Briefing | 30 June 2019

Current issues in pensions financial reporting

RISK | PENSIONS | INVESTMENT | INSURANCE

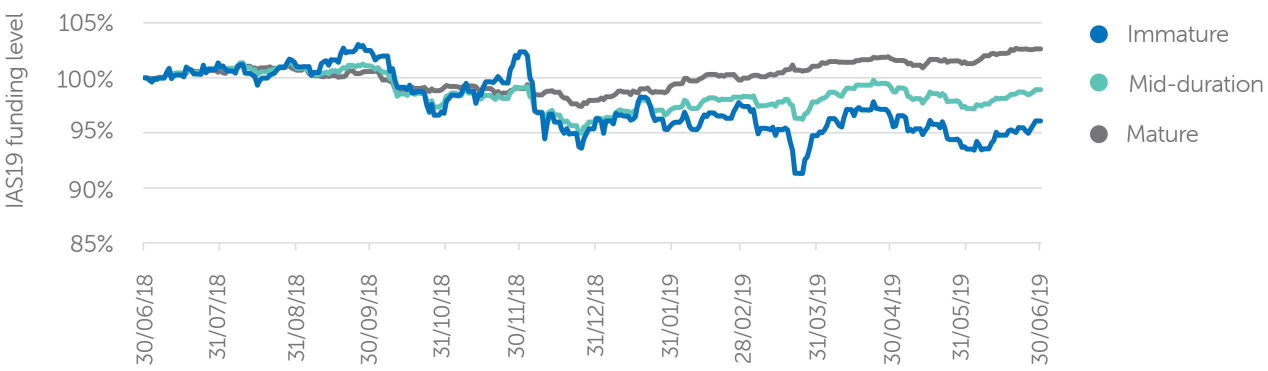
This note is for those who will be involved in preparing and auditing pension disclosures, under Accounting Standards FRS102 (UK non-listed), IAS19 (EU listed) and ASC715 (US listed) at 30 June 2019.

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

A mixed picture for funding levels

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

PROGRESSION OF IAS19 FUNDING LEVEL FOR TYPICAL SCHEMES



Source: Barnett Waddingham model

For companies reporting at 30 June 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 may not have been matched by growth in asset values.

For companies reporting half-year figures, the position is slightly more positive, with immature schemes seeing little change since 31 December 2018 and the more mature schemes seeing a marked improvement. There may also a further small reduction in liabilities from moving to the latest version of the mortality projection models, which continues to show slower improvements in life expectancy (see below for further details).

New mortality tables and projections

The Continuous Mortality Investigation (CMI) Mortality Projections Model, is widely used in the industry to model future improvements in mortality rates. The model is based on assumptions that current observed rates of mortality improvement will converge to a long-term rate over a period of time. The latest version of the model, CMI_2018, was published in March 2019.

The core parameters for the updated model places more weight on recent experience, which has shown lower improvements and has resulted in lower life expectancies. As a result, the CMI_2018 core model will reduce liability values as at 30 June 2019 in comparison to previous years. However, there is likely to be greater focus going forward on the use of the core parameters, which makes no allowance for differing mortality improvements between different groups of the population. There is some evidence to suggest that those in higher socio-economic groups are experiencing faster improvements in life expectancy than the general population. Similar evidence is also emerging from the experience of occupational pension scheme members.

The CMI recently produced an updated mortality rates table of members of defined benefit self-administered pension schemes. The "S3" dataset provides the most recent mortality assumptions. The dataset is significantly larger than the previous set of tables (the "S2" series), and a greater proportion of the experience relate to members of public sector schemes. For this reason, the S3 series is not directly comparable to the S2 series and any adjustments applied to S2 series tables to reflect scheme specific experience are unlikely to be appropriate for the S3 series.

Most schemes will need to undertake an analysis of appropriate mortality assumptions at their next full actuarial valuation and the results will influence the selection of mortality assumptions for accounting purposes.

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.

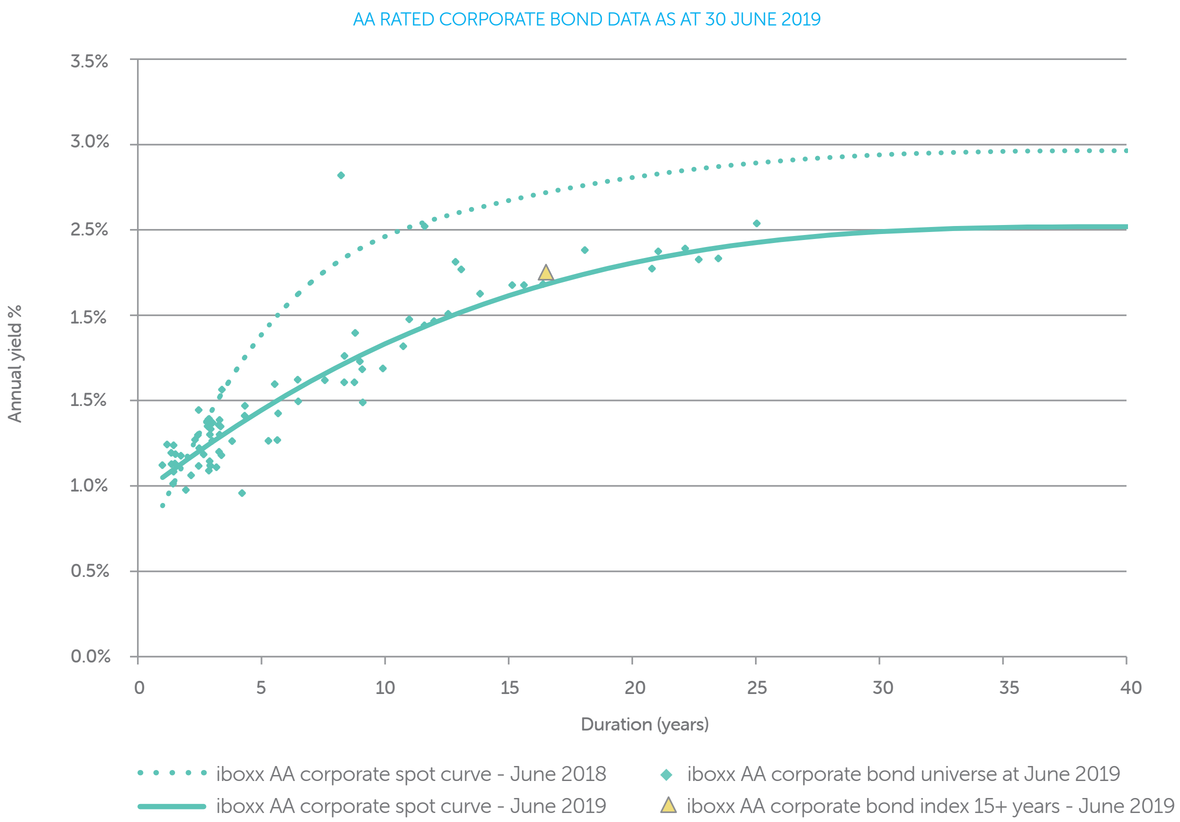
Discount rate

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 June 2019.

Figure 1: iBoxx AA Corporate bond universe at 30 June2019

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 June 2019	SEDR 31 March 2019	SEDR 30 June 2018
10	2.05% pa	2.20% pa	2.55% pa
15	2.25% pa	2.35% pa	2.70% pa
20	2.35% pa	2.50% pa	2.80% pa
25	2.40% pa	2.50% pa	2.85% pa

At the end of Q2 2019, single equivalent discount rates on AA corporate bonds were lower in contrast to last quarter and 30 June 2018. This 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% increase on the discount rate would translate to a decrease 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 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. This depends 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 a quarter ago.

Inflation

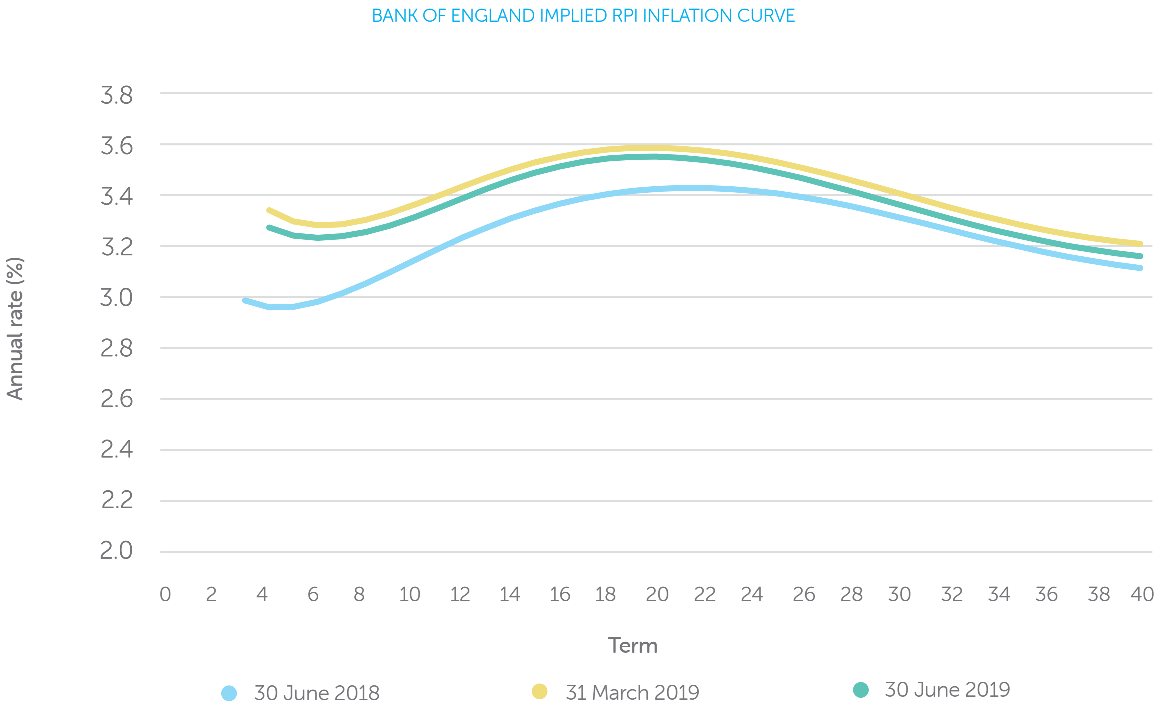
Retail Prices Index (RPI)

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. For example, 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, the implied rates of future inflation are higher than those observed at the previous year-end. For those schemes reporting from 30 June 2019 with inflation-linked liabilities, this is likely to mean a slight increase in liability value although this impact will depend on the maturity of the liabilities.

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 June 2019	SEIR 31 March 2019	SEIR 30 June 2018
10	3.45% pa	3.50% pa	3.30% pa
15	3.45% pa	3.50% pa	3.35% pa
20	3.40% pa	3.45% pa	3.30% pa
25	3.35% pa	3.40% pa	3.30% pa

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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.

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 converted 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.

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.

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Illuminate - Instant scenario testing

Pension schemes can have a significant impact on a company's accounting position. We have added an interactive modelling tool in order to help finance directors understand and quantify the factors influencing the financial position of the scheme, so 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.

Survey of assumptions used by the FTSE 100 as of 31 December 2017

Our 17th annual survey of FTSE 100 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 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. This is 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 a 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.

Accounting consolidation

The year-end pension consolidation process can be hard work. Consolidating multiple arrangements in different currencies, from different advisers, into a single disclosure note can be challenging. Often these need completing in a very short space of time, putting the finance team under a huge amount of pressure.

Our cloud based Account software enables us to consolidate your pension scheme disclosures quickly and efficiently, providing you with a full audit trail and easy access to see how things are progressing. We have harnessed changes in working and technology in recent years to move away from the traditional consolidation approach of updating figures provided prior to the year end. We can now capture year-end figures directly from your local actuary within minutes to give you a more accurate and robust year-end process.

Please get in touch if you would like a demo or find out how we can save you time and cost at the year-end.

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:

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