News on...

Barnett Waddingham

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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 and duration, taking into account the nature and 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 in deriving the discount rate. The yield on government bonds (gilts) is also shown for comparison:

Index (annualised yield)	31/03/2012	31/12/2011	31/03/2011
ML Sterling Non Gilts AA Over 15 years	4.66%	4.63%	5.55%
ML Sterling Corporates AA Over 15 years	4.67%	4.63%	5.52%
iBoxx Sterling Corporates AA Over 15 years	4.62%	4.68%	5.53%
Over 15 Year Fixed Interest Gilts	3.29%	2.96%	4.35%

At the end of Quarter 1 2012, the index yields on bonds of all types are significantly lower than the levels as at the end of Quarter 1 2011. This is likely to result in lower discount rates being adopted for accounting purposes which, all other things being equal, will lead to significantly higher values being placed on pension scheme liabilities. The yields on corporate bond indices were virtually unchanged over the quarter, although gilt yields have risen slightly.

Figure 1

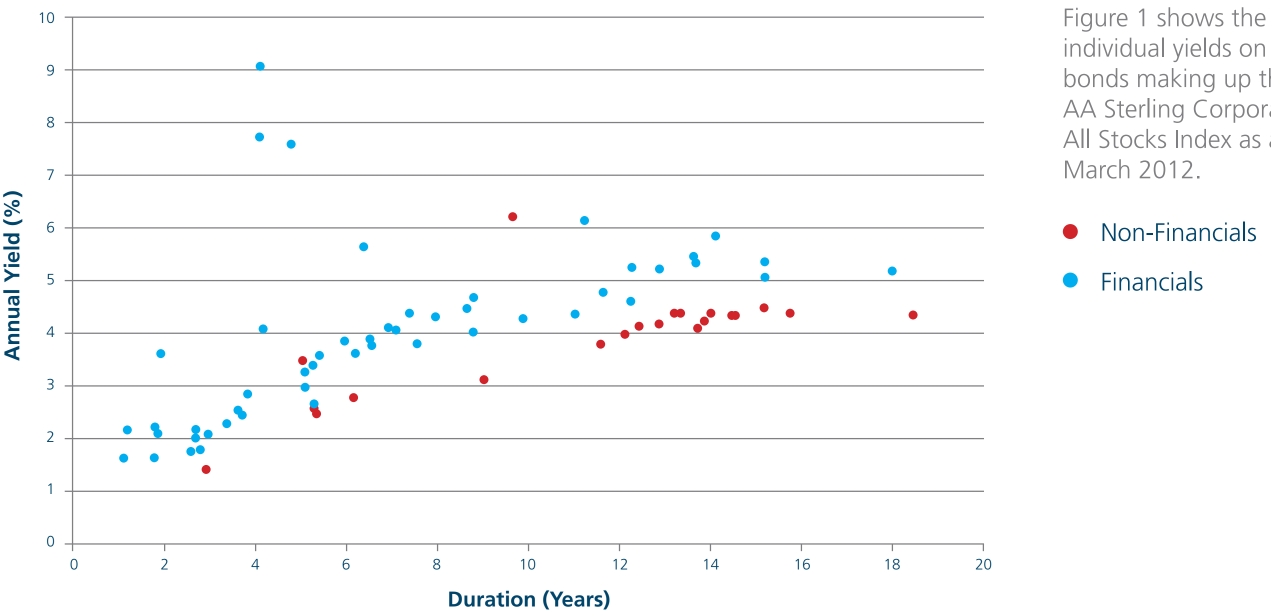


Figure 1 shows the individual yields on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index as at 30 March 2012.

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.
- It is possible to use multiple yields to discount tranches of liabilities at different durations, for example by using an AA bond yield curve rather than merely using 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.
- Yields on AA bonds issued by financial companies continue to be higher than comparable bonds issued by non-financials and the difference has increased over the quarter. This reflects continued uncertainty in the financial sector possibly due to increased concern about the exposure of financial institutions to sovereign debt. 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

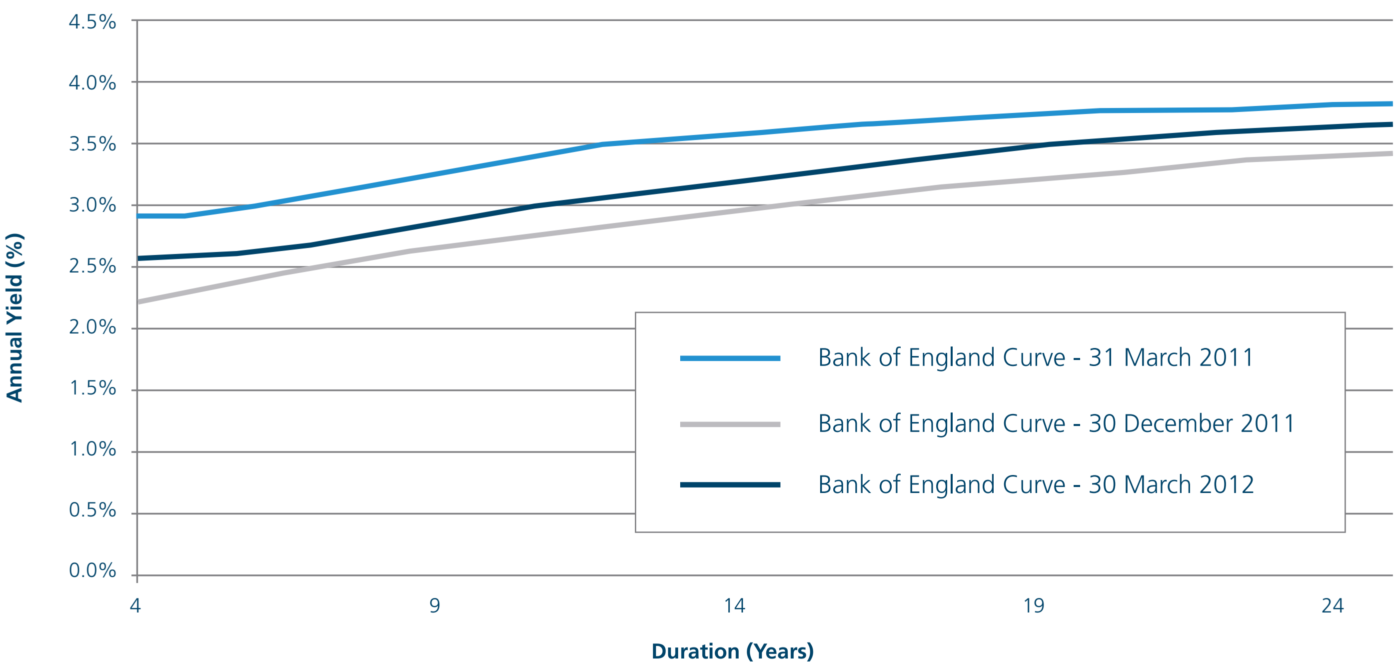
Retail Prices Index (RPI)

The table below shows the market implied inflation rates. As can be seen from the annualised inflation yield curve in Figure 2, market implied inflation varies considerably depending on the term being considered. It may, therefore, be appropriate to adopt inflation assumptions 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 less than 20 years.

There may be other considerations to take into account when choosing inflation assumptions, such as whether to adjust for a possible 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.

Index	31/03/2012	31/12/2011	31/03/2011
Bank of England 20 year market implied inflation	3.50%	3.27%	3.76%

Figure 2 **Spot Yield Curves (annualised)**



Data source: Bank of England

Implied rates of future inflation are lower than those of a year ago at all durations. However, implied rates of future inflation have increased slightly over the last quarter at all durations. Allowing for a lower implied inflation rate would result in lower pension scheme liabilities. For schemes with a significant proportion of benefits linked to inflation this will go some way towards offsetting the increase in liabilities resulting from the lower discount rate.

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 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 composition of the two indices. In 2010 a change was made to the way the indices were calculated and this is 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 of 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.

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 five 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.

Historically 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. Companies could consider reviewing their mortality assumptions to ensure they are not overly prudent and potentially overstating pension liabilities in their accounts.

Other Pension Accounting Issues

Recent Market Volatility

The large falls in equity markets over the third quarter of 2011 have been mitigated by the rises over the final quarter of 2011 and the first quarter of 2012. Coupled with the rises seen in the first half of last year, equities are generally at comparable level to last year. Those schemes holding bonds (particularly gilts) will also have benefitted from an increase in the value of these investments. Liabilities are, however, likely to be higher due to the lower discount rates.

For most schemes the funding level assessed under the accounting standards is likely to have deteriorated over the year, although not to the extent seen when measured on schemes' funding bases. Funding bases typically reference government bond yields, whereas accounting bases reference corporate bond yields. Despite their slight rise over the quarter, gilt yields have generally fallen by a greater amount than corporate bond yields over the last year, meaning scheme liabilities have increased by a greater extent on funding bases compared to accounting bases (all other things being equal).

Other Pension Accounting Issues continued...

Proposed changes to FRS17 from 2015

During the second quarter of 2011, the International Accounting Standards Board (IASB) published a revised IAS19 standard, intended to simplify and improve the quality of disclosures made about employee benefits plans (see our Current Issues in Pensions Financial Reporting 30 June 2011).

Following this, the UK Accounting Standards Board (ASB) published a financial reporting exposure draft setting out revised proposals for the future of financial reporting in the UK and Republic of Ireland and hence this will affect all companies currently reporting under FRS17.

It was originally proposed that there would be a three tier accounting structure, with "publically accountable" entities being required to use international standards (IFRS). This is now being scrapped. Entities not subject to full IFRS will be required to use FRS for Small and Medium sized Enterprises (SMEs), unless they are able to use FRS for smaller entities (FRSSE).

The FRS for SMEs is much simpler than IAS19 and requires fewer disclosures than IAS19. However, in line with the new IAS19 standard, the ASB is moving away from allowing companies to set the expected return on a Scheme's assets according to the assets actually held by the Scheme. Instead the calculation used to calculate the P&L charge will effectively assume all assets are invested in AA-rated corporate bonds.

As AA rated bonds are generally expected to produce lower returns than a typical scheme's investment strategy this is likely to increase the P&L charge for most companies.

It is proposed that the change will come into force for accounting periods beginning on or after 1 January 2015 (instead of July 2013 as previously proposed) although earlier adoption is encouraged.

What should companies be doing now?

The changes to the standards will affect companies that report under IAS19 from 2013 and all companies from 2015. Companies will need to fully understand the implications the changes will have on their financial statements. They will also need to consider any merits of early adoption as well as the likely cost implications associated with implementing the changes.

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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