



## PENSION SURPLUSES – TOO MUCH OF A GOOD THING?

Dear Sid

Changes in accounting standards are causing yet another problem for companies and shareholders – too much surplus. How can that be a problem you ask? Well it is a problem if it is surplus locked in the pension scheme which the company and shareholders cannot touch. Such “irrecoverable” surplus could represent wasted company contributions or reflect an investment strategy which is too risky – why should shareholders allow risks to be taken in the investment strategy if they get all the grief and cost of any deficit on the downside, but none of the surplus on the upside?

### PCS Market Analysis

The latest PCS analysis of the pension schemes of the FTSE100 shows that a staggering 20 companies are now reporting an irrecoverable surplus. Total reported irrecoverable surpluses in the FTSE100 now total £2.4 billion. This is a huge increase of approximately 150% over the position just 12 months ago.

The top ten largest reported irrecoverable surpluses in the FTSE100 are as follows:

British Airways	£1,159 Million
Cable & Wireless	£405 Million
Scottish & Southern Energy	£211 Million
Thompson Reuters	£119 Million
Rolls-Royce	£114 Million
Compass	£92 Million
Anglo American	£68 Million
Bhp Billiton	£55 Million
British American Tobacco	£44 Million
Associated British Foods	£34 Million

- Changing accounting standards significantly increase the risk of irrecoverable surpluses.
- PCS analysis of FTSE100 pension schemes shows that reported irrecoverable surpluses now total £2.4 billion, an increase of 150% over the last 12 months.
- 20 FTSE100 companies have now reported irrecoverable surpluses.
- The largest irrecoverable surplus is £1,159 million which belongs to British Airways
- Companies should act now to deal with the “problems” of irrecoverable surpluses and put in place a clear “end game” strategy.

In the case of British Airways the irrecoverable pension surplus is equivalent to over 40% of the market value of the company.

### How has this situation come about?

The accounting standard which governs the reporting on pension schemes for the large majority of companies is IAS19. This standard treats the pension surplus or deficit (net of deferred tax) as a balance sheet asset or liability of the company. However, it does not make it clear that there are restrictions on the asset that can be taken to the balance sheet. The standard states:

*“An asset may arise where a defined benefit plan has been overfunded or in certain cases where actuarial gains are recognised. An entity recognises an asset in such cases because:*

- (a) the entity controls a resource, which is the ability to use the surplus to generate future benefits;*
- (b) that control is a result of past events (contributions paid by the entity and service rendered by the employee); and*
- (c) future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit.”*

In plain English, this means that the maximum surplus that can be treated as an asset on a company’s balance sheet is the value of possible future refunds and reductions to future contributions. However for most pension schemes, refunds of surplus funds are unlikely to be possible. Moreover, the number of employee members of pension schemes is dwindling as schemes are closed to new entrants (and, increasingly, closed to all future accrual). This will likely limit the value of any reduction in future contributions. All of this means that the maximum surplus that can be treated as a balance sheet asset may well be limited.

Last year the International Accounting Standards Board (the IASB) clarified the circumstances under which a company can recognise the value of a possible reduction in future contributions as a balance sheet asset. This clarification was published in a statement – IFRIC 14. This states that for pension surplus to be treated as a balance sheet asset, companies must have either an “unconditional right” to a refund (which means they do not need the consent of a third party) or have “sufficient scope to reduce future contributions”.

However IFRIC 14 also included "clarification" on the impact of a "minimum funding requirement" (we interpret the "minimum funding requirement" to include the UK's Statutory Funding Objective (SFO) and the Schedule of Contributions). Under this new clarification, an IAS19 surplus could be reduced, if the trustees' funding (SFO) basis is more prudent (ie produces a higher liability) than the IAS19 basis. In addition, an IAS19 deficit could be increased (or surplus reduced) to allow for the requirement to pay the contributions set out on the Schedule of Contributions. These "minimum funding requirement" effects only happen if there are restrictions on the company's use of surplus. But it is already clear that IFRIC 14 will affect a large number of companies.

IFRIC 14 only applies for periods beginning on or after 1 January 2008. However companies who do not adopt IFRIC 14 for 2007 accounts may well be under pressure from their auditors to explain what impact IFRIC 14 would have had if it had been adopted. Compass Group was the first FTSE 100 company to adjust its accounts (for its year ended 30 September 2007) for IFRIC 14, resulting in a £92 million increase in its overall pension deficit.

#### **So what should companies be doing?**

Companies need to look again at their rationale for taking risk in the pension scheme and whether, or not, it continues to make sense from a shareholder perspective. The problem that companies face of course is that pension investment strategy is controlled by the trustees, who are not always answerable to companies and shareholders. Moreover, trustees are not renowned for making quick and rapid changes to investment strategy.

Companies should therefore check that their pension investment strategy continues to make sense from a shareholder perspective. If it does not, there needs to be an urgent discussion with the trustees on the investment strategy. In many cases we believe it would make sense for companies to lock into gains and encourage a significant reduction in risk taking in the pension scheme. Moreover, we believe that trustees will generally welcome a move to reduce investment risk.

This is not simply an investment issue. There are also a number of other options that companies should be exploring, such as the use of contingent assets. Indeed it is surprising that greater use is not made of such options.

#### **The big picture strategy**

Increasingly now, companies and pension schemes are in an "end game" scenario. For large numbers of companies the big picture strategy should be to manage the pension liabilities downwards as fast as possible, typically using a combination of transfer value exercises for deferred pensioners and buyouts for pensioners.

The insurance company buyout market has seen a rush of new entrants in the last 12 months resulting in much more competitive pricing and a flood of new business. For current pensioners it is possible to buy out the liabilities with a premium over IAS19 values of approximately 10% or even less, making buyouts of pensioner liabilities increasingly attractive. Even insurance companies are looking to do this, with Friends Provident being a recent example of a buyout deal (with Norwich Union) for pensioner liabilities.

For deferred pensioners, the pricing of a buyout represents a much bigger step up from the IAS19 liability in the company's accounts - and hence is much less attractive. However, for these liabilities, companies should be considering a transfer value exercise - whereby members are offered a much more attractive exit route from the pension scheme in a deal which can leave the company, trustees and members all better off.

Increasingly shareholders will want to know that companies are planning to deal with the "problems" of irrecoverable surpluses and have a clear "end game" strategy in place. PCS can work with companies to plan and deliver their "end game" strategy and avoid the pitfalls of irrecoverable surpluses.

Yours sincerely,




For further information on the services PCS can offer you, please email us at [solutions@pensionstrategies.co.uk](mailto:solutions@pensionstrategies.co.uk) or visit our website at [www.pensionstrategies.co.uk](http://www.pensionstrategies.co.uk) to register your interest. Alternatively call Charles Cowling on 0161 242 5388 or Saroop Rooprai on 020 7895 7938.

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