

# Current Issues in Pension Financial Reporting

31 March 2010

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)	31/03/2010	31/12/2009	31/03/2009
ML Sterling Non Gilts AA Over 15 years	5.60%	5.81%	6.92%
ML Sterling Corporates AA Over 15 years	5.62%	5.84%	7.05%
iBoxx Sterling Corporates AA Over 15 years	5.50%	5.66%	6.69%
15 Year Fixed Interest Gilt Yield	4.42%	4.45%	3.76%

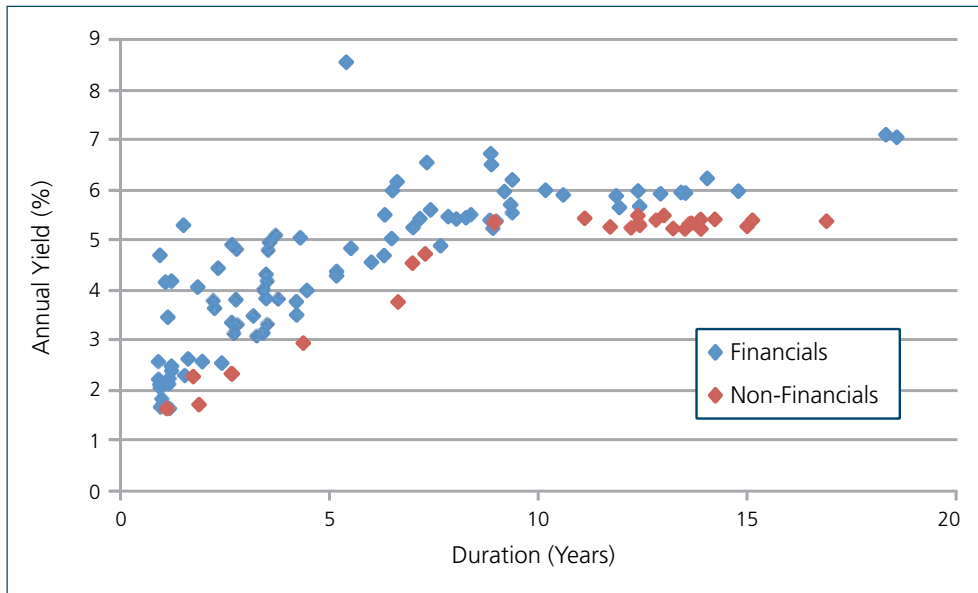
In 2008 the additional yields available from corporate bonds above those available from comparable gilts (the so-called "spread") widened significantly as a result of the "credit crunch". In general, this spread subsequently narrowed over 2009 as confidence returned to the markets. This trend has continued over the first quarter of 2010.

The fall in index yields in the above table are likely to result in lower discount rates being adopted for accounting purposes which, in turn, will result in higher values being placed on pension scheme liabilities.

## Discount Rate (Continued)

Figure 1 shows the individual yields on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index as at 31 March 2010.

Figure 1



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. This feature was significant in 2008 because a number of shorter duration bonds in the index had relatively high yields. It was therefore argued that the long duration of pension scheme liabilities should be taken into account in choosing the discount rate and the shorter duration bonds ignored. Figure 1 illustrates that this effect has now reversed with longer duration yields having a higher yield.
- It is possible to use multiple yields to discount tranches of liabilities at different durations based upon a 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.
- In 2008 there was a wide variation in the yields on various bond indices that have typically been used to determine discount rates for accounting purposes. This variation narrowed significantly in 2009 and this trend continued over the first quarter of 2010. The choice of an appropriate index to determine the discount rate is, therefore, less likely to be controversial this year.
- Yields on AA bonds issued by financial companies continue to be higher than comparable bonds issued by non-financials. This reflects continued uncertainty in the financial sector. For example, excluding financial companies from the constituents would reduce the iBoxx Sterling Corporates AA Over 15 years by around 0.25% pa.

## Inflation

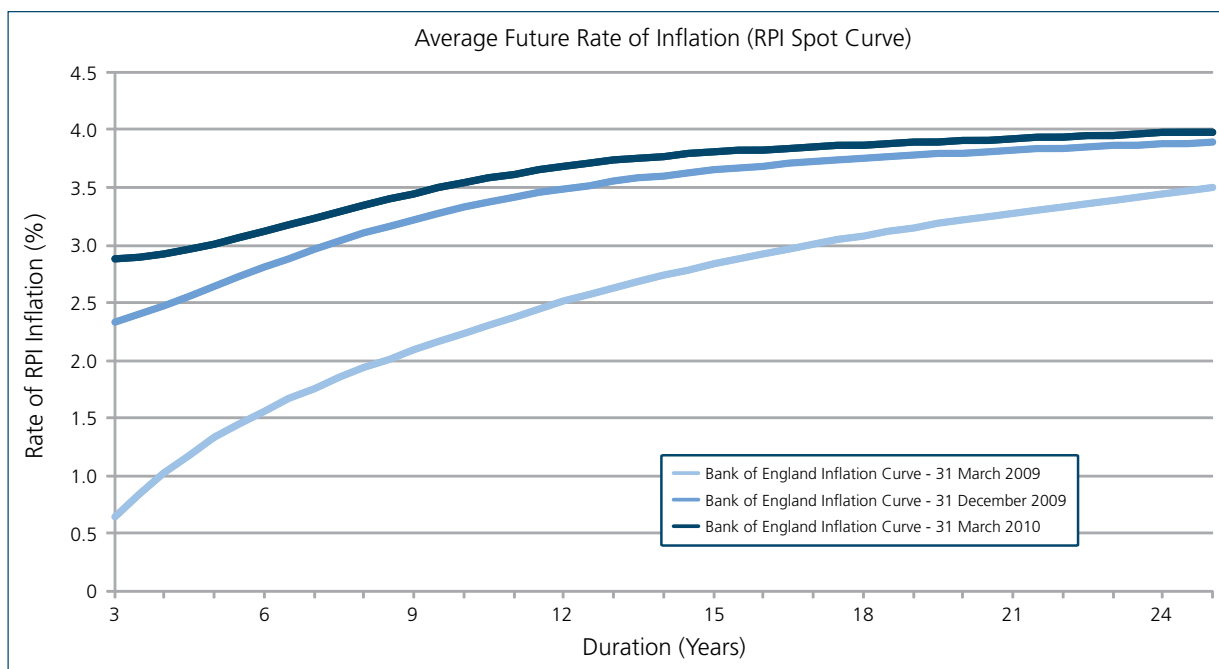
The Bank of England's 20 year market implied inflation figure was 3.91% pa as at 31 March 2010 (3.22% at 31 March 2009). However, as can be seen from the annualised inflation yield curve in figure 2, market implied inflation varies considerably depending on the term being considered. It may well, therefore, be appropriate to adopt inflation assumptions appropriate to the characteristics of each specific scheme rather than merely adopting the Bank of England's 20 year rate. 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 factored into 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.

Implied rates of future inflation have generally increased during the last year. Allowing for increases in the inflation assumption would result in higher pension scheme liabilities.

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

Figure 2



## 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 should consider reviewing their mortality assumptions to ensure they are not using overly prudent assumptions and potentially overstating pension liabilities in their accounts.

## Other Pension Accounting Issues

**Scheme closures / redundancy exercises / business reorganisations** – Any decision by an employer to close a scheme, make 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 may also be different depending on the accounting standard being considered.

**IFRIC 14** – From 31 December 2008 IAS 19 accounting figures may be affected by IFRIC 14. IFRIC 14 looks at the implications for recognising pension scheme surpluses and whether any additional liability should be included on the balance sheet based on any contributions that the employer has committed to pay.

**Review of Accounting Standards** – There are various projects underway that are looking at reviewing the way in which pension schemes are accounted for. The International Accounting Standards Board (IASB) is due to release an exposure draft that amends IAS19 such that the concept of higher expected returns on assets no longer exists. Instead, the same rate will be applied to both the assets and liabilities in determining the profit and loss charge. This is likely to increase the profit and loss charge for most companies.

In addition to the above change, there is a more fundamental review of the discount rate used to place a value on the liabilities of a pension scheme. There are currently no firm decisions as to how this review might affect the accounting standards but more details are expected later in the year.

## Further information

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

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