

Current Issues in Pensions Financial Reporting

30 June 2010

The key financial assumptions 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 of high quality (usually AA-rated) corporate bonds of appropriate currency and duration, 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 in deriving the discount rate. An indicative yield on government bonds (gilts) is also shown for comparison:

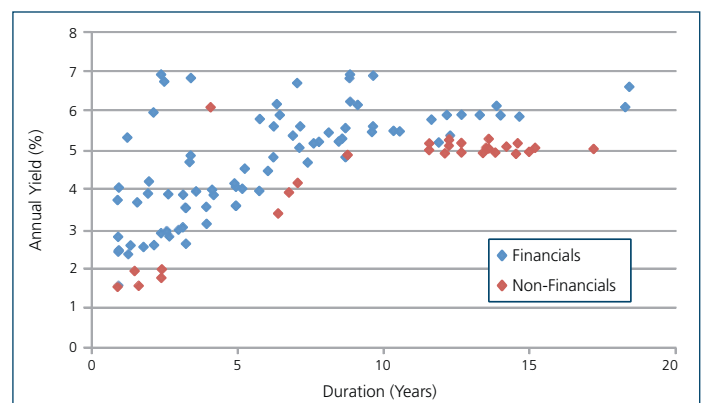
Index (annualised yield)	30/06/2010	31/03/2010	30/06/2009
ML Sterling Non Gilts AA Over 15 years	5.38%	5.60%	6.37%
ML Sterling Corporates AA Over 15 years	5.37%	5.62%	6.44%
iBoxx Sterling Corporates AA Over 15 years	5.31%	5.50%	6.20%
15 Year Fixed Interest Gilt Yield	3.93%	4.42%	4.12%

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 and the first quarter of 2010 as confidence returned to the markets. However the spread widened slightly over the second quarter of 2010.

The fall in index yields in the above table is 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.

Figure 1 shows the individual yields on the bonds making up the iBoxx AA Sterling Corporate Bond All Stocks Index as at 30 June 2010.

Figure 1



Source: Markit Group

Discount Rate (Continued)

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

- The yields on individual AA bonds vary by duration, as shown in 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.
- One option is to discount tranches of liabilities at different durations based on 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. Figure 1 shows that yields on different bonds with the same duration can be significantly different, notably at shorter terms.

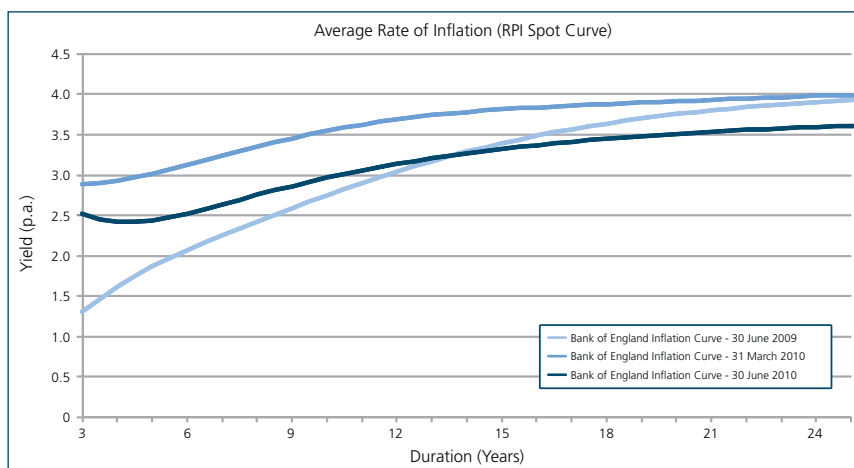
- In 2008 there was a wide variation in the yields on various bond indices that have typically been used to determine discount rates for accounting purposes. This variation narrowed significantly in 2009 and over the first half of 2010. The choice of index to determine the discount rate is, therefore, 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 3.50% pa as at 30 June 2010 (3.75% at 30 June 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. This effect is less pronounced than it was a year ago as short term inflation expectations have increased but longer term expectations have fallen. However, it may well still be appropriate to adopt inflation assumptions appropriate to the characteristics of

each specific scheme rather than using a broad measure such as 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 allow for an "inflation risk premium" that is argued by some to be distorting 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.

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 as at 31 December 2009 showed a difference of up to six years in the life expectancy assumptions adopted, which was up from around five years for the year before. Each additional year of life expectancy can add around 2-3% 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. Trustees are, however, 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

Section 251 of the Pensions Act 2004

Whilst the prospect of receiving a refund of surplus from the pension scheme may seem remote in the current climate employers should consider whether it is necessary for the trustees to put in place a resolution under section 251 of the Pension Act 2004 to allow the payment of surplus to a sponsoring employer should one arise at some point in the future.

Such a resolution is required even if the scheme rules currently permit such a payment. The resolution would give the trustees the right to make payments to the employer but they would not be obliged to do so as other considerations, such as the interests of members, still need to be taken into account before any payment is made. If no such resolution is made before 6 April 2011 the scheme may never be able to refund surplus to an employer in the future.

There is also a more immediate potential knock on effect on employers that account for pensions under IAS19. Under IAS19 (and the interpretation IFRIC14) companies may be required to recognise additional liabilities to reflect the contributions they are required to make under a recovery plan agreed with trustees. An employer does not need to recognise any additional liabilities if it has an unconditional right to the surplus under the scheme rules at some point in the future. This right could potentially disappear if no resolution is passed in time which would impact on the surplus or deficit recognised on the balance sheet. The IFRIC14 requirement to recognise additional liabilities is not restricted to schemes in surplus – it can also affect schemes in deficit.

Although this may not seem to be an issue for employers who account under FRS17 the potential convergence of UK and International accounting standards mean it could become one in the future.

We suggest that employers engage with the scheme trustees on this issue to determine whether a resolution is appropriate, taking legal advice as necessary.

Exposure Draft on changes to IAS19

The IASB (International Accounting Standards Board) has published an Exposure Draft with proposed changes to the accounting standard IAS19 which deals with how companies should account for employee benefit schemes. The Exposure Draft is under consultation until September this year after which a revised standard will be published. A new 'final' standard is expected in the middle of 2011 but is unlikely to take effect until January 2013 at the earliest.

Whilst the Exposure Draft proposes a number of changes to IAS19, the IASB has stated that it does not intend at this stage to change how assets and liabilities are valued, in particular the choice of discount rate to be adopted.

Other Pension Accounting Issues (Continued)

The most significant changes proposed by the standard include:

- Companies should no longer be allowed to defer recognition of actuarial gains and losses and they should instead be recognised immediately on the balance sheet through other comprehensive income. Therefore, all companies will now recognise the full deficit on their balance sheets.
- The finance cost element is currently calculated as the company's best estimate of the expected return on the scheme's assets less the interest on the liabilities, calculated using the discount rate for the period. In response to concerns that the expected return on assets was being manipulated the IASB has proposed that the finance cost should be calculated as the net interest on the scheme deficit (or surplus) using the discount rate for the period.

- The new standard will also clarify that the present value of administration expenses should be included within the liabilities if they are paid through defined benefit plans whereas it was possible in the past to allow for these expenses in the expected return on assets or within the service cost.
- There are also a number of proposed changes to the disclosure requirements.

The change to the calculation of the finance cost is likely to reduce reported profits. Other changes are likely to see an increase in the liabilities recognised on the balance sheet and increased volatility for companies that previously deferred recognition of gains and losses. The requirement to include the present value of administration expenses could be significant, especially for small schemes.

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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