

# Current Issues in Pensions Financial Reporting

30 September 2009

The key financial assumptions used in valuing the 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 companies trying to set 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 pensions disclosures.

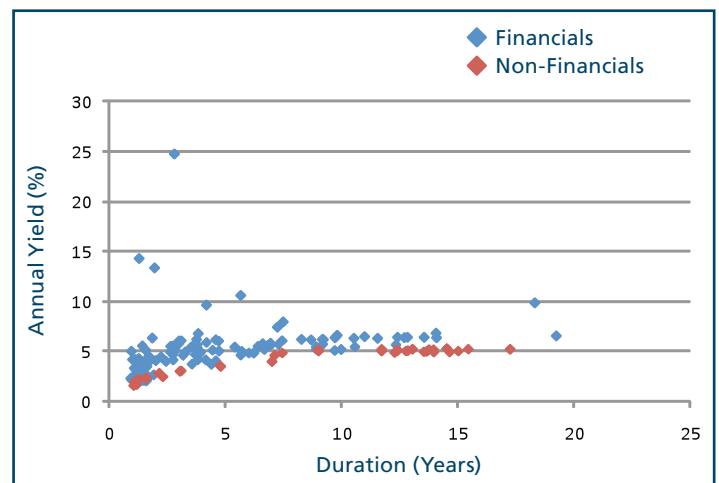
## Discount Rate

The table below shows some of the key market indices that could be used to derive the discount rate. The yield on government bonds (gilts) is also shown for comparison:

Index (annualised yield)	30/09/2009	30/06/2009	30/09/2008
Barclays Capital Sterling Non Gilts AA Over 15 years	5.60%	6.36%	7.05%
ML Sterling Non Gilts AA Over 15 years	5.62%	6.38%	7.05%
ML Sterling Corporates AA Over 15 years	5.66%	6.44%	7.17%
iBoxx Sterling Corporates AA Over 15 years	5.46%	6.20%	7.30%
Over 15 Year Gilt Yield	3.94%	4.12%	4.68%

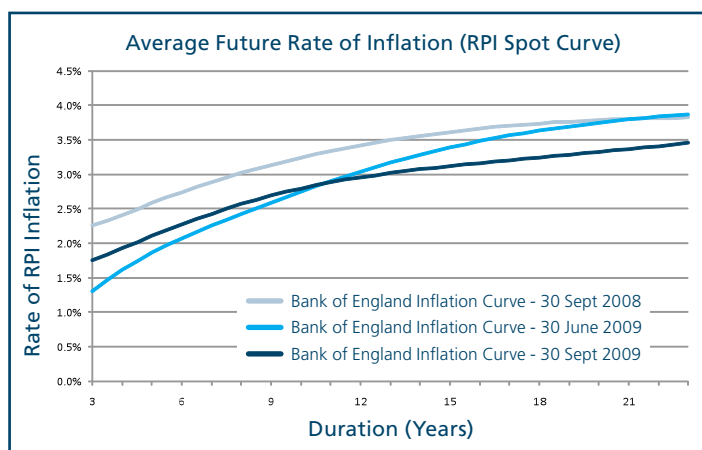
The difference between the yield implied by each of the various corporate bond indices above and the corresponding gilt yield (the corporate bond 'spread') has narrowed over the past quarter and reduced even more significantly over the last year. This is largely due to falls in the yields on the individual corporate bonds making up the index rather than some of the falls we saw earlier in the year as high yielding financial AA rated bonds were downgraded. Falls in the above indices are likely to result in lower discount rates being adopted which in turn will result in a higher value being placed on the liabilities.

The graph opposite shows the individual yields on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index as at 30 September 2009.



Other issues that should be noted when setting the discount rate include:

- The yield on AA bonds continues to vary with the duration of the bonds as shown by the graph above. Therefore, the duration of a pension scheme's liabilities should be considered when setting the discount rate. A year ago a number of shorter duration bonds had relatively high yields. It could, therefore, have been argued that duration should have been taken into account as this would have resulted in adoption of a lower discount rate and which places a higher value on the liabilities. The effect of this is now much less significant, and focusing upon the index yield without any reduction is now likely to be more appropriate
- It is possible to consider an AA bond yield curve (rather than using an average provided by an index) when setting the discount rate. However, care should be taken as these curves can be derived in a variety of different ways. The methodology chosen can result in big variations in the rates at different durations and hence in the discount rate assumption adopted
- The variability in yields between the bonds making up the index is much less marked than was the case a year ago. Therefore, it is likely there will now be less variation in views about an appropriate discount rate assumption
- AA bond indices can be based on either 'non-gilts' or corporate bonds'. The constituents of such indices will differ as will the average yields. However the difference at 30 September 2009 on the relevant Merrill Lynch indices was relatively small
- Yields on AA bonds issued by financial institutions continue to be higher than equivalent bonds issued by non-financial institutions. This reflects continued uncertainty in the financial sector. For example, excluding financials would reduce the iBoxx Sterling Corporates AA Over 15 years by about 0.5% pa



There has been a significant amount of volatility in the Bank of England's long term implied inflation measure over recent months. Companies might wish to consider whether or not there is an argument at looking into more stable approaches when determining a view on long term inflation.

## Other Pension Accounting Issues

**Scheme Closures/Redundancy Exercises/Business Reorganisations** – Any decision by an employer to close a scheme, make a significant number of employees redundant or dispose of sections of the business may impact upon the Profit and Loss charge over the year. This issue could be complicated if the scheme is in surplus. The implications vary depending on the accounting standard adopted.

**IFRIC 14** – From 31 December 2008 IAS 19 accounting figures may be affected by IFRIC 14. IFRIC 14 looks at the implications for recognising surpluses and whether any additional liability should be included on the balance sheet. IFRIC 14 suggests that an additional liability may arise in some circumstances and does not simply place a limit on the amount of surplus you can recognise.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively, please contact either:

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## Inflation

The Bank of England's 20 year market implied inflation figure was 3.32% pa as at 30 September 2009. The annualised inflation yield curve below, however, shows that market implied inflation varies considerably depending on the term being considered. A range of assumptions may therefore be appropriate depending on the term of the liabilities. There are also other considerations, such as whether to adjust for a possible 'inflation risk premium'.

Falls in the implied inflation figure over the last three months will, other things being equal, result in a lower value being placed on a scheme's liabilities at 30 September 2009.

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