Q3 QUARTERLY GUIDE
PENSIONS ACCOUNTING

As at 30 September 2015

Guidance for
Finance Directors

In association with

QUARTERLY GUIDE TO PENSIONS ACCOUNTING AS AT 30 SEPTEMBER 2015

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:

- Changes in market conditions since 30 September 2014
- Expected assumptions at 30 September 2015
- Recent developments
- Latest information from FTSE 100 company disclosures
- Simple guide to IAS 19

MARKETS BETWEEN 30 SEPTEMBER 2014 AND 30 SEPTEMBER 2015:

- The FTSE All-Share Total Return Index has decreased by 2.3%
- The MSCI World Index (GBP) has decreased by 0.3%
- The iBoxx >15 year AA corporate bond yield index has decreased from 3.85% to 3.65%
- The FTSE 20 year fixed interest gilt yield index has decreased from 2.95% to 2.40%
- The Bank of England 15-year spot inflation rate has decreased from 3.25% to 3.05%

AA corporate bond yields have fallen over the year, which will lead to lower discount rates and a higher value being placed on pension liabilities. Part of this increase has been offset by lower expectations of inflation, but in general, pension liabilities will have increased compared to last year.

The main driver of balance sheet volatility will be on the asset side. Equity markets have been lacklustre, particularly in Q3. On the other hand, gilt markets have performed well, and in particular have outperformed corporate bonds. Therefore, pension plans heavily invested in growth assets are likely to see an increase in deficits overall. Pension plans with a significant proportion of assets allocated to gilts and other fixed interest investments will have performed better, with those plans heavily invested in gilts potentially seeing an improvement in the balance sheet position.

EXPECTED ASSUMPTIONS AT 30 SEPTEMBER 2015

The expected range of assumptions at 30 September 2015 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.

Discount rate	3.40% to 4.00%
Price inflation (RPI)	3.00% to 3.50%
Price inflation (CPI)	1.80% to 3.00%
Salary inflation	3.00% to 5.00%
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

MORTALITY IMPROVEMENTS

At the end of September the Continuous Mortality Investigation (CMI) released the latest version of its mortality improvements model. The 2015 update produces projected life expectancies that are lower than the 2014 model. Adopting the new model reduces liabilities by approximately 1% but the exact impact for any particular plan will depend on the make up of the plan's membership. As this is a reversal in recent trends companies need to carefully consider the new information before deciding whether to adopt the change for their disclosures.

FRS 102

FRS 102 was issued in March 2013 and is mandatory for annual periods beginning on or after 1 January 2015. Chapter 28 of FRS 102 will replace FRS 17 and applies an approach that is broadly consistent with IAS 19 (see the section on amendments to FRS 102 below) but with reduced disclosure requirements.

FRS 102, like the recently revised IAS 19, removes the expected return on assets assumption and effectively replaces it with the discount rate. This change will have a negative impact on pension costs for the vast majority of companies. The size of the impact varies from case to case and depends on the pension plan's investment allocation and the asset return assumptions used. An indication of the P&L impact can be assessed alongside provision of the year end accounting numbers if required.

One of the most significant changes under the new standard is the impact on group plans. These are pension plans where there is more than one participating employer and the employers are under common control (e.g. a parent and its subsidiaries). Under FRS 17, many group plans were able apply a multi-employer exemption which allowed them to avoid recognising a share of a plan surplus or deficit in the individual company accounts. FRS 102 requires the plan surplus or deficit to be recognised on at least one individual company balance sheet. If there is no contractual agreement or stated policy for charging the net defined benefit cost to participating employers the deficit will be allocated to the single employer that is deemed 'legally responsible' for the plan. This is often the principal employer. The resulting reduction in net assets for the affected employer can result in problems with dividend payments or distributable reserves. Companies should be considering whether they need to implement an accounting policy for allocating the deficit to the participating employers. Such a policy will allow companies to spread the deficit between the employers, which will help to reduce the potential for issues with dividend blocks.

JLT's Client Alert: *"Important changes to how companies account for pensions"* provides further detail on the changes.

AMENDMENTS TO FRS 102

In February 2015, the Financial Reporting Council (FRC) published amendments to FRS 102. The amendments clarify that companies will not need to recognise additional liabilities in respect of a 'schedule of contributions' agreed with pension plan trustees. Companies reporting under IFRS may have to recognise an additional liability, in certain circumstances, in accordance with IFRIC 14.

The final amendments also require that the amount and timing of agreed deficit recovery contributions are disclosed.

The amendments have the same effective date as FRS 102 being applicable to accounting periods beginning on or after 1 January 2015.

These changes provide welcome news for companies reporting under UK GAAP. The amendments represent the only material pensions related difference between UK GAAP and IFRS and so companies choosing between FRS 101 and FRS 102 should consider this as part of their deliberations.

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 IAS 19 and IFRIC 14. 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 exposure draft is open for comment until 19 October 2015.

IFRIC 14 – AVAILABILITY OF REFUNDS FROM A DEFINED BENEFIT PLAN

The IFRS Interpretations Committee ("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.

In its May 2014 meeting the Committee tentatively decided to develop either an interpretation or an amendment on the issue. Following further discussion in its July and September 2014 meetings the Committee agreed to recommend an amendment. In its January 2015 meeting the IASB tentatively agreed with the Committee's recommendation to propose narrow-scope amendments to IAS 19 and IFRIC 14. An exposure draft was issued in June 2015.

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.

If the proposed amendments are adopted companies may 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.

IFRIC 14 – CONTINUATION OF A MINIMUM FUNDING REQUIREMENT

In February 2015 the Committee received a request to clarify the application of IFRIC 14.

When assessing the impact of minimum funding requirements for a plan, companies must make an assumption about the length of time over which the contributions relating to future service will continue. The value of these future contributions is then compared to the future value of the IAS 19 service cost (assessed over the estimated life of the pension plan) as part of determining the limit on a defined benefit asset.

One view is that the contributions should be assumed to continue over the estimated life of the pension plan. This approach is consistent with the period over which the future service cost must be assessed. However, in the UK the contribution rate under the statutory minimum funding arrangement is renegotiated with the pension plan Trustees regularly (at least every three years). The contributions agreed are then only payable for a fixed period. Therefore, another view is that the contributions should only apply for the minimum period agreed.

The Committee's view was that companies should assume a continuation of the existing funding requirement for future service consistent with the assumption for the future service cost. In addition, the estimate should not allow for any changes to the minimum funding requirement that require future negotiations with the trustees.

The Committee agreed that sufficient guidance exists and neither an Interpretation nor an amendment was necessary. The Committee decided not to add the issue to its agenda.

DISCOUNT RATES RESEARCH PROJECT

A research project on the use of discount rates is underway with the IASB considering a summary of initial findings in its September 2015 meeting. 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. The IASB will consider the initial research further at its next meeting.

POST-EMPLOYMENT BENEFITS RESEARCH PROJECT

In its September 2014 meeting, the IASB considered a plan for a research project to review accounting for post-employment benefits. The IASB expects to consider the next steps for the project in late 2015, which will discuss what is a conceptually sound and robust measurement model for pension plans. The trigger for this is the increase in popularity of pension plans which do not fit comfortably into either the 'defined benefit' or 'defined contribution' definitions, i.e. 'hybrid' pension plans, which incorporate features of both types of plan. Such plans were not envisaged when IAS 19 Employee Benefits was developed and are becoming problematic due to diversity in how they are measured and disclosed.

This research paper could potentially result in a fundamental re-write of IAS 19. JLT will carefully monitor developments and the potential impact of the project as it progresses.

DISCOUNT RATES – REGIONAL MARKETS

In June 2013, the Committee received a request to address the issue of determining the discount rate in a regional market consisting of multiple countries sharing the same currency (for example, the Eurozone). The Committee agreed that in determining the discount rate an entity shall include high quality corporate bonds issued by entities operating in other countries, provided that these bonds are issued in the currency in which the benefits are to be paid. The Committee recommended that the IASB should amend paragraph 83 of IAS 19 through the Annual Improvements project.

The IASB agreed with the proposal and published an exposure draft (Annual Improvements to IFRSs 2012–2014 Cycle) in December 2013 to this effect. In May 2014 the Committee considered the comments on the exposure draft and recommended that the IASB should finalise the proposed amendments as exposed. The amendments were issued in September and are effective from 1 January 2016 with earlier application permitted. For entities reporting under EU IFRS adoption will of course be subject to EU endorsement which is expected Q4 2015.

DISCOUNTING (THE VECTOR APPROACH)

More and more plans are moving their funding valuations, and how they view and manage their pension liabilities, to a cash flow based process with the use of a yield curve (a vector approach) rather than using a single average discount rate.

JLT believe that there are strong theoretical attractions of this approach; however, accounting firms (including BDO) do not believe it is acceptable. If the vector approach was allowed then using the one-year rate for the interest cost will, in current market conditions, see significantly lower figures flow through to the P&L.

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.

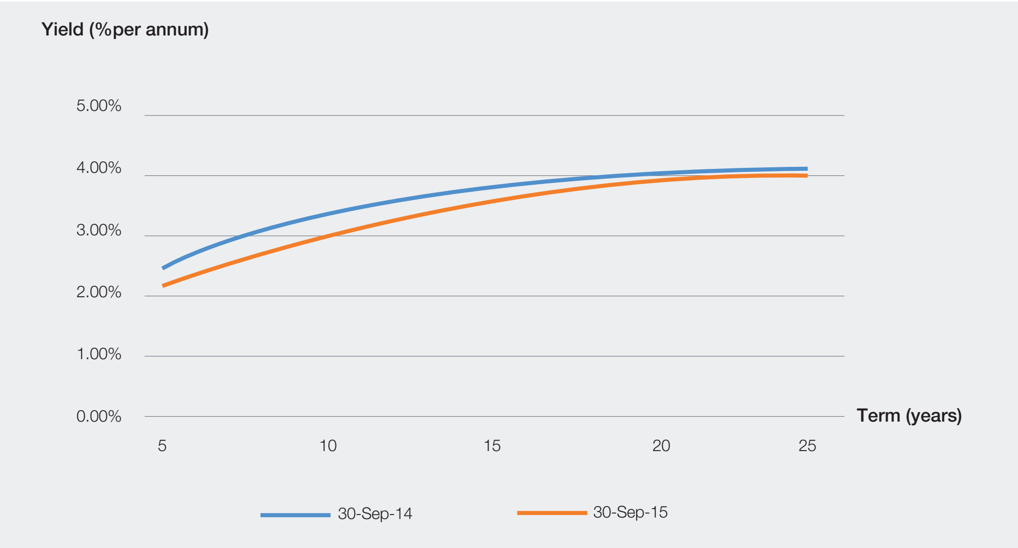
DISCOUNT RATE

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 shorter terms but are broadly similar at longer terms.

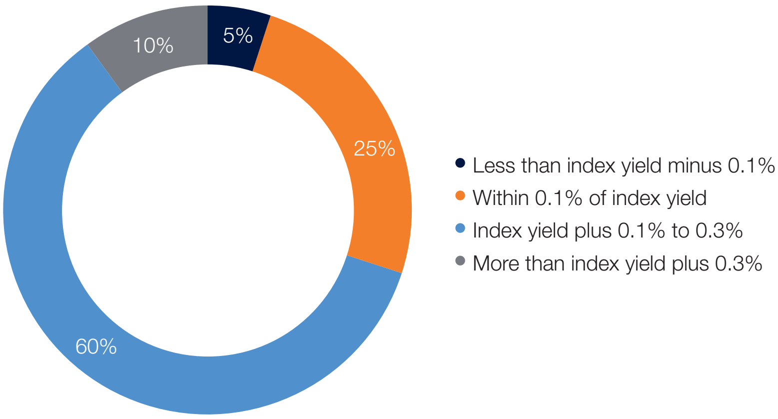
Figure 1: AA corporate bonds



Source: : iBoxx and JLT analysis

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.

Figure 2:



Source: JLT analysis

Significance

+0.1% on discount rate

Liabilities ↓ ~ 2%

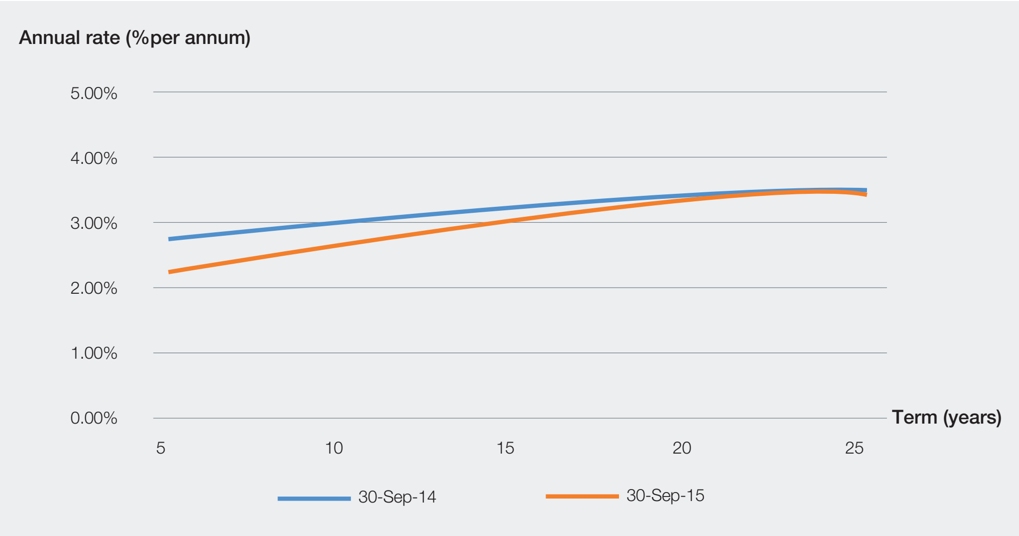
Service cost ↓ ~ 2.5%

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. This implied 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:

Figure 3: Market implied inflation (RPI)

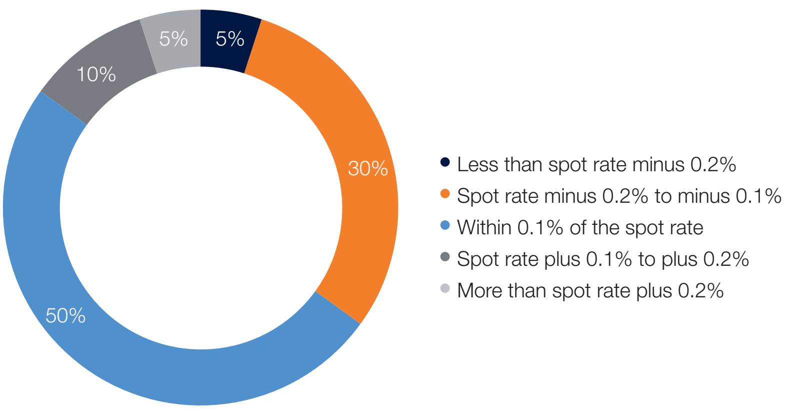


Source: Bank of England

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 25 years. The approximate spread of price inflation assumptions, relative to the annualised 15-year spot rate, is shown in the chart below:

Figure 4:



Source: JLT analysis

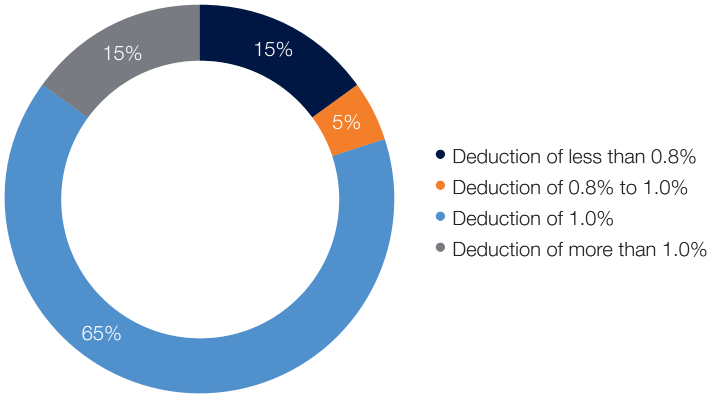
Significance
+0.1% on rate of inflation

Inflation linked 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 75bps to 110bps.

Figure 5:

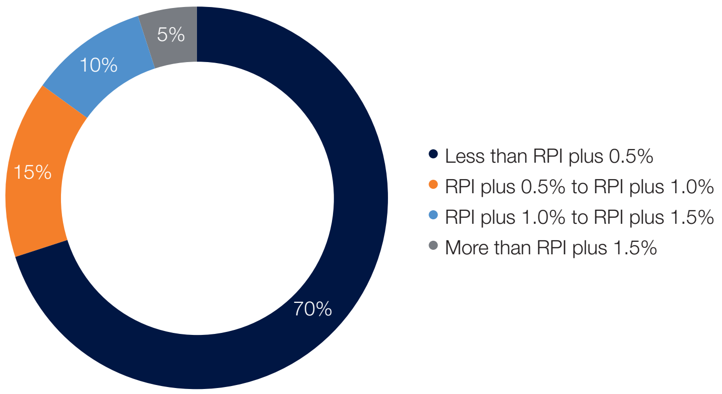


Source: JLT analysis

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.

Figure 6:



Source: JLT analysis

Significance
+0.1% on rate of inflation

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

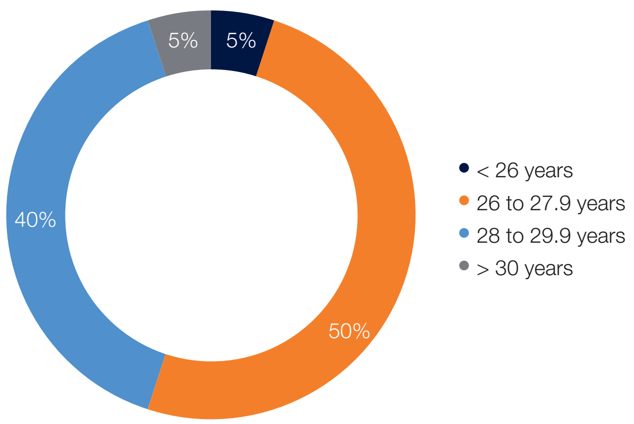
In recent years a large number of companies have begun setting salary increases equal or just above RPI. Some companies are now setting this by reference to CPI. Very few companies used a rate higher than 1.5% above RPI. In addition many companies have now either closed their defined benefit plan to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

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 age 60 figure.

Figure 7:



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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