JLT

Q3 QUARTERLY GUIDE PENSIONS ACCOUNTING

As at 30 September 2017

Guidance for Finance Directors

QUARTERLY GUIDE TO PENSIONS ACCOUNTING AS AT 30 SEPTEMBER 2017

This guide is intended for use by finance directors in discussions with their actuaries and auditors on the actuarial assumptions to be adopted for recognising pension assets and liabilities in financial statements. It is divided into five sections:

- Markets between 30 September 2016 and 30 September 2017
- Expected assumptions at 30 September 2017
- Recent developments
- Latest information from FTSE 100 company disclosures
- Simple guide to IAS 19

MARKETS BETWEEN 30 SEPTEMBER 2016 AND 30 SEPTEMBER 2017:

- The FTSE All-Share Total Return Index has increased by 11.9%
- The FTSE All World Ex-UK Total Return Index has increased by 15.8%
- The iBoxx >15 year AA Corporate Bond Yield Index has increased from 2.2% to 2.6%
- The FTSE 20 year Fixed Interest Gilt Yield Index has increased from 1.5% to 2.0%
- The Bank of England 15-year spot inflation rate has increased from 3.2% to 3.5%

Over the last 12 months AA corporate bond yields have increased leading to a fall in the value being placed on pension obligations. Long-term inflation expectations have also increased but not enough to offset the benefit of the increase in bond yields. In addition, investment returns on growth assets have been very good over the period. Therefore we expect deficits to have fallen over the year.

EXPECTED ASSUMPTIONS AT 30 SEPTEMBER 2017

The expected range of assumptions at 30 September 2017 is as follows. For the discount rate and inflation assumptions, we would expect more mature plans to adopt assumptions towards the lower end of the range indicated and less mature plans to adopt assumptions towards the higher end of the range indicated. However, given the recent significant falls in interest rates, we expect finance directors and companies to apply extra effort to justify discount rate assumptions towards the higher end of the likely range of possible assumptions.

Discount rate	2.4% to 2.9%
Price inflation (RPI)	3.2% to 3.4%
Price inflation (CPI)	2.0% to 2.9%
Salary inflation	2.0% to 5.5%
Assumed life expectancy	25 to 30 years for a male now aged 60 (justified by nature of employee population or historic experience). 1 to 2 years higher for a male retiring 20 years from now.

RECENT DEVELOPMENTS

PROPOSED CHANGES TO IAS 19 AND IFRIC 14

Proposed amendments to international pension accounting requirements were published by the IASB for public comment in June 2015. The exposure draft covers two different proposals to amend IFRIC 14 and IAS 19. The first relates to the availability of refunds from a defined benefit plan. The second relates to remeasurements on a plan amendment, curtailment or settlement. We discuss these two proposals in more detail in the next two sections.

The IFRS Interpretations Committee ("the Committee") recommended that the proposed amendments be finalised subject to some drafting changes on 7 September 2016. On 13 December 2016 the IASB has tentatively decided to finalise these amendments, subject to some further drafting changes.

The Committee also recommended that:

- an entity should apply the amendments to IFRIC 14 retrospectively (with an exemption for adjustments to the carrying amount of assets outside the scope of IAS 19);
- an entity should apply the amendments to IAS 19 prospectively;
- no transition relief should be provided for first-time adopters; and
- the proposed amendments should be applied for accounting period beginning on or after 1 January 2019, with earlier application permitted.

In September 2017, the Board tentatively decided to finalise the amendments to IAS 19 separately from the amendments to IFRIC 14 and requires entities to apply the amendments to IAS 19 to annual reporting periods beginning on or after 1 January 2019, with earlier application permitted.

The Board also tentatively decided to perform further work to assess whether it can establish a more principles-based approach in IFRIC 14 for an entity to assess the availability of a refund of a surplus. This effectively placed the potential IFRIC 14 amendments on hold for now.

If the update to IFRIC 14 is finalised in its current form this could significantly increase the deficit that many companies will disclose on their balance sheet.

IFRIC 14 - AVAILABILITY OF REFUNDS FROM A DEFINED BENEFIT PLAN

The Committee has been discussing whether a trustee's power to augment benefits or to wind up a plan should affect the employer's unconditional right to a refund and thus restrict the recognition of an asset in accordance with IFRIC 14. There is currently diversity in practice when interpreting IFRIC 14.

The proposed amendments clarify that the ability to recognise an asset on the basis of a refund is eliminated or reduced if a third party (e.g. the plan Trustees) has unilateral powers to either:

- use the surplus for other purposes (e.g. enhance members' benefits) or
- wind-up the plan to avoid the surplus becoming available to the sponsor in the first place.

The proposed amendments also clarify that:

- where a third party has unilateral power over investment decisions (e.g. the purchase of an annuity buy-in policy) without affecting the benefits for plan members, then this does not affect the ability to recognise a surplus.
- companies should only take account of statutory requirements that are substantively enacted, as well as taking account of the terms and conditions that are contractually agreed and any constructive obligations.
- when a plan amendment, curtailment or settlement occurs a gain or loss on settlement or past service cost should be calculated and recognised in profit or loss and the asset ceiling should be reassessed for the updated surplus with any adjustment recognised in other comprehensive income (more details given on this below).

This amendment implies that the ability to recognise an asset on the basis of a refund is eliminated or reduced if a third party (e.g. the plan Trustees) has unilateral powers to settle the liabilities of the plan in full. It does not require that the third party only has powers to wind-up the plan. It was confirmed that this amendment would apply to other parties' powers to purchase annuities to settle in full the plan's liabilities.

This change from a focus on wind-up to a focus on the ability to purchase annuity buy-out policies could have major significance for some companies. It is often the case that Trustees will not have a unilateral power to wind up, but they will have a unilateral power to purchase annuities in members' names. If the Trust Deed and Rules allow the Trustees to purchase annuities without employer consent then a company's ability to recognise an asset on the basis of a refund would be eliminated.

In September 2017, the Board received an update on the expected effects of the amendments to IFRIC 14 and tentatively decided to perform further work to assess whether it can establish a more principles-based approach in IFRIC 14 for an entity to assess the availability of a refund of a surplus. The Board will further consider the amendments to IFRIC 14 at a future meeting.

If the proposals are finalised in their current form all companies will need to review their current interpretation of the impact of IFRIC 14.

JLT's Client Alert: *"Pensions accounting – will contributions agreed with the trustees affect your company balance sheet?"* provides further detail on IFRIC 14.

REMEASUREMENT ON A PLAN AMENDMENT, CURTAILMENT OR SETTLEMENT

In January 2014 the Committee received a request to clarify the accounting treatment for a plan amendment, curtailment or settlement. It related to whether the remeasurement of the net defined benefit liability (asset) should be reflected in determining net interest and actuarial assumptions for the post-event period.

In its May meeting the Committee discussed the issue and tentatively decided to develop an amendment. This amendment will require an entity to take account of the remeasurements of the net defined benefit liability when determining net interest for the post-event period. It will also require the updated actuarial assumptions to be used for the calculation of current service cost and net interest for the post-event period.

In its July 2014 meeting the Committee concluded that the proposed amendment met the criteria for Annual Improvements.

In its November 2014 meeting the Committee clarified that the amendment will not require remeasurements of the net defined benefit liability if a significant market fluctuation occurs during a reporting period. The Committee considered that this issue might be too broad for it to deal with and could lead to a significant change in the application of IAS 19 and a significant burden on entities.

In its January 2015 meeting the IASB tentatively agreed with the Committee's recommendations to amend IAS 19. The IASB also agreed with the Committee's observation that the requirement to remeasure the net defined benefit liability (asset) is determined on a plan-by-plan basis. An exposure draft was issued in June 2015.

In September 2016, the Committee recommended that the proposed amendments be finalised.

In its December 2016 meeting, the IASB tentatively agreed with the Committee's recommendations, subject to some drafting changes. However, the Board has asked the Committee to reconsider the implications of including minor plan events (i.e. plan events for which the past service cost, or gain or loss on settlement, would not be material) within the scope of the amendments.

In its March 2017 meeting, the Committee recommended that the Board should not explicitly exclude minor plan events from the scope of the amendments and discussed its implications. The Board will discuss the Committee's recommendations at a future Board meeting.

Following its September 2017 meeting, the Board plans to issue the amendments to IAS 19 in December 2017.

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB) AGENDA CONSULTATION

FASB published its agenda consultation on 4 August 2016. Chapter 2 of the agenda consultation concentrates on 'Pensions and Other Postretirement Benefit Plans' and opens two separate issues for comment.

The first issue relates to delayed recognition or smoothing of gains and losses in earnings. US GAAP currently allows either immediate recognition or delayed recognition using the corridor approach. The agenda consultation discusses some alternative options, including convergence with IAS 19 (i.e. no recycling of historic gains and losses and elimination of actuarial gains and losses from the income statement), and elimination of all smoothing so that all changes are recognised immediately in the income statement.

The second issue relates to the measurement of the defined benefit obligation and concentrates in particular on hybrid plans. This issue is quite similar to the discussions that the IASB has been having in relation to its post-employment benefits research project (further details below).

ALTERNATIVE APPROACH TO MEASURING THE INTEREST COST

In recent years companies across the UK have improved the methodology used to set the discount rate under IAS 19. The industry standard is now to place a value on the defined benefit obligation by using the individual spot rates from a AA corporate bond yield curve to discount the projected benefit cashflows.

In practice a single equivalent discount rate is presented which, when used to discount the projected benefit cashflows, would give broadly the same result as using a full AA corporate bond yield curve to discount the same cashflows.

Further development of this methodology has highlighted an alternative approach to calculating the interest cost. This was explored in more detail in an August 2015 briefing paper by the American Academy of Actuaries "Alternatives for Pension Cost Recognition – Issues and Implications".

Under the alternative approach it is acknowledged that each future benefit cashflow is discounted using a different spot rate based on the time until payment (as a full yield curve is being applied). Therefore, an alternative approach to calculating the interest cost is to apply the spot rate in each individual year to the appropriate discounted benefit cashflow. As the current yield curve is upward sloping this will lead to a smaller interest cost as more weight is given to near term payments (which are discounted less).

The U.S. Securities and Exchange Commission has already noted that it would not object to this approach being adopted by U.S. companies. JLT believes that the approach will also be acceptable under UK GAAP and IFRS.

The impact from using the alternative approach is greatest under US GAAP as the US standard has not moved to the net interest cost approach now used by UK GAAP and IFRS. However, for pension plans in deficit the alternative approach can result in a reduction in the net interest cost recognised.

DISCOUNT RATES RESEARCH PROJECT

A research project on the use of discount rates has concluded following the IASB meeting in March 2017 and the project findings are currently in review. The research project arose after it was highlighted that different standards specify different discount rates and that the reasons for the differences was not well understood.

The discount rate for IAS 19 is a key focus of the research project. Any changes to the methodology behind the discount rate could have a significant impact on pension liabilities. JLT will carefully monitor developments and the potential impact of the project as it progresses.

LATEST INFORMATION FROM FTSE 100 COMPANY DISCLOSURES

This analysis is based on the most recent annual report available at 30 September for each FTSE 100 company with a defined benefit pension plan.

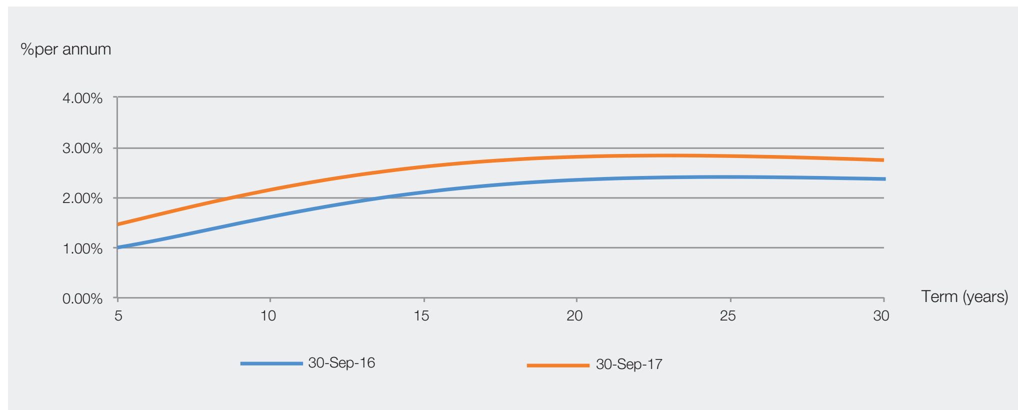
DISCOUNT RATE

Under IAS 19, the discount rate used to value liabilities is set by reference to yields available on high-quality (taken to mean AA) corporate bonds of currency and term consistent with the liabilities. Pension liabilities are long-term in nature and market data is sparse at longer durations.

Historically, when setting the discount rate, a AA corporate bond index has been used to determine a headline rate, which was then adjusted to reflect the difference between the duration of the pension plan liabilities and that of the index. However, there has been a move in recent years towards a more sophisticated approach, which considers the full yield curve implied by the constituents of the index. The yield curve is applied to the plan's projected liability cash flows, or to the cash flows of an illustrative plan with a similar duration. A single equivalent discount rate can then be derived which produces the same result as this more sophisticated approach.

The change in the AA corporate bond yield curve over the year is illustrated in the chart below. It can be seen that AA corporate bond yields have fallen at all terms.

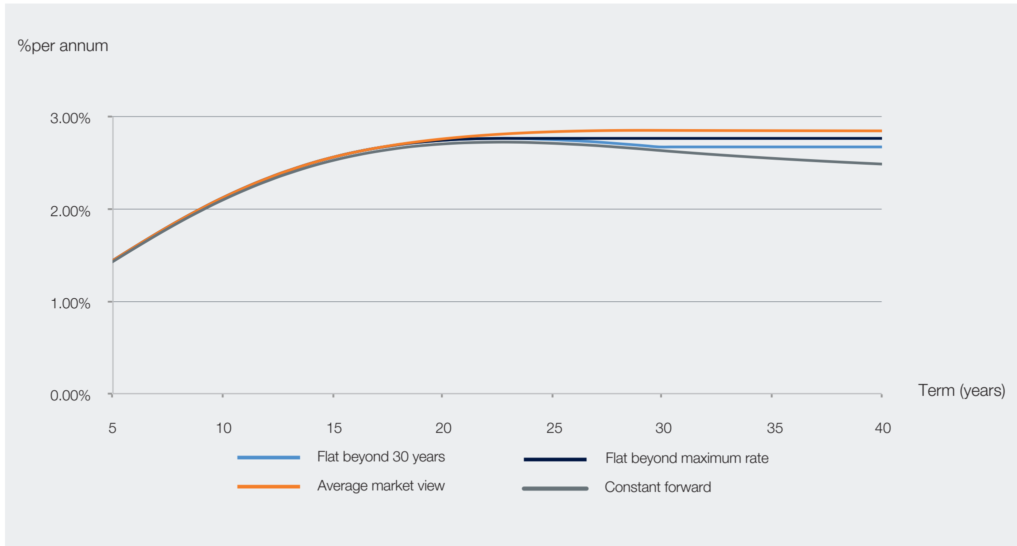
AA corporate bond yield curve



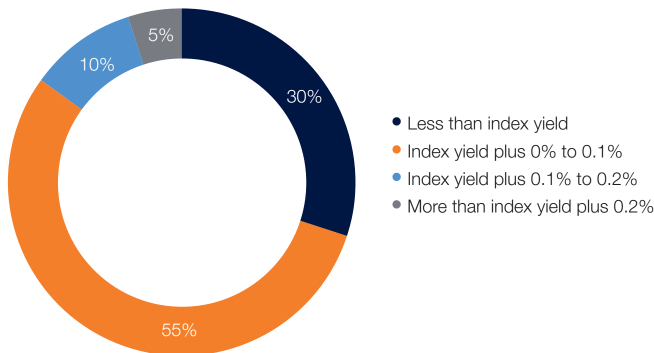
Source: : JLT analysis

It is also important to note that there is no one 'correct' way of deriving a AA corporate bond yield curve. There are alternative approaches that are equally valid but produce different discount rates, often achieved by varying the method used to extrapolate the long end of the curve. This is illustrated in the chart below. More companies are considering alternative approaches to deriving the discount rate.

AA corporate bond yield curve models



The resulting assumption can still be illustrated relative to the yield on the index. The approximate spread of discount rates around the index yield which have been adopted by FTSE 100 companies is shown in the chart below.



Source: JLT analysis

Significance
+0.1% on discount rate

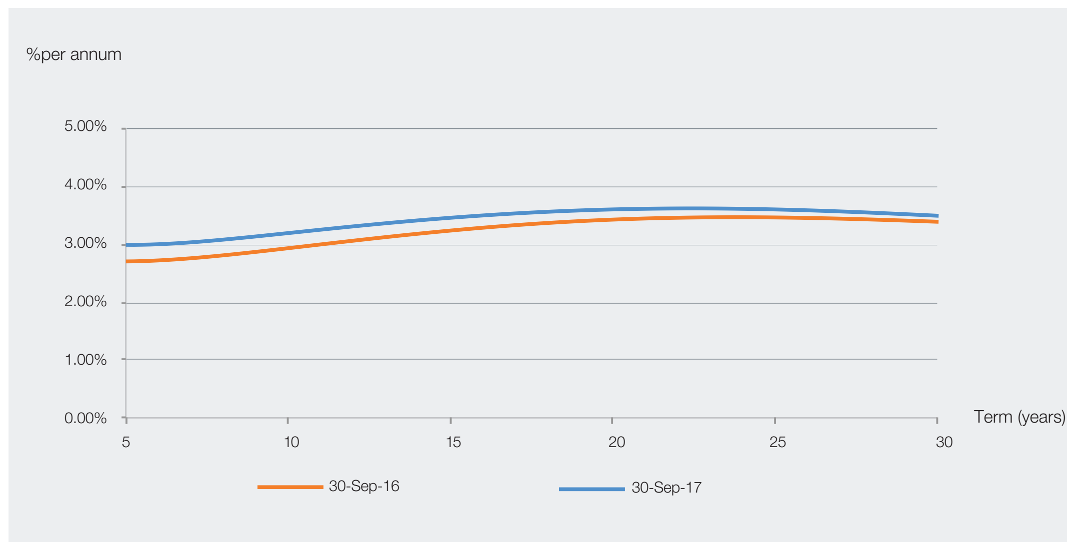
Liabilities ↓ ~ 2%
Service cost ↓ ~ 2.5%

PRICE INFLATION (RPI)

The inflation assumption is typically very important in that it underlies a number of the other key assumptions such as pension increases in payment and deferment, as well as long-term salary growth.

A long-term market-implied rate of inflation can be derived from the yield curves of fixed and index-linked gilts. The implied inflation curve is applied to the plan's projected liability cash flows, or to the cash flows of an illustrative plan with a similar duration. A single equivalent inflation rate can then be derived. This single equivalent rate will vary according to the duration of the liabilities. The change in the inflation spot curve over the year is illustrated in the chart below:

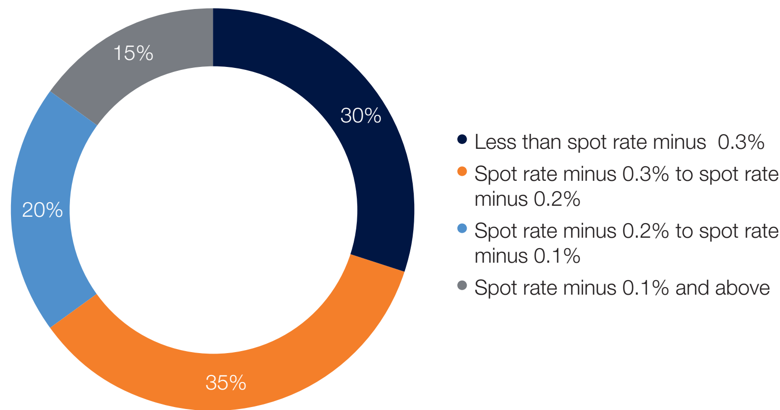
Spot inflation curve



Source: Bank of England and JLT analysis

The rates of inflation that companies used last year drifted below the rates implied by the curve, possibly to reflect a "inflation risk premium" on index-linked gilts. The "inflation risk premium" is due to the relative market supply and demand features of the conventional and index-linked gilt markets and is typically set to be 0.1% or 0.2% p.a.

The Bank of England publishes spot inflation rates implied by the market, with projections up to 40 years. The approximate spread of price inflation assumptions, relative to the annualised 15-year spot rate, is shown in the chart below.



Source: JLT analysis

Significance

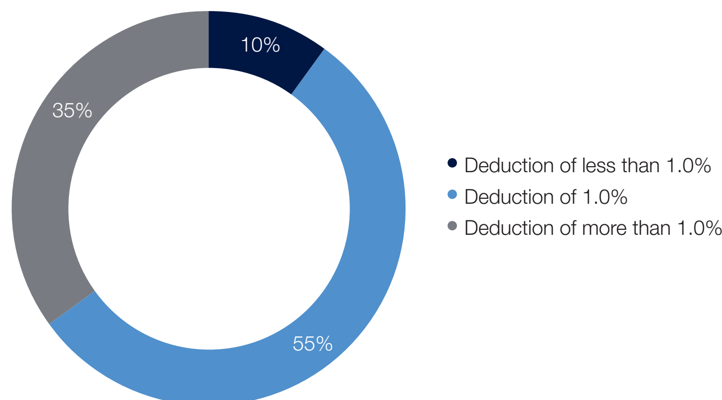
+0.1% on rate of salary inflation

Active member liabilities ↑ ~ 2%

Service cost ↑ ~ 2.5%

CPI INFLATION

There are currently no reliable market indicators for CPI inflation so market practice is to apply a deduction to the RPI inflation assumption to arrive at the CPI inflation assumption. The most common deduction from RPI for CPI is 100bps. The spread of deductions is indicated by the chart below, the range of deductions being from 70bps to 120bps.

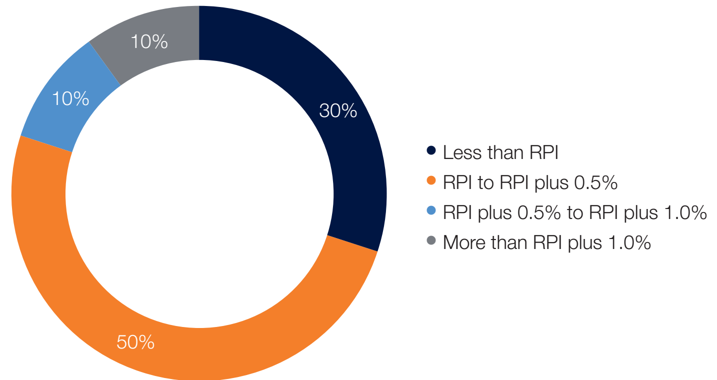


Source: JLT analysis

SALARY INFLATION

There is a generally accepted link between price inflation and salary inflation, which is reflected in the choice of salary inflation assumptions. The approximate spread of salary inflation assumptions, relative to RPI (i.e. assumed price inflation), is shown in the chart below.

In recent years a large number of companies have begun setting salary increases equal or just above RPI. Some companies are now setting this by reference to CPI. Very few companies used a rate higher than 1.5% above RPI. In addition many companies have now either closed their defined benefit plan to future accrual or have applied a cap to future pensionable salary growth.



Source: JLT analysis

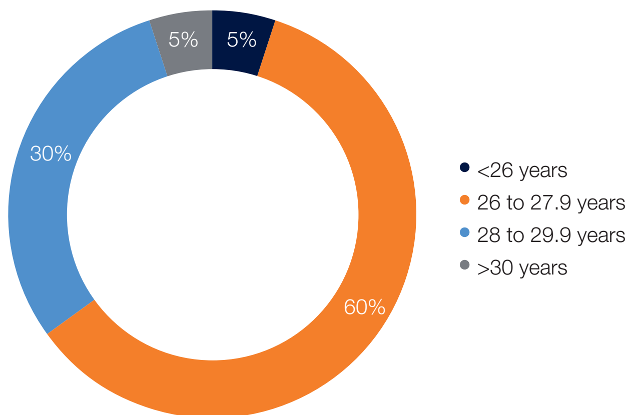
Significance
+0.1% on rate of salary inflation

Active member liabilities ↑ ~ 1.5%
Service cost ↑ ~ 1.5%

MORTALITY

The increase in the assumed life expectancy of a pensioner has continued, but the rate of change is now slowing. Seventy-six of the FTSE 100 companies have now adequately disclosed their mortality assumptions. Of these, all have disclosed a figure for the previous year. On average, the assumed life expectancy of a male aged 60 increased by 0.3 years from the previous year's figure. Only two companies increased their assumed life expectancy by more than two years. Most companies also quote a life expectancy for future pensioners – this is, on average, 2.0 years higher than the figure for current pensioners. "Future pensioners" is typically defined as "currently 20 years from retirement."

There are many different mortality tables used. Recent studies indicate conflicting ideas and therefore we are expecting to see a wider range of assumptions used. Companies most frequently quote the assumed life expectancy for a male currently aged 60; where they have used a different age, we have converted their figure to an equivalent age 60 figure.



Source: JLT analysis

Significance
+1 year assumed life expectancy

Liabilities ↑ ~ 2.5%
Service cost ↑ ~ 2.5%

SIMPLE GUIDE TO IAS 19

IAS 19 is issued by the International Accounting Standards Board (IASB) and gives directions on the accounting treatment of defined benefit assets and liabilities.

BALANCE SHEET

The main balance sheet items are:

- **Fair value of plan assets** – Must be the market price (where available) and based on the bid value of quoted securities.
- **Present value of defined benefit obligations** – This is the value of the past service liabilities, calculated on service to date but with allowance for pay increases through to retirement (or earlier leaving). This calculation must be carried out using a discount rate based on market yields on high-quality corporate bonds.

Some adjustments are then possible:

- **Impact of asset ceiling** – The fair value of plan assets must be limited if there is a surplus in the plan and the surplus assets are greater than the amount which can be recovered either by means of a refund or in the form of a contribution reduction (but note the effect of IFRIC 14).
- **Deferred tax**

INCOME STATEMENT

The main income statement items are:

- **Service cost** – This comprises:
  - Current service cost, which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period
  - Past service cost, which is the change in present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by the plan)
  - Settlement gains or losses
  - Expenses
- **Net interest on the defined benefit liability (asset) in profit or loss** – This is the change during the period in the net defined benefit liability (asset) that arises from the passage of time. It is determined by multiplying the net defined benefit liability (asset) by the discount rate, both as determined at the start of the annual reporting period, taking account of any changes in the net defined benefit liability (asset) during the period as a result of contribution and benefit payments. It can be viewed as comprising interest income on plan assets, interest cost on the defined benefit obligation and interest on the effect of the asset ceiling.

REMEASUREMENTS

Remeasurements are recognised in Other Comprehensive Income and consist of:

- Actuarial gains and losses from changes in the present value of the defined benefit obligation resulting from:
  - Experience adjustments
  - The effects of changes in actuarial assumptions
  - The return on plan assets, excluding amounts included in net interest
  - Any change in the effect of the asset ceiling.

DISCLOSURE ITEMS

The required disclosures in the accounts include:

- Characteristics of the plan including the nature of the benefits, a description of the regulatory environment in which the plan operates and governance responsibilities.
- Description of the risks to which the plan exposes the entity including any entity specific, plan specific or concentrations of risk.
- Description of any plan amendments, curtailments and settlements.

- Reconciliation of opening and closing present value of the defined benefit obligation, including current service cost, interest cost, member contributions, remeasurements, benefits paid, past service costs, curtailments and settlements. Remeasurements must show separately actuarial gains and losses due to plan experience, changes in demographic assumptions and changes in financial assumptions.
- Reconciliation of opening and closing value of plan assets, including interest income, the return on plan assets excluding interest income, company contributions, member contributions, benefits paid and settlements.
- Reconciliation of opening and closing effect of the asset ceiling.
- The total expense recognised in the income statement, including current service cost, past service cost, settlements, expenses and net interest cost.
- Disaggregation of the fair value of plan assets into classes that distinguish the nature and risks of those assets.
- Fair value of the entity's own transferable financial instruments held as plan investments and the fair value of plan assets that are property occupied by, or other assets used by, the entity.
- The significant actuarial assumptions used, including the discount rates, expected returns on plan assets, pay inflation, and any other material assumptions.
- Sensitivity analysis for each significant actuarial assumption.
- Description of any asset-liability matching strategies.
- Indication of the effect of the defined benefit plan on the entity's future cashflows including a description of the funding arrangements, expected contributions payable in the next reporting period and information about the maturity profile of the plan.
- Additional disclosures may be required for multi-employer plans.

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