



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 four sections:

- Recent developments and markets
- Latest information from FTSE 100 company disclosures
- PCS expected IAS19 assumptions
- Simple guide to IAS19

#### Markets

Since 31 March 2006:

- The FTSE All Share Total Return Index has increased by 11%
- The MSCI World Index (GBP) has increased by 0.5%
- The yield on long dated fixed gilts has increased from 4.25% to 4.65%
- The yield on long dated index linked gilts has increased from 1.10% to 1.25%
- The yield on long dated AA bonds has increased from 4.90% to 5.35%

Against this backdrop of market movements (and significant increases in employer contributions), we might have expected pension scheme funding positions to show a marked improvement. However the improvement from markets is, for many companies, offset by a need to use more up-to-date mortality assumptions. Overall therefore, we predict a modest improvement in the average funding level of between 5% and 10%.

## Recent Developments

### Asset Ceilings

As more companies are moving into a surplus position on their accounting bases, care needs to be taken to allow for the ceilings imposed by the accounting standards, and to consider ways of mitigating any "lost" assets.

### Settlement Gains from Individuals Transferring Out

Some companies have issued letters to members notifying them of their transfer out options, and sometimes also offering members some incentive to do so. This can lead to settlement gains in the Company accounts, due to the amounts paid out being lower than their value on the accounting basis.

Under FRS and IAS where the Statement Of Recognised Income and Expense (SORIE) is used these accounting settlement gains are normally taken through the P&L account. But the guidance is not clear, and therefore it is also possible to take them through the Statement Of Total Recognised Gains and Losses (STRGL)/SORIE.

It is also worth noting that under FAS and IAS (where the SORIE is not used) these gains may end up going through the P&L accounts as charges where there are unrecognised losses.

### Career Average Schemes

The present accounting standards generally require companies to account for such schemes on a uniform accrual basis to avoid back-end loading. However, there could be arguments to show that in a particular situation no back-end loading is taking place, e.g. where the benefit structure has been reduced for future service. Also it has been argued that this back-end loading principle should not be applied to these Career Average Schemes, but we would expect auditors to oppose this approach.

### Multi-employer and Group Plans

The different accounting standards have different requirements:

FAS – Defined contribution account.

IAS – There needs to be a contractual agreement (multi-employer) or a stated policy (Group) on how to apportion the assets and liabilities, to account on a defined benefit basis. Otherwise defined contribution account.

FRS – The assets and liabilities need to split on a "reasonable and consistent" basis to account on a defined benefit basis. Otherwise defined contribution account. The "reasonable and consistent" may be open to some interpretation.

### Benefit Change or Assumption Change

The effects of benefit changes costs go through the P&L account under FRS or IAS (where the SORIE is used), whereas an assumption change would go through the STRGL/SORIE.

Some changes could be construed as either e.g. a change to commutation (the giving up of pension for a tax free lump sum payment) terms where previously there was no specific assumption for the number of members taking up this option. Under such a scenario most auditors would accept that such a change could go through either the P&L or the STRGL/SORIE as long as the method is applied consistently year on year. The circumstances of any specific change should be considered in detail before applying this principle.

### Valuing Derivatives

A couple of general points are:

**Admissibility** – in general they are admissible, but if the counter party is connected to the Company then it may have to be excluded.

**Valuing derivatives** - should be based on risk free rates based on the term/duration of the liabilities and consistent with the assumptions used for the other assets.

### Insurance Companies

Plan assets exclude non-transferrable financial instruments issued by the entity. It is not clear how unit-linked policies should be treated (where the insurer is simply the investment vehicle).

### FAS Changes

For periods ending on or after 15 December 2006, the full deficits go onto the balance sheet. There are also revised disclosures, which include adjustments to reserves to flow through from the P&L items. These are still calculated as they were previously: effectively, all gains and losses go through the P&L, mainly using the spreading/amortisation approach. For periods ending on or after 15 December 2008, companies will not be allowed to use earlier measurement dates.

### FRS17 Changes

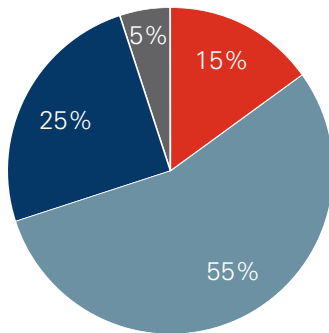
For periods beginning on or after 6 April 2007 the disclosures are changing to be more in line with IAS19, and the use of bid value of assets will be required (as opposed to the existing mid value). Also, there are extra voluntary new reporting disclosures. These would include disclosing the buyout funding level, as well as many other items. Even though early adoption has been encouraged, we have not seen any such disclosures yet.

## Latest Information from FTSE 100 company disclosures

This analysis is based on the most recent annual report available at 31 March 2007, for each of the FTSE100 companies. The majority of the 56 companies with a year-end of 31 December had published their 2006 report by that date.

### Discount Rate

Not surprisingly the discount rates used were mostly very close to the index yield on long dated AA corporate bonds. However, there is increasing variation, as companies are finding reasons to move away from the index yield in either direction. The approximate spread of discount rates is as follows:



- < index yield minus 0.05%
- within 0.05% of index yield
- index yield plus 0.05% to 0.1%
- > index yield plus 0.1%

**Significance**  
+0.1% on discount rate

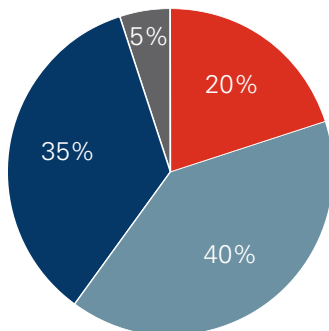


**Liabilities** ↑ ~2%  
**Service cost** ↑ ~2.5%

IAS19 requires that the discount rate used for a particular company should reflect the duration of the pension liabilities for that company. This can be used to justify a discount rate which is slightly higher than the index yield. The more mature plans are beginning to use higher discount rates, which is what the yield curves should suggest. Auditors are questioning more closely the appropriateness of the discount rate for the duration of the liabilities.

### Return on Assets (Equities)

The key component of the return on assets assumption is the assumed return on equities. Under FRS17 separate assumed returns were required for different asset classes. However, under IAS19 it is permitted to use an overall assumed asset return. Where companies have done this we have considered the implied equity return assumption. The approximate spread of equity return assumptions (relative to the return available on Government bonds) is as follows:

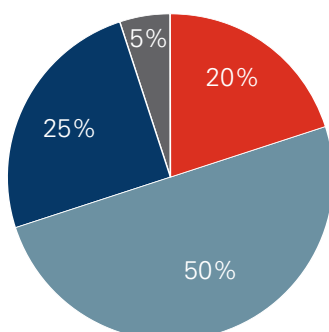


- gilt yield plus 2.5% to 3%
- gilt yield plus 3% to 3.5%
- gilt yield plus 3.5% to 4%
- gilt yield plus 4% to 5%

### Mortality

The most striking feature of the recent wave of annual reports has been the sudden increase in the assumed life expectancy of a pensioner, as we predicted three months ago. To date, 71 FTSE 100 companies have adequately disclosed their mortality assumptions (a number which is itself rapidly increasing). Of these, 40 have disclosed a figure for the previous year: on average, the assumed life expectancy of a male aged 60 increased by 1.2 years from the previous year's figure. Several companies increased their assumed life expectancy by three years in 2006. However some of the Companies have disclosed this assumption this year, but did not disclose last year's assumption, and these Companies have typically disclosed lower than average life expectancies; which has peculiarly brought the average disclosed rate down.

There are many different mortality tables used. The most common base table is PA92 with medium cohort (MC) allowance for future improvement. Companies tend to 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.



- 20 to 22.9 years
- 23 to 24.9 years
- 25 to 26.9 years
- 27 to 29 years

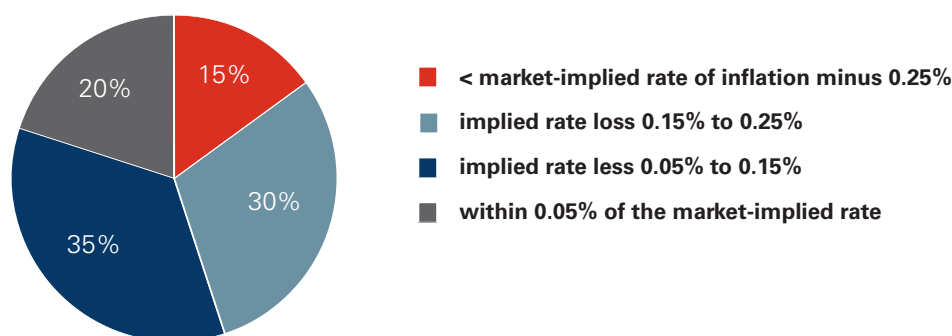
**Significance**  
+1 year assumed life expectancy



**Liabilities** ↑ ~2.5%  
**Service cost** ↑ ~2.5%

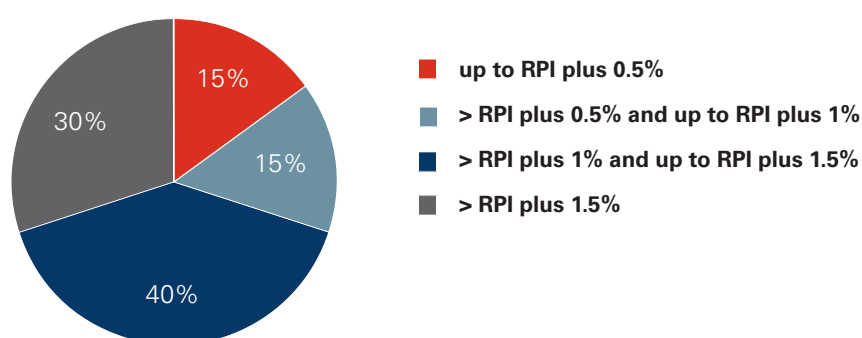
### Price Inflation

A 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. An increasing number of companies are using a rate of inflation, which is a little lower than the rate implied by the yield curves. The approximate spread of price inflation assumptions is as follows:



### 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, is as follows:



### PCS Expected Assumptions at 31 March 2007

The expected range of assumptions at 31 March 2007 is as follows:

Discount rate	-	5.05% to 5.55%
Price inflation	-	2.60% to 3.25%
Salary inflation	-	3.0% to 5.0%
Return on equities	-	7.0% to 8.7%
Assumed life expectancy	-	24 to 27 years for a man now aged 60 (down to 20 years when it can be justified by nature of employee population or experience). 1.0 to 2.0 years higher for a male retiring 20 years from now.

The expected assumptions noted below are based on the following market conditions (*corresponding figures at 31 March 2006 are shown in brackets*):

■ FTSE 20yr fixed gilt index yield	-	4.65%	(4.25%)
■ FTSE >15yr IL gilt index yield	-	1.25%	(1.1%)
■ Market implied inflation	-	3.25%	(3.1%)
■ Yield on long dated corporate bonds	-	5.35%	(4.90%)

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## Simple Guide to IAS19

IAS19 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:

- **Unrecognised past service cost** - If a benefit improvement is granted that does not vest immediately, then the cost of this benefit improvement can be spread and charged to the profit and loss account over a number of years. The amount of this cost which has not yet been charged to the income statement is the unrecognised past service cost.
- **Unrecognised gains (or losses)** - Companies have the option under IAS19 to reduce balance sheet volatility by recognising only a portion of the actuarial gains (or losses). If the cumulative unrecognised actuarial gain is greater than the greater of 10% of the assets and 10% of the past service liabilities, then the amount in excess of this 10% corridor can be unrecognised. Companies can then spread this unrecognised amount as a charge through the income statement. Companies are permitted (but not required) to recognise gains or losses that fall within the 10% corridor.
- **Unrecognised transition obligation** - Companies that did not recognise the full amount of the net liability on first adoption of IAS19 will have an unrecognised transition obligation. This unrecognised amount is spread and charged to the income statement over a period up to five years.
- **Asset ceiling adjustment** - The fair value of plan assets must be limited if there are surplus assets in excess of the past service liabilities, and these 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.

### Income statement

The main items charged to operating profit are:

- **Current service cost** - This is the present value of the benefits arising during that year calculated using the projected unit credit method (i.e. with allowance for pay increases through to retirement or earlier leaving).
- **Past service cost** - This is the present value of any benefit improvement that vests immediately.
- **Amortisation of unrecognised amounts** - The balance sheet impact of unrecognised amounts, as discussed above, can be spread over a number of years (usually over the expected average working lives of participating employees). If this applies then a portion of the unrecognised amount is charged each year to the profit and loss account.
- **Curtailement and settlement gains (or losses)** - The gain (or loss) recognised is the net change in the assets / liabilities, plus the proportionate share of unrecognised amounts.

The main items charged to other finance expense include:

- **Return on assets** - This is the expected return on assets based on market expectations at the beginning of the year, allowing for expected cash flows during the year.
- **Interest cost** - This is interest charged on the liabilities at the beginning of the year (at the discount rate used to value the liabilities), allowing for expected cash flows during the year, as the benefit payments are one year closer to settlement.

### Statement of recognised income and expense (SORIE)

The items recognised here are:

- **Actual return less expected return on plan assets** - This is an actuarial gain (or loss) and applies when the company has opted for immediate recognition of all actuarial gains or losses.
- **Experience gains/losses on liabilities** - Again this applies only when the company has opted for immediate recognition of all actuarial gains or losses.
- **Changes in assumptions** - This is the change in liabilities arising from any changes in the actuarial assumptions.

### Disclosure items

The required disclosures in the accounts include:

- Accounting policy on recognition of actuarial gains and losses
- General description of the type of plan
- Reconciliation of opening and closing value of past service liabilities, including current service cost, interest cost, member contributions, actuarial gains/losses, benefits paid, past service cost, curtailments and settlements
- Separation of liabilities between funded plans (whether wholly or partly) and unfunded plans
- Reconciliation of opening and closing value of plan assets, including expected return on assets, actuarial gains/losses, company contributions, member contributions, benefits paid, settlements.
- Reconciliation of balance sheet to the values of plan assets and liabilities showing any unrecognised amounts or asset ceiling adjustments
- The total expense recognised in the income statement, including current service cost, interest cost, expected return on plan assets, actuarial gains/losses, past service cost, curtailments and settlements
- The amount recognised in the SORIE for actuarial gains/losses
- The major constituent categories of the plan assets (by percentage and/or amount) and a description of the basis used to determine the expected return on assets
- The actual return on plan assets
- The principal actuarial assumptions used, including the discount rates, expected returns on plan assets, pay inflation, any other material assumptions
- The amounts for the current year and previous four years of the past service liabilities, plan assets, plan surplus (or deficit) and the experience adjustments arising on the liabilities and on the assets (expressed as an amount or as a percentage)
- The company's best estimate of the contributions it expects to pay in the following year.