Barnett Waddingham
a **true partnership** approach

Current Issues in Pensions

The key financial assumptions required for determining pension liabilities under the Accounting Standards FRS17 (FRS102 for accounting periods beginning on or after 1 January 2015) (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.

Market update

Equities are generally at similar levels to this time last year although there were regional variations, with Japanese equities having performed particularly well. UK government bond holdings and corporate bonds are also at similar levels to this time last year.

The overall effect of market movements will differ for schemes depending on their asset allocation. Ignoring deficit contributions and scheme experience, schemes with a large proportion of their assets in UK government bonds or corporate bonds will have fared better than those heavily invested in overseas and 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)	31/12/2015	30/09/2015	31/12/2014
ML Sterling Non-Gilts AA Over 15 years	3.57%	3.41%	3.29%
ML Sterling Corporates AA Over 15 years	3.67%	3.57%	3.39%
iBoxx Sterling Corporates AA Over 15 years	3.68%	3.63%	3.41%
Over 15 Year Fixed Interest Gilts	2.59%	2.39%	2.43%

At the end of Q4 2015, the yields on bonds of all types are higher now than they were at 31 December 2014. This is likely to result in slightly higher discount rates being adopted for accounting purposes to those adopted last year, although this may vary according to how companies have allowed for the duration of their scheme's liabilities when setting the discount rate.

Pension Scheme Accounting Modeller – Instant Scenario Testing

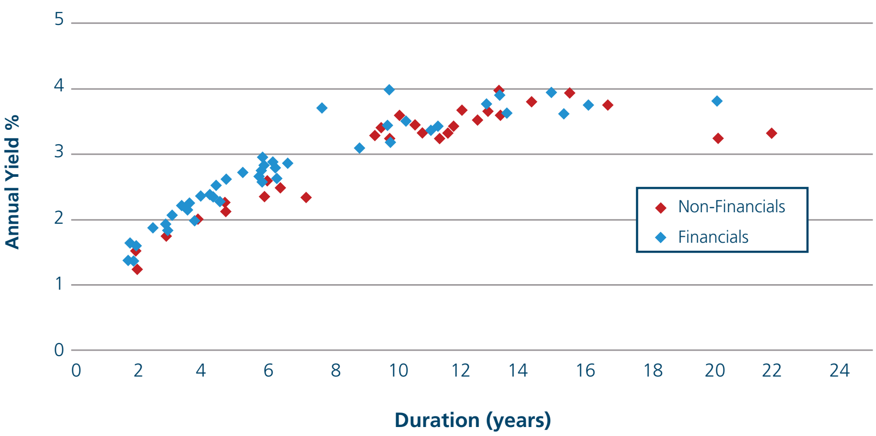
Pension schemes can have a significant impact on a company's accounting position. Our interactive modelling tool can help Finance Directors understand and quantify the factors influencing the financial position of the scheme so that they can be linked into the company's own internal plans for its core business.

The 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.

How we can help

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

Figure 1: Individual yields as at 31 December 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 December 2015 is approximately 14 years and this is generally shorter than the duration of most pension schemes' liabilities.

  As can be seen in Figure 1, the yields vary significantly in the short to mid durations, but flatten out at the longer durations.

  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 it could be possible to justify discount rates of between 3.75% p.a. and 4.0% p.a. for immature schemes. As ever, consistency with the approach adopted in previous years should be considered.

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

- 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.

- It may be possible to 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. This approach provides a larger universe of bonds (particularly at the longer durations) to be considered when setting the discount rate. One of the bond issuers was downgraded in April 2015 and currently, an adjustment of no more than 0.05% p.a. to the index is likely to be appropriate (compared to 0.2% p.a. to 0.25% p.a. at 31 March 2015).

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 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.

Impact of Pensions on UK Business

Our fifth annual report considers the impact that pension provision is having on UK business.

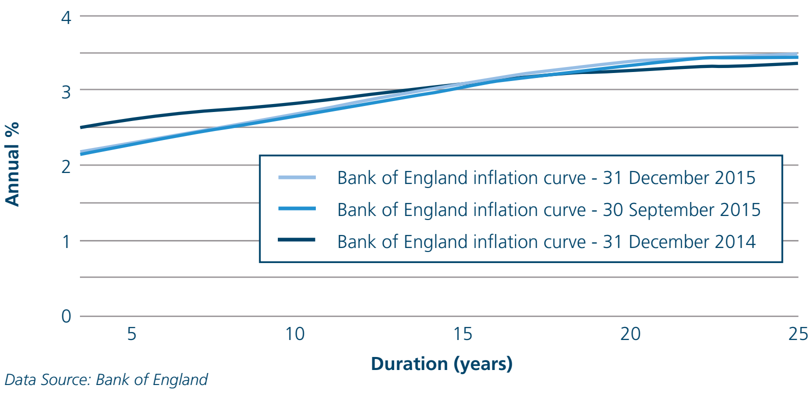
The survey offers a unique assessment of the financial impact of DB pension schemes within the context of the wider finances of FTSE350 companies.

The full report is available on our website

How we can help

Index (annualised rate)	31/12/2015	30/09/2015	31/12/2014
Bank of England 20 year market implied inflation	3.44%	3.39%	3.32%
Bank of England 15 year market implied inflation	3.12%	3.07%	3.11%

Figure 2: Spot inflation curves (annualised)



Data Source: Bank of England

Implied rates of future inflation have remained at similar levels since those observed at the previous quarter. They remain lower than those of a year ago at shorter durations and are similar to those at longer durations. For schemes with significant proportions of benefits linked to inflation this may provide light mitigation against the increase in liabilities resulting from lower discount rates.

Survey of assumptions used by the FTSE100 as at 31 December 2014

Our fourteenth annual survey of FTSE100 pensions accounting assumptions has revealed that most companies increased their IAS19 discount rate at 31 December 2014 relative to the yield on a long-term AA bond index.

The survey focuses on the assumptions adopted by FTSE100 companies for determining the value of their pension liabilities for accounting purposes.

FTSE100 companies may be disheartened that there has been a decline in IAS19 funding levels over the year to 31 December 2014, despite making significant contributions and seeing falling long-term inflation expectations over 2014.

The full survey is available on our website.

How we can help

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 the Consumer Prices Index (CPI) instead, and over 20 years to 2010 CPI was 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 used by FTSE 100 companies showed a difference of up to six 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.

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.

FRS move towards an IFRS-based framework

The Financial Reporting Council (FRC) has formally approved the new UK accounting standards:

- FRS101: Reduced Disclosure Framework;
- FRS102: The Financial Reporting Standard;
- FRS104: Interim Financial Reporting and
- 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 for accounting periods beginning on or after 1 January 2015. 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

With regard to accounting for pension schemes, FRS102 replaces FRS17 and will have implications for pensions accounting disclosures. For the majority of entities, FRS102 is compulsory for accounting periods beginning on or after 1 January 2015. 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. There are other changes affecting, for example, the way surpluses are restricted which may give companies freedom to recognise surpluses where they were prohibited from doing so under FRS17.

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, 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.

FRS104: Interim Financial Reporting

Following the introduction of FRS102, the FRC introduced FRS 104 - 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

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.

How we can help

FRS104 is 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 will withdraw the Financial Reporting Standard for Smaller Entities (FRSSE) from 1 January 2016.

The International Accounting Standards Board (IASB) is consulting on further changes to IAS19 regarding scheme amendments and curtailments and the consultation closes for public comment on 19 October 2015. The proposed changes would require profit and loss items to be recalculated to allow for remeasurement of assets and liabilities at the date such an event occurs, which could be significant for those that rely on profit and loss charges being fixed at the start of the year. These amendments may not come into force until 2017.

The proposed amendments to IFRIC14 'IAS19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements' 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 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. 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 in line with the current treatment under FRS17. However, this restriction under FRS17 is relaxed under FRS102, and therefore such a change to IFRIC14 would once again lead to different treatment between FRS and IFRS.

Training for those involved in Pensions Financial Reporting (FRS17, FRS102, FRS101 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, FRS101, 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 DB pension arrangements. 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.

For more information please email corporateconsulting@barnett-waddingham.co.uk

How we can help

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 ASC 715. 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 is means there is unlikely to be a significant benefit for UK schemes of moving (unless they are unfunded or very badly funded).

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   0207 776 2200   www.barnett-waddingham.co.uk