values resulting from increased discount rates, and increased inflation expectations.

While the picture ahead of the year end appears to suggest improved position, market volatility in early October and the prospect of deadlock in the Brexit negotiations means there is still potential for the gains to be reversed.

GMP Equalisation

Guaranteed Minimum Pension (GMP) is a special tranche of pension for contracted-out service prior to 6 April 1997, intended to replace a sacrificed part of the state pension. In July 2018, Lloyds Bank went to court together with its pension scheme trustees and trade unions, seeking clarification as to whether its pension schemes are obligated to equalise GMP benefits between members of different sexes. It is expected that the High Court will provide greater clarity on the nature of such obligations and may set industry practice with regards to the methodology to be used.

It is unclear at this time what the appropriate approach of accounting for GMP equalisation will be. Based on preliminary consultations with audit firms, it appears that auditors are leaning towards treating these liabilities as past service costs. If this were the case, auditors would consider the impact of GMP equalisation on scheme liabilities to represent a P&L charge.

> The impact is very much dependent on individual schemes' benefit structures, but based on our experience to date we might expect to see overall liability values increase by around 1%-4%. For many companies this could be a huge impact on P&L.

It remains to be seen if there will be any flexibility with regards to how the additional liabilities are recognised. A potential alternative to the above approach would be to treat them as a remeasurement in other comprehensive income, leading to no P&L charge. It may also be possible to restate prior year figures on the grounds that there was always an obligation to equalise GMPs.

It will be important for companies to engage with this issue well ahead of the year-end and be prepared for any adjustments that have to be made to disclosures to account for GMP equalisation.

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.

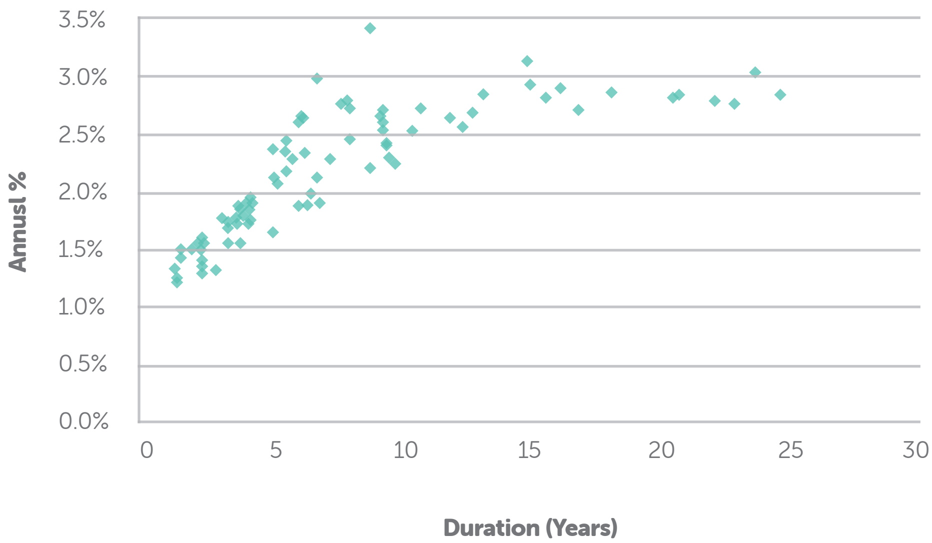
The table below shows some of the key market indices that could be taken into account when deriving the discount rate. The yield on government bonds (gilts) is also shown for comparison:

Index (annualised yield)	30 Sep 2018	30 Jun 2018	30 Sep 2017
ML Sterling Non-Gilts AA Over 15 years	2.55%	2.41%	2.50%
ML Sterling Corporates AA Over 15 years	2.70%	2.58%	2.58%
iBoxx Sterling Corporates AA Over 15 years	2.81%	2.72%	2.64%
Over 15 Year Fixed Interest Gilts	1.87%	1.68%	1.85%

At the end of Q3 2018, yields on AA corporate bonds were higher than they were last quarter and also higher than those at 30 September 2017. This will result in higher discount rates being adopted for accounting purposes compared to last year. Each 10 bps increase on the single equivalent discount rate would translate to a decrease of approximately 2% in liabilities for a scheme with a 20 year duration.

Figure 1 shows the individual yields on the bonds making up the iBoxx AA Corporate Bond universe as at 30 September 2018.

iBoxx AA Corporate bond universe at 30 September 2018



Data Source: iBoxx

Figure 1

As can be seen in Figure 1, the yields vary significantly in the short to mid durations, but flatten out at the longer durations. The duration of the iBoxx Sterling Corporates AA over 15 years as at 30 September 2018 is 15.70 years but this is generally shorter than the duration of most pension schemes' liabilities. 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.

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 below the index yield if the duration of the scheme's liabilities is shorter than the index. For longer durations, yields are generally above the index and by extrapolating beyond the yield on the longest duration AA bonds the maximum discount rate it may be possible to justify discount rates above 3.0% for immature schemes. As ever, consistency with the approach adopted in previous years should be considered.

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.

It may 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 no more than 0.05% pa to a rate derived from the standard AA rated corporate bond data set is likely to be appropriate which is broadly the same as a quarter ago.

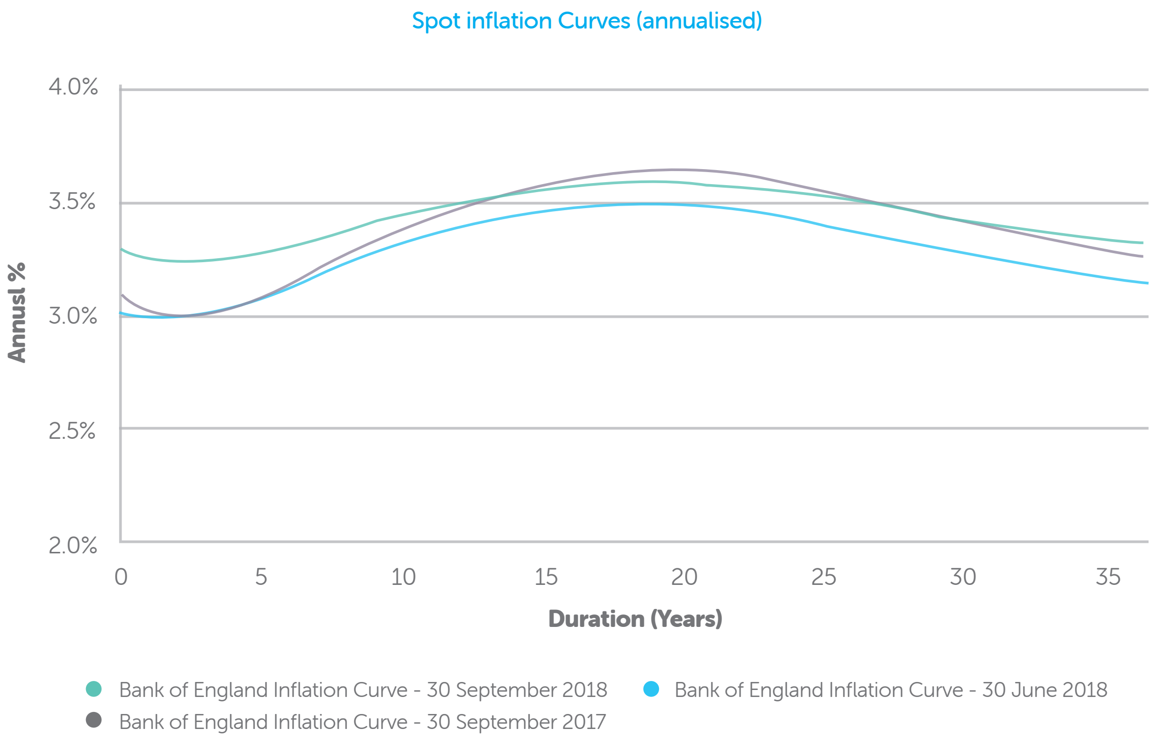
Inflation

Retail Prices Index (RPI)

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 expectations for the future vary 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 (BoE's) inflation spot rate at a duration equivalent to the scheme's liabilities. 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.

Index (annualised rate)	30 Sep 2018	30 Jun 2017	30 Sep 2017
Bank of England 20 year market implied inflation	3.58%	3.48%	3.61%
Bank of England 15 year market implied inflation	3.50%	3.40%	3.47%



Data Source: Bank of England

Figure 2

Implied rates of future inflation are 10 to 15 bps higher this quarter than the rates observed at the previous quarter for all all durations. These rates fall broadly in line with rates observed a year ago, for durations greater than 15 years, although expectations at shorter terms have risen. For those schemes reporting at 30 September 2018 with inflation-linked liabilities, this will serve to increase the liabilities, partially offsetting any decrease arising from a fall in discount rates.

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.

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.

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 approximately a 1.2% fall 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.

We have 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.

The current UK framework

The Financial Reporting Council (FRC) UK accounting standards:

- FRS101: Reduced Disclosure Framework
- FRS102: The Financial Reporting Standard
- FRS104: Interim Financial Reporting
- FRS105: The Financial Reporting Standard applicable to the Micro-entities Regime

We look at each of these in more detail:

FRS101: Reduced Disclosure Framework

FRS101 sets out a reduced disclosure framework for qualifying entities. A qualifying entity is a member of a group where the parent of that group prepares publicly available consolidated financial statements and where that member is included in the consolidation, but other criteria must also be met.

This effectively means that subsidiaries of groups preparing accounts in line with IFRS can apply consistent accounting policies with those group accounts, but can also take advantage of disclosure exemptions to reduce the time and cost of preparing accounts.

There are some restrictions; charities may not be qualifying entities, and qualifying entities who prepare consolidated financial statements, either because they are required to do so or they do so voluntarily, may not apply FRS101.

FRS102: The Financial Reporting Standard

FRS102 is a single reporting standard that has replaced the old UK GAAP (comprises a number of Financial Reporting Standards, Statement of Standard Accounting Practice and Urgent Issue Task Force). The accounting standard addresses a specific area of accounting, including transitional provisions and specific requirements for specialised entities. Specific requirements for specialised entities is comprised with public benefit entities, retirement benefit schemes and financial institutions.

FRS102 makes it difficult to account for group plans (with more than one participating employer where these are under common control) as defined contribution (DC) schemes in future, as at least one group company will need to account for the scheme on a defined benefit (DB) basis.

It is only possible to account for multi-employer plans on a DC basis (with more than one participating employer where these are not under common control) if there is insufficient information to use DB accounting methods. Further, if such an entity wishes to use DC accounting and has agreed contributions to fund a deficit it will need to reflect the present value of these on its balance sheet and the impact of any revisions as an expense.

The FRC has published a revised version of FRS102 following a review carried out last year. The amendments do not appear to have a significant impact on accounting for pension schemes although it may lead to some changes to the way group plans are accounted for.

FRS104: Interim Financial Reporting

FRS104 does not in itself require any company to prepare an interim statement but may be used by companies which are required to produce interim financial statements under other rules (for example because they are listed). FRS104 is based on the interim reporting requirements of IAS34, which may be used by some entities instead of FRS104, and replaces the ASB Statement Half-yearly financial reports. The revision is intended to bring interim reporting into the new framework but does not make any changes to which entities are required to prepare interim reports.

Disclosure requirements under FRS104 are based on those under FRS102 for annual financial statements. For pensions, the FRC has stated:

- the cost of a defined benefit plan for an interim period is calculated on a year-to-date basis
- the defined benefit obligation can be approximated based on the latest actuarial valuation and adjusted for changes in member demographics

FRS104 became effective for interim periods beginning on or after 1 January 2015.

FRS105: The Financial Reporting Standard applicable to the Micro-entities Regime

FRS105 is an accounting standard intended for financial statements of companies which qualify for the micro-entities regime. It is based on FRS102 but its accounting requirements are adapted to satisfy the legal requirements applicable to micro-entities and to reflect the simpler nature and smaller size of micro-entities. FRS105 is effective for accounting periods beginning on or after 1 January 2016 though early application is permitted. The FRC withdrew the Financial Reporting Standard for Smaller Entities (FRSSE) from 1 January 2016, with any companies previously subject to this regime who do not qualify for Micro-entities regime being subject to FRS102 going forward.

IFRIC14 and IAS19

The International Accounting Standards Board (IASB) has finalised its proposed amendments to IAS19. The changes to IAS19 will take effect from the first annual reporting period that begins on or after 1 January 2019. The amendments include a requirement for profit and loss items (current service cost and net interest) to be recalculated following an event which triggers remeasurement of assets and liabilities, such as amendments, curtailments, and settlements. This could be significant for those that rely on profit and loss charges being fixed at the start of the year.

The IASB had also proposed amendments to IFRIC14 were intended to address how the powers of other parties, such as the trustees of the plan, affect an employer's right to a refund of a surplus from the plan.

Broadly, these proposed amendments to IFRIC14 change the circumstances where an entity could be deemed to have an 'unconditional right' to a surplus, and require restriction of the amount recognised if the trustees of the scheme have a unilateral power (in the scheme rules) to use a surplus for other purposes (e.g. settling liabilities in full, making benefit improvements or by triggering a wind-up).

For example, this could result in some schemes which are closed to future benefit accrual no longer being able to recognise a surplus (as was the case under the old UK GAAP and FRS17). However, this restriction under FRS17 was relaxed under FRS102, and therefore such a change to IFRIC14 would once again lead to different treatment between UK GAAP and IFRS.

The IASB, following further consideration of the likely impact of the amendments, has carried out further work to see if it is possible introduce a more principles based approach under IFRIC14 for companies to assess and measure their right to a surplus refund. The preliminary conclusion is that this appears to be feasible but it looks as though further work on this has been put on hold for the time being until the IASB has tackled another long standing issue – how to account for schemes which provide an investment return guarantee. No timetable has been given for completing this work.

Yield curve approach to accounting

A number of companies in the US are beginning to use a "yield curve" approach to calculating interest cost and service cost components of the Net Periodic Benefit Cost for defined benefit obligations under ASC715. By applying a term dependent spot rate to the present value of each future cashflow, it is possible to reduce these costs since the current shape of the yield curve would lead to a lower interest rate (when compared to the single equivalent discount rate) being used for the interest cost calculation. This approach would also lead to a reduction in the service cost as it would utilise the higher interest rates for longer duration liabilities. Note, under this alternative approach, the present value of future benefit cashflows at the measurement date, formally known as the 'Projected Benefit Obligation' will be unchanged from the current approach of using a single equivalent discount rate.

The Securities and Exchange Commission has responded by stating that they would not object to moving to this approach. However, they did state that once a company moved to this approach, they would not expect them to move back to using a single equivalent discount rate. They also noted that appropriate disclosures about the change, such as the effect it would have, would be required.

The IASB and ASB have not yet given any indication of whether this approach is acceptable under IFRS or UK GAAP but the net interest approach used for IAS19 / FRS102 means there is unlikely to be a significant benefit for UK schemes of moving (unless they are unfunded or very badly funded).

Further information

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively, please email corporateconsulting@barnett-waddingham.co.uk.

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.

BARNETT WADDINGHAM
beyond the expected

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 DB pension schemes within the context of the wider finances of FTSE350 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 DC schemes in 2017.

The full report is available on our website

Survey of assumptions used by the FTSE100 as at 31 December 2017

Our seventeeth annual survey of FTSE100 pensions accounting assumptions revealed an increase in IAS19 funding levels over the year to 31 December 2017.

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 - 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 corporateconsulting@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