

Accounting for pensions

Managing the Pension
Accounting Gap

July 2019



XPS Pensions

Introduction

Big changes are on the horizon for pension schemes:

- the Pensions Regulator is preparing to consult on a new cash funding code of practice; and
- proposed changes to pension law will require companies to agree a Long Term Objective for pensions.

These changes will drive even greater differences between accounting and the economic cost of pensions – creating an Accounting Gap. As a result, accounting disclosures will be an ever more important window to help explain these differences.

In our 2019 annual accounting for pensions report we take a look at:

1. The Accounting Gap and the importance of disclosures in managing this.

Long term funding targets expected to result in an Accounting Gap

The Accounting Gap could be **£260bn*** across all UK companies. This gap results from the difference between accounting balance sheets and future long term targets. Companies are already being steered towards these targets by the Regulator's 2019 funding statement.

Clear communication of risks and actions in accounts is key

Given this, companies should ensure they are clearly communicating the actions they are taking to manage pension cost and risk. We believe annual pension disclosures are the perfect opportunity to do so. It can prevent stakeholders overestimating the future cash cost of pensions and allow management to receive credit for actions that reduce pension risk and improve future business value.

2. Our accounting assumption survey results based on 150 of our clients.

- We have seen a material range in discount rates likely to be driven by greater variation in the approach to setting rates.
- Average life expectancies have fallen reflecting the trends in national data.
- The majority of schemes had GMP equalisation costs of less than 1% and all but a minority recorded this as a charge through P&L.



It is becoming essential that accounts set out how the numbers on the balance sheet interact with cash and risk management actions. If users of accounts understand risk then the company will get credit for managing it.

Wayne Segers
Principal



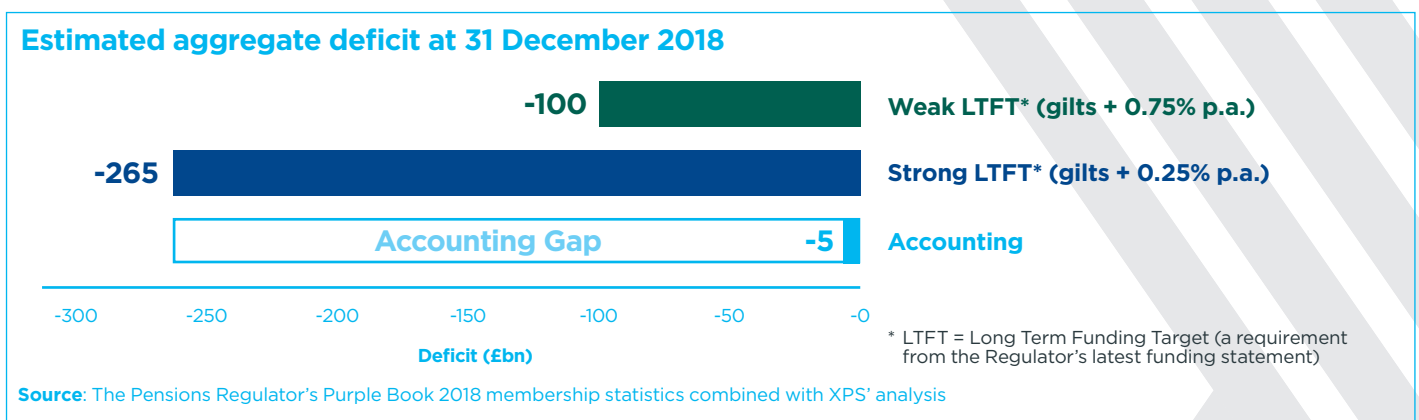
* Source: The Pensions Regulator's Purple Book 2018 membership statistics combined with XPS' analysis

What is the Accounting Gap?

Accounting disclosures do not reflect measures that drive cash funding or pension risk management for most pension schemes.

Following a number of high profile corporate failures, the government and the Pensions Regulator are taking action to improve protections for members. The Pensions Regulator has already strengthened its approach in its 2019 funding statement. All schemes should now have a Long Term Funding Target (LTFT) that reduces dependence on the employer, and have a plan to get there. We believe LTFT is the Pensions Regulator's terminology which will ultimately become the Government's required Long Term Objective. This can lead to increased contributions, competition with dividends and lower risk investment strategies. We expect more to come from new legislation and a new funding code of practice, due to be consulted on later this year.

The gap across all schemes: The chart below shows the difference between accounting deficits and typical Long Term Funding Targets. This could be £260bn higher than what is shown in the accounts across all UK companies. Investors will want to understand how this impacts cash flow, dividends and capital investment.



Circumstances will be different across schemes

The individual story will be different for every scheme and as a consequence potential actions to consider will vary. To highlight this, we have estimated the gap between accounting and long term targets for companies in our survey.

55%
accounting deficit and a larger LTFT deficit

Action

- Clearly set out difference between cash funding and accounting.
- Consider contingent assets to ensure cash funding is predictable over future years.
- Set out any future de-risking plans as funding improves to demonstrate management of risk.

19%
accounting surplus but a LTFT deficit

Action

- Manage cash – it will be key to avoid trapped surplus.
- Clearly set out why you may be cash funding even though accounts show a surplus. Consider contingent assets to lower the cash and accounting gap.
- Help users of accounts understand plans on managing risk so you obtain credit for reducing risk (e.g. by reducing growth assets).

26%
in surplus under LTFT as well as accounting

Action

- Help users of accounts understand accounting P&L versus cash impact of future de-risking actions.
- For example, forewarn of P&L charges that might occur which actually have no cash or economic cost (for example, the impact of granting security) to the business and have the benefit of removing pension risk (e.g. insurance).

Using disclosures to manage the Accounting Gap

In 2017 an FRC thematic review looked at pension disclosures and encouraged better communication of pension funding. The review had a heavy emphasis on ensuring that readers of corporate accounts understand pension risks and the difference between the pensions costs disclosed in accounts compared to the actual funding arrangements in place. This is more important than ever if expected new rules create a new Long Term Objective and widen the gap between accounting and funding targets.



The FRC expects companies to identify and explain their bases of pension valuation.

FRC



Companies could usefully explain that [contributions] are reviewed as part of each funding valuation.

FRC

Here we feel that in addition to the prescribed disclosure items, a good disclosure could cover:

1 The difference in measurement between accounting and funding.

2 The Long Term Objective for pensions, why this was chosen and how it can help reduce dependence of the scheme on the company.

3 How this is expected to impact cash funding and any contingent support being used to manage cash costs.

4 Any other important actions being taken to manage risk.



Given recent headlines on pensions competing with dividends, we believe good pension disclosures can help allay concerns and set out a clear path for managing pension risk.

Vicky Randhawa
Consultant





Survey results

In 2018 we released our first accounting for pensions report as a merged business. A year on and we have updated our accounting survey to review market practice. Our survey covers 150 of our clients with pension scheme assets ranging in size from £10m to over £1bn.

1. Discount rate

The discount rate assumption often has the greatest impact on liabilities. Pensions are effectively a long term series of cash flows and the discount rate is used to calculate the value of those cash flows.

The distribution of discount rate assumptions adopted at 31 December 2018 based on our survey is set out in the chart below:

Discount rate distribution



2.8% p.a.

Average discount rate assumption of 2.8% p.a. adopted by 41% of schemes

This reflects that a significant proportion of our clients have not used alternative methods to set the discount rate and instead are keeping methodology consistent with the previous year and in line with standard practice.

2.6% – 3.1% p.a.

Discount rate range at 31 December 2018

Discount rates range from 2.6% p.a. to 3.1% across schemes ranging in duration from 11 to 31 years.

Those with rates above 2.85% p.a. are more likely to have used non-standard discount rate methodologies.

0.5% p.a.

Up to 0.5% p.a. gap between discount rates at similar durations resulting in a 9% difference in liability value

Between a narrow duration range of 16 – 18 years we saw schemes used the highest (3.1% p.a.) and lowest (2.6% p.a.) observed discount rates.

43%

of schemes set the discount rate using the same underlying methodology by deriving a single equivalent discount rate using a full AA corporate bond yield curve weighted against scheme or similar duration cash flows.

What would the range be if reporters used a standard approach?

A standard approach (like that used by 43% of schemes in the survey) would lead to a small variation in discount rates by duration at 31 December 2018.

Scheme age	Immature	Medium to Immature	Medium to Mature	Mature
Average duration (years)	30	25	20	15
Single equivalent discount rate % p.a.	2.84%	2.81%	2.79%	2.74%

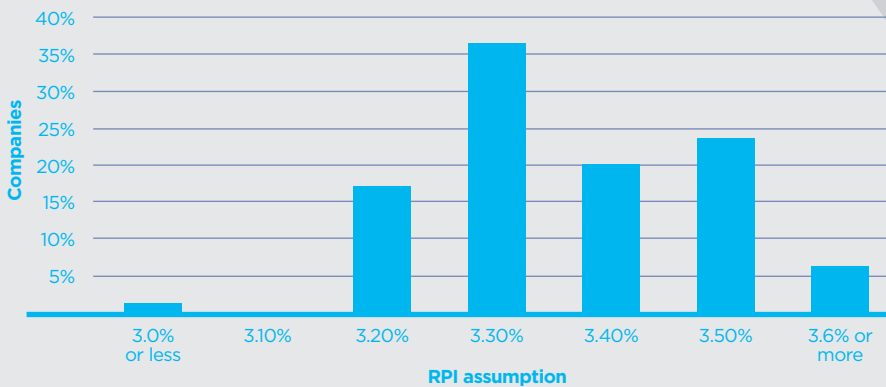
The above table shows a relatively narrow 10 basis point gap between discount rates across durations over 15 years apart if standard method were adopted to set the rate. This compares to an observed 50 basis point gap across companies with similar durations in the survey, highlighting the use of alternative method amongst some reporters.

2. Inflation

The inflation assumption is used to estimate future increases to pensions both up to and during payment. Increases in pensions as a result of inflation linkages are an important part of benefits and the assumption is often material to disclosed pension costs.

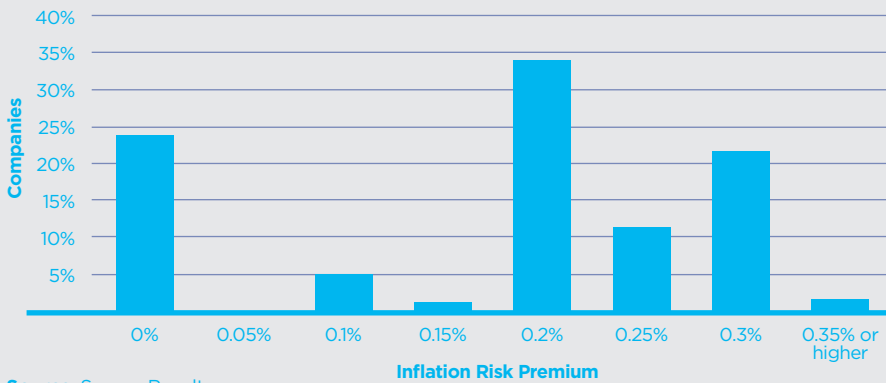
The chart below shows the RPI inflation rates assumed by companies at the end of 2018:

RPI distribution



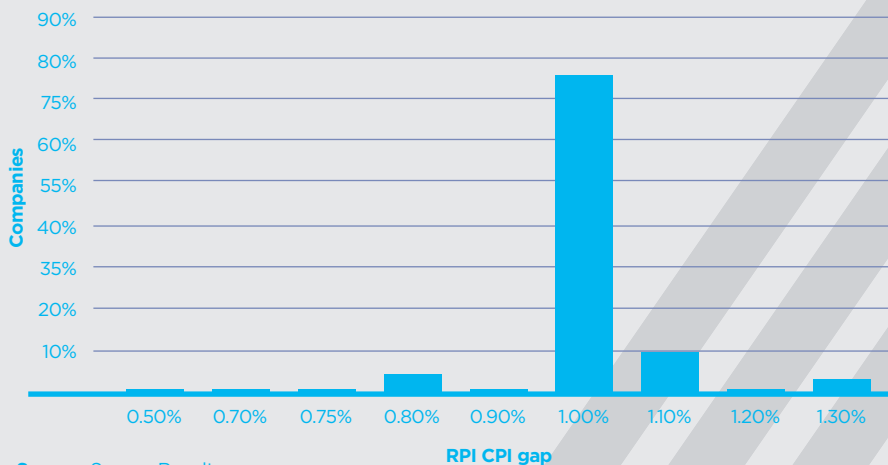
Source: Survey Results

Inflation Risk Premium - distribution



Source: Survey Results

Assumed gap between RPI and CPI - distribution



Source: Survey Results

76%

of schemes included an allowance for an inflation risk premium (IRP)

Of these, 46% adopted the average IRP of 0.2% p.a. while 30% adopted an IRP of 0.3% p.a.

1.00% p.a.

average gap between RPI and CPI

The gap adopted ranged from 0.5% p.a. to 1.3% p.a.

On 17 January 2019, the House of Lords Economic Affairs Committee published a report on 'Measuring Inflation' in which they made a number of recommendations. Among these is that the government should start issuing CPI linked gilts and stop issuing RPI linked ones. If this were to happen (over time with a sufficiently deep and liquid market in CPI linked gilts) this would provide an updated and more accurate way of measuring CPI inflation and setting future CPI assumptions directly rather than by reference to RPI.

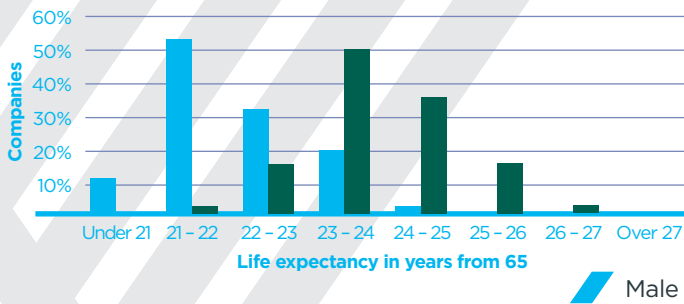
Other recommendations such as improving the measurement of RPI are expected to narrow the gap between RPI and CPI.

3. Life expectancy

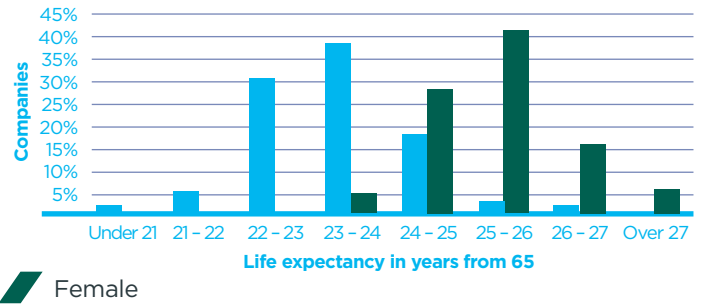
How long we expect members of a pension scheme to live determines how long their pensions are expected to be paid for. This involves estimating not only how long current pensioners might live, but how life expectancies might improve for pension scheme members yet to retire.

We are continuing to see that national life expectancy as reported by the Continuous Mortality Investigation (CMI) is not improving as fast as previously thought. With this trend however has come greater audit scrutiny and we are seeing requests for companies to provide evidence as to why using national statistics is suitable for their pension schemes.

Distribution of life expectancy from 65 for a 65 year old

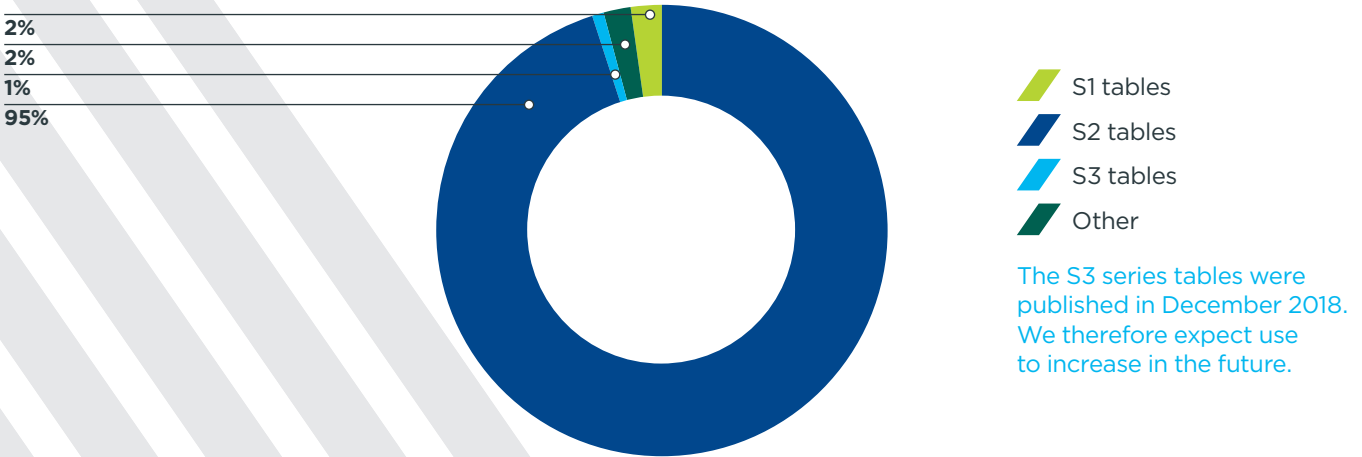


Distribution of life expectancy from 65 for a 45 year old

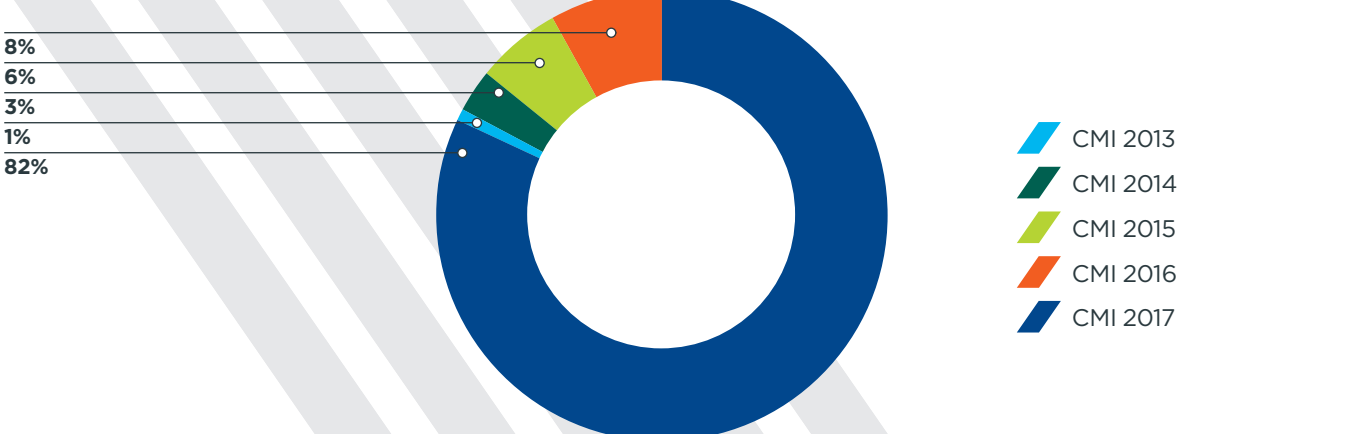


Average life expectancies based on assumptions adopted at 31 December 2018 have fallen around a quarter of a year compared to the assumptions adopted last year. This reflects the wide-spread adoption of CMI 2017 by the majority of reporters this year, many of which updated from using CMI 2016 last year.

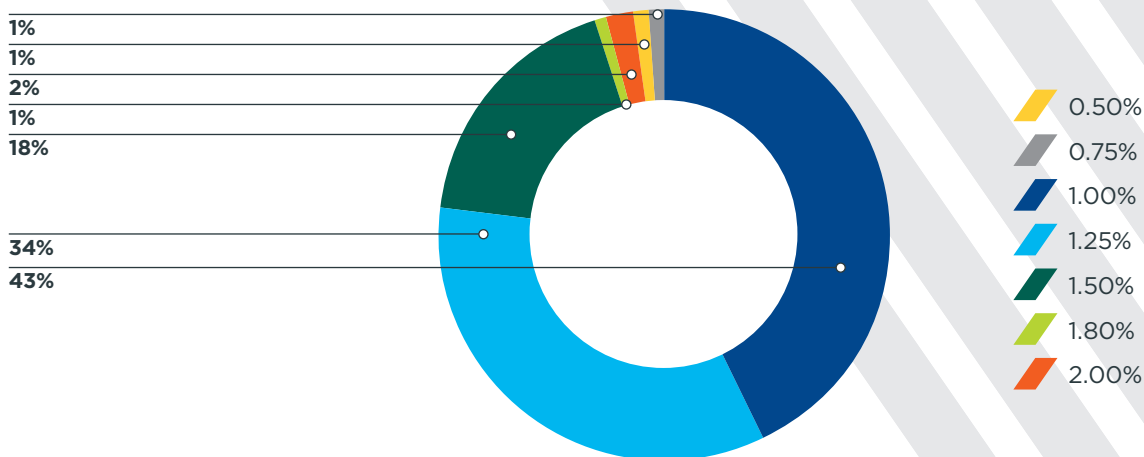
Base tables - distribution



Projection method - distribution



Long term future improvements – distribution



Our survey shows that 86% of schemes used a mortality assumption that differs from their funding assumption. This reflects the fact that many companies set their life expectancy assumption for accounting relative to the funding assumption, but often removing some prudence and/or updating for the most recent CMI projection model. In recent years this has led to a reduction in life expectancies, helping to improve balance sheet positions.

82%

of schemes adopted the most up-to-date projection model

This was CMI 2017 at the year-end which lowers the value placed on liabilities compared to CMI 2016.

97%

of schemes used the default smoothing parameter of 7.5

A handful of schemes adopted a lower parameter of 7 or 6.5 which would reduce the value placed on scheme's liabilities by around 1% - 3% for a typical scheme (using CMI 2017).

CMI 2018 was released in March 2019. As well as allowing for actual deaths up to the end of 2018, the core model puts more weight on the recent lower trends in life expectancy seen in the general population which together mean CMI 2018 projects lower future improvements in longevity than CMI 2017.

In line with typical practice, many schemes are likely to look to update to CMI 2018 for future accounting dates now this is available. However, for the first time we are seeing some auditors not allowing companies to use the latest life expectancy data automatically (i.e. CMI 2018) without tailoring it to their membership.

Tailoring mortality assumptions by comparing the latest data to your specific scheme characteristics also helps to ensure that benefit payments are not being overvalued.

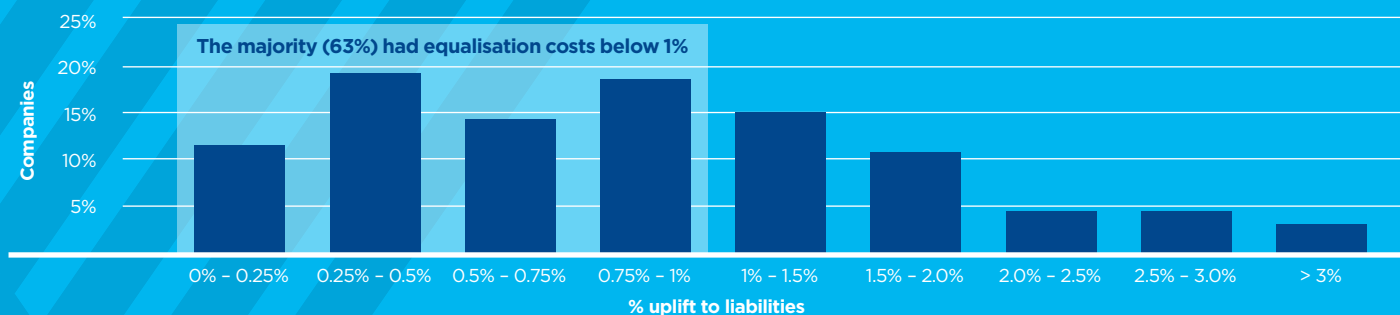
For next year's disclosures, sponsors may wish to discuss the mortality assumption in more detail with their advisers, making sure they understand the flexibility around setting this for accounting purposes and whether tailoring would be beneficial.

4. GMP Equalisation

Following the High Court ruling on 26 October 2018, it was finally confirmed that schemes need to remove the inequalities arising between the benefits of men and women due to unequal GMPs earned from 17 May 1990 to 5 April 1997.

120 of the schemes we surveyed had to account for the impact of the above.

Impact of GMP Equalisation



63%

of schemes had an uplift of less than 1%

Before the judgment, the impact was widely considered across the industry to be around a 1% - 3% uplift to liabilities. But more detailed scheme specific calculations have shown most schemes have considerably lower estimated uplifts.

9.6%

maximum uplift

Estimated GMP costs are scheme specific and one scheme in our survey having an estimated uplift in excess of 9%.

94

schemes used a robust calculation model based on summary data

This was the standard XPS approach adopted for many schemes using our purpose built GMP Equalisation Calculator.

A minority of schemes adopted other approaches such as full member by member equalisation calculations (where only a handful of members were affected), or basing the allowance on recent GMP equalisation exercises carried out as part of a buy-in process.

15

schemes used a rule of thumb approach

This tended to be used by smaller schemes with assets less than £30m where proportionality and materiality were considered and the approach agreed with the auditor in advance.

106

schemes recorded the impact through P&L as a past service cost

This was default approach we saw required by auditors unless an explicit, evidenced assumption for GMP equalisation has previously been allowed for.

In addition to the schemes above, there are still a handful of clients continuing to argue their case for OCI treatment who have not yet reached agreement with their auditors.

6

schemes recorded the change through OCI

In most cases this was an approach adopted by overseas groups with lead auditors located outside of the UK.

Current issues for pensions accounting

Audit approach

In July 2018 the FRC published a report on the findings of its thematic review into the audit of pensions called 'The audit of Defined Benefit Pension Schemes'. This review concluded that improvement was required in almost half of IAS19 audits.

Following this review, and off the back of a number of high profile audit investigations, such as BHS, Carillion and Patisserie Valerie we have seen a much a higher level of audit scrutiny of pensions.

This has arisen in a number of areas:

- Extra scrutiny over methodology for setting assumptions, particularly around more scheme specific demographic assumptions like mortality
- More detailed questions around the calculation of disclosure items
- More efforts by auditors to reproduce figures from base member data
- Extra information and scrutiny of membership movements, and
- More detailed checking of asset values and the custodianship arrangements

We have seen a wide range of these areas tested, and coverage varies between audit firms and client. In many instances the increased level of detail required has taken clients by surprise and may be difficult to understand.

We think that auditors will rightly continue to scrutinise pensions more carefully, and we expect the rough edges from the new processes to be smoothed off as auditors refine their procedures to focus on the best way to carry out their testing in coming years.

IAS 19 Restriction of surplus (IFRIC 14)

Back in 2015 the IASB began a consultation to review the current requirements which determine if a company can disclose a pension scheme's surplus as an asset on the company's balance sheet. The current IAS 19 standard does not adequately cover this and the IFRIC 14 interpretation was produced to provide guidance. Broadly, if a company can demonstrate it can get an economic benefit from the surplus at any point in the lifetime of the scheme, then it can reflect the surplus. The 2015 proposals would

make this test harder meaning that most schemes would no longer be able to recognise a surplus, and potentially even have to show a deficit to reflect future cash contributions going into the scheme.

The 2015 proposals got almost to the final hurdle but then were dropped by the IASB. There is a proposal to issue another consultation on this subject and so this may come back to life.

It is worth noting that any new consultation is likely to take some years to develop into a revised

accounting standard, if it does at all. That said, it is clear the IASB is not satisfied with the current standard and the direction of travel may well be to make it more difficult to recognise surpluses.

With 45% of schemes in surplus at the moment and the Regulator's push for higher funding targets it is possible that this could be a big impact to balance sheets if it is harder to show a surplus.

Remeasurement of balance sheet when accounting for past service costs

If a scheme makes a change during the year which either changes the value or removes past service liabilities, then this should be recognised at the time that this change is contractually binding. Typically a P&L charge (or credit) would be made based on assumptions at this point. It was previously unclear whether the balance sheet position should be recalculated at this point or not. The recent narrow scope amendment to IAS 19 clarified that the balance sheet should be remeasured, which opens the door to potentially less predictable P&L charges in years

where past service charges occur. This is because the interest cost P&L item will be based partly on the assumptions set at the start of the year and partly on the assumptions set at the date of the event. It is also possible that the impact on the interest cost item might be larger than the impact of the event itself, leading to unexpected results. For example, a scheme closure may release a P&L credit in itself, but the timing of the remeasurement might lead to a higher interest cost charge than had no event occurred.

This also potentially opens up the opportunity to 'game' the P&L by creating a past service cost event in the middle of the accounting period, but we understand that auditors will expect these events to be 'substantive' in order to recognise them.

On the face of it this is a fairly small change, but it could make accounting for these events more complex.

This is applicable for accounting periods beginning on or after 1 January 2019, and early adoption is possible.

FRS 102

Proposed amendments to rules on multi-employer schemes

Currently under FRS 102, when an entity participates in a multi-employer pension scheme and does not have sufficient information available to split its share of the scheme out from the whole, it is possible to account for the scheme on a pay as you go defined contribution basis. This means that the balance sheet item is the present value of future contributions and the P&L item is the annual cash contributions.

This does not fully reflect the risks and obligations of the company and the preference is for this to be accounted for on a defined benefit basis, meaning that the balance sheet is the difference between the estimated value of the pension obligations that

have been built up by the company, and the assets of the scheme that are (at least notionally) allocated to it.

It is not clear what the transitional approach is to move between the defined contribution and defined benefit methods should sufficient information become available to prepare defined benefit disclosures.

This issue often affects companies operating in the public or pseudo public sector.

The FRC recently published an Exposure Draft setting out proposed amendments to FRS 102 which, if implemented, will clarify how to deal with this change.

Under the draft amendments, the balance sheet impact at the date of from defined contribution to defined benefit accounting would be recognised as a one off item in Other Comprehensive Income, presented separately to the other OCI items.

If the proposed amendments go ahead, they will have effect for accounting periods beginning on or after 1 January 2020, with early application permitted.



It's been a fairly quiet year for new developments in the accounting standards, but GMP equalisation has kept us busy. Audit firms have responded actively to the criticism of their work on pensions by the FRC and I expect the increased level of audit scrutiny we have seen to become routine in the coming years.

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About us

XPS Pensions Group is the largest pure pensions consultancy in the UK, specialising in actuarial, investment consulting and administration, with revenues of around £110 million. The XPS Pensions Group business combines expertise, insight and technology to address the needs of over 1,000 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 870,000 members and provide advisory services to schemes of all sizes including 25 with over £1bn of assets.

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