

Current Issues in Pensions Financial Reporting

The key financial assumptions required for determining pension liabilities under the FRS17 Accounting Standards (FRS102 for accounting periods beginning on or after 1 January 2015) are the discount rate and the rate of future inflation.

There are a number of considerations for university Finance Directors to take into account when setting these assumptions and for auditors in determining whether the assumptions are appropriate. This note, aimed specifically at those involved in the preparation of pension disclosures of University Self Administered Trusts (SATs), sets out some of the technical issues relevant to those involved in the preparation and the audit of pension disclosures.



Market update

Overseas equities, UK Government bond holdings and corporate bonds have had strong positive returns over the year so SATs with a large proportion of their assets invested in these asset classes will have fared better than those heavily invested in UK equities.

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:

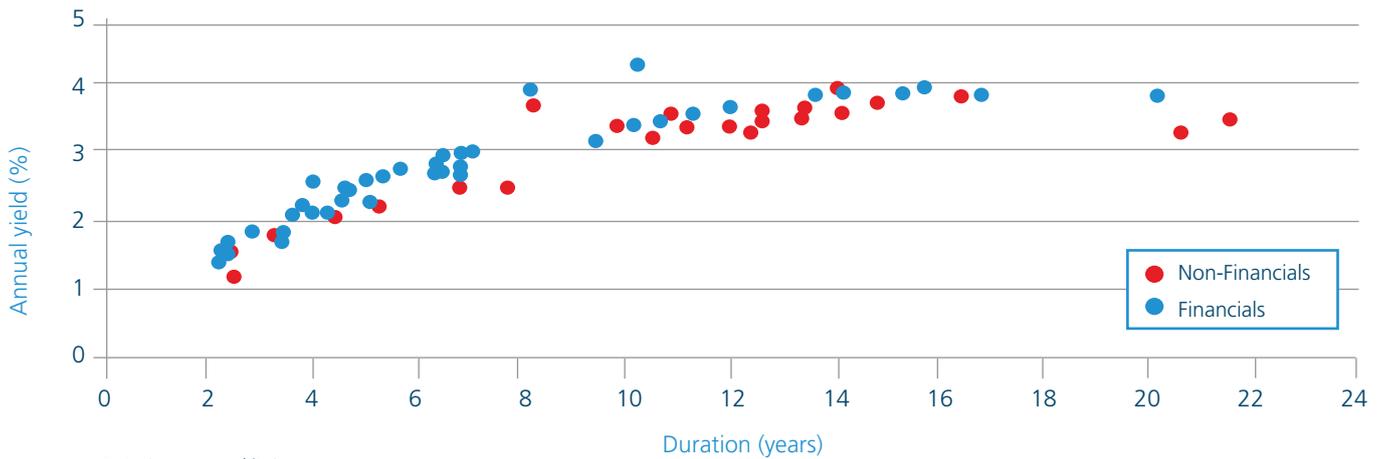
Index (annualised yield)	31/07/2015	31/07/2014	31/07/2013
ML Sterling Non-Gilts AA Over 15 years	3.36%	3.99%	4.19%
ML Sterling Corporates AA Over 15 years	3.50%	4.05%	4.31%
iBoxx Sterling Corporates AA Over 15 years	3.48%	4.08%	4.33%
iBoxx AA Corporate 20 year spot yield.	3.57%	4.25%	4.73%
Over 15 Year Fixed Interest Gilts	2.49%	3.26%	3.43%

At the end of July 2015, the yields on bonds of all types are lower than those as at 31 July 2014. This is likely to result in lower discount rates being adopted for accounting purposes to those adopted last year which, all other things being equal, will lead to higher values being placed on pension scheme liabilities.

With the transition to FRS102 and the likely need to make disclosures as to the impact of the reporting changes during the transition, increasing deficits will become more of an issue to universities.

Figure 1 (overleaf) shows the individual yields on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index as at 31 July 2015.

Figure 1: Individual yields as at 31 July 2015 on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index



Data Source: Markit Group

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 31 July 2015 is approximately 14 years and this is generally shorter than the duration of most pension schemes' liabilities. The iBoxx 20 year yield is shown in the table on page one.

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 represents a change from last year, 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. As ever, consistency with the approach adopted in previous years should be considered.

We continue to see private companies using a discount rate above the AA Corporate Bond index yield reflecting this consideration.

Our [survey of assumptions adopted by university SATs as at 31 July 2014](#) showed that the average discount rate used was 4.2% p.a. which was higher than the AA Corporate Bond index yield presumably reflecting this issue.

- 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.
- We have also seen private companies adopt 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. The standard indices are compiled by averaging the ratings given to bonds by each of the three main ratings agencies (Moody's, S&P and Fitch in the example of the iBoxx Corporate Bond Index) and including bonds that have an average rating of AA or above.

This 'single agency' approach provides a larger universe of bonds (particularly at the longer durations), to be considered when setting the discount rate. An upward adjustment of around 0.10% p.a. to the index yield is likely to be justifiable if a 'single agency' approach is deemed appropriate.

Inflation

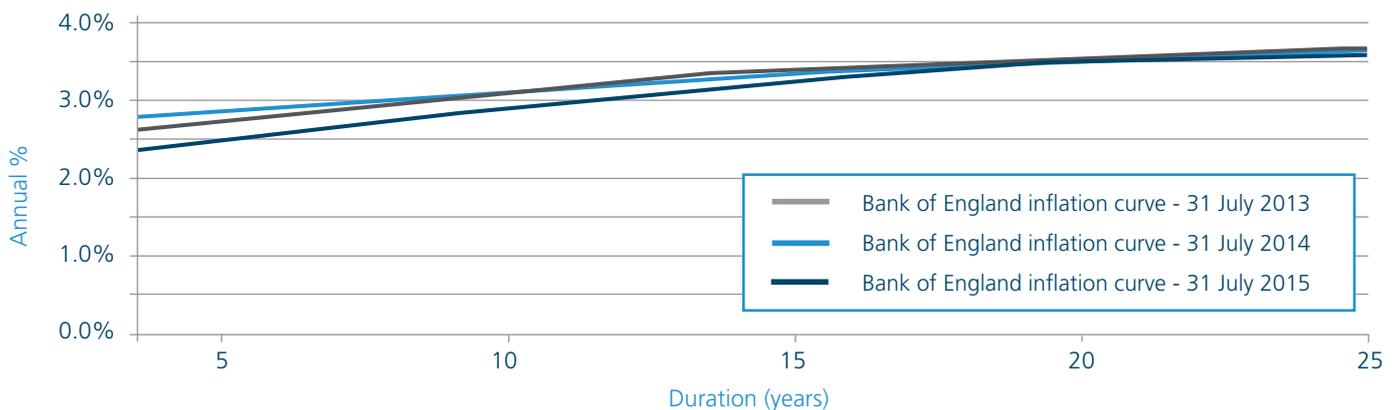
Retail Prices Index

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 expectations for the future vary 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. Adjustments of up to 0.4% p.a. are typically used to reflect this effect.

Implied rates of future inflation are at similar levels those of a year ago.

Index (annualised rate)	31/07/2015	31/07/2014	31/07/2013
Bank of England 20 year market implied inflation	3.50%	3.49%	3.54%
Bank of England 15 year market implied inflation	3.25%	3.34%	3.37%

Figure 2: Spot inflation curves (annualised)



Data Source: Bank of England

Consumer Prices Index

The figures above relate to inflation as measured by the Retail Prices Index (RPI). Many SATs also 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 1.0% p.a.

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% p.a. and 1.5% p.a. A more recent paper published by the OBR in March 2015 suggests the gap to be about 1.0% p.a. while the Bank of England central long-term estimate suggests 1.3% p.a.

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 adopted by university SATs as at 31 July 2014](#) showed a difference of up to four years in the life expectancy assumptions adopted. Each additional year of life expectancy can add around 3% to the value of SAT pension scheme liabilities and hence the chosen assumption can have a big impact on the results.

For simplicity, Finance 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 accounting disclosures 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.

Transition to FRS102

On 5 March 2013, the Financial Reporting Council Board formally approved the new UK accounting standard, FRS102. With regard to accounting for university SATs, this will replace the current FRS17 and will have implications for pensions accounting disclosures by bringing them broadly in line with the revised IAS19 standard for EU-listed entities, albeit with fewer disclosure requirements.

FRS102 is 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. In most cases this will result in an increase to the disclosed pension cost.

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 (DC) 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 defined benefit (DB) accounting methods.

It is likely that universities will need to make disclosures as to the impact of the changes during the transition.

Universities Superannuation Scheme

Currently, under FRS17, organisations with Universities Superannuation Scheme (USS) liabilities that are unable to identify their share of a pension scheme's assets and liabilities are able to account for their liabilities on a DC basis. This means that these organisations may be recording a pension expense equal to the contributions which they are required to make to their schemes in their company accounts. As a result the pension scheme asset or liability does not appear on the organisation's balance sheet.

However, the introduction of FRS102 will impact these organisations, and could require recognition of additional liabilities even if a DC accounting basis is used. Specifically, where a commitment has been made to a deficit recovery plan for a pension arrangement, a liability equal to the present value of those future deficit payments will need to be recognised on the balance sheet and any changes in this recovery plan following a valuation would need to be recognised as an additional pension expense (or credit).

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 university Finance Directors understand and quantify the factors influencing the financial position of the SAT so that they can be linked into the university'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.

University Accounting Survey - July 2014

In April 2015, we published our sixth annual survey of the assumptions adopted by UK universities for determining the value of their pension liabilities for accounting purposes. As well as participating in the Universities Superannuation Scheme (USS) and local government schemes, many universities operate their own occupational defined benefit schemes (or Self Administered Trusts) for non-academic staff.

This survey focuses on SATs and looks at the significance of these schemes in the context of the overall finances of the university as well at the assumptions used in their FRS17 disclosures as at 31 July 2014.

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 SATs. We will provide background on the theory behind the main pension accounting standards – FRS17 (FRS102) 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

☎ 020 7776 2200



3626972
August 2015

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office. Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), Barnett Waddingham Investments LLP (OC323081), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at Cheapside House, 138 Cheapside, London EC2V 6BW. Barnett Waddingham LLP is authorised and regulated by the Financial Conduct Authority and is licensed by the Institute and Faculty of Actuaries for a range of investment business activities. Barnett Waddingham Investments LLP and BW SIPP LLP are authorised and regulated by the Financial Conduct Authority. Barnett Waddingham Actuaries and Consultants Limited is licensed by the Institute and Faculty of Actuaries in respect of a range of investment business activities.