



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 December 2006:

- The FTSE All-Share Total Return Index has increased by 5%
- The MSCI World Index (GBP) has increased by 5%
- The yield on long-dated fixed gilts has remained at 4.5%
- The yield on long-dated index-linked gilts has decreased from 1.1% to 0.9%
- The yield on long-dated AA bonds has increased from 5.1% to 5.8%

Because of these favourable market movements (and increases in employer contributions), pension scheme funding positions are showing a marked improvement. However the improvement from markets is, for many companies, still offset by a need to use more up-to-date mortality assumptions. Overall therefore, we predict an improvement in the average funding level of around 7% from 12 months ago.

Recent Developments

Asset Ceilings – IFRIC14 (issued by the International Financial Reporting Committee)

IAS19 guidance on the recognition of pension surplus in the balance sheet and the effects of “minimum funding requirements” have been clarified by IFRIC 14.

However, even after this clarification there are still some uncertainties on its detailed application, particularly on the precise conditions that need to be satisfied in order to regard the employer as having an unconditional right to use the surplus.

Under IAS19, any surplus can be recognised as long as the employer has an unconditional right to use the surplus at some point during the life of the plan or on its wind-up. If there is a wide scope (within the Scheme’s Trust Deed and Rules) for the employer to use surplus then IFRIC14 will probably have no impact, or might even allow any previous restriction on surplus to be removed.

However if the scope for the employer to use surplus is not so wide and where there is a “minimum funding requirement” there can be two separate effects:

1. The available surplus could be reduced if the “minimum funding requirement” basis is more prudent than the IAS19 basis.
2. The IAS19 deficit could be increased (or surplus reduced) to allow for extra contributions required to cover any shortfall in the “minimum funding requirement”.

We interpret the “minimum funding requirement” to include the UK’s Statutory Funding Objective (SFO) and the Schedule of Contributions.

IFRIC14 applies for periods beginning on or after 1 January 2008 with earlier application permitted. However, if you do not adopt IFRIC14 for 2007 accounts you must in any event disclose what impact IFRIC14 would have had if it had been adopted.

In summary, IFRIC14:

1. does not need to be applied until periods beginning on or after 1/1/08
2. could reduce accounting surplus
3. could increase accounting deficit
4. requires further clarification
5. requires specialist advice
6. could typically affect your scheme if:
 - i. the ability for the company to use surplus is restricted; and
 - ii. the SFO funding basis is stronger than the IAS19 basis and/or there are some SFO deficit contributions required
7. in any event requires some action now.

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

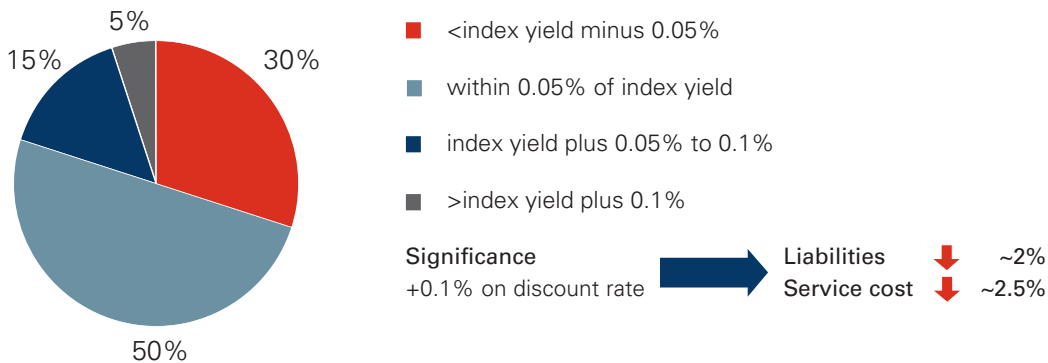
For periods beginning on or after 6 April 2007, the disclosures are changing to be more in line with IAS19, and the use of bid value of assets will be required (as opposed to the existing mid value). Also, there are extra voluntary new reporting disclosures. These would include disclosing the buyout 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 December 2007, for each of the FTSE100 companies.

Discount Rate

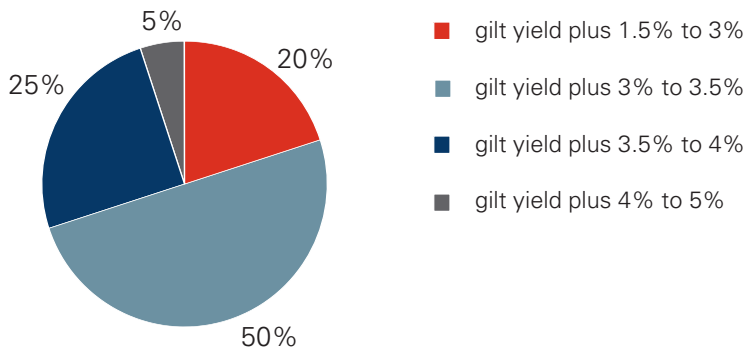
Not surprisingly the discount rates used were mostly very close to the index yield on long-dated AA corporate bonds. However, there is increasing variation, as companies are finding reasons to move away from the index yield in either direction. The approximate spread of discount rates is as follows:



IAS19 requires that the discount rate used for a particular company should reflect the duration of the pension liabilities for that company. Currently the yield curve at high durations is so flat that there is little reason to move away from the index yield. In March, some companies did not fully respond to the recent increase in bond yields.

Return on Assets (Equities)

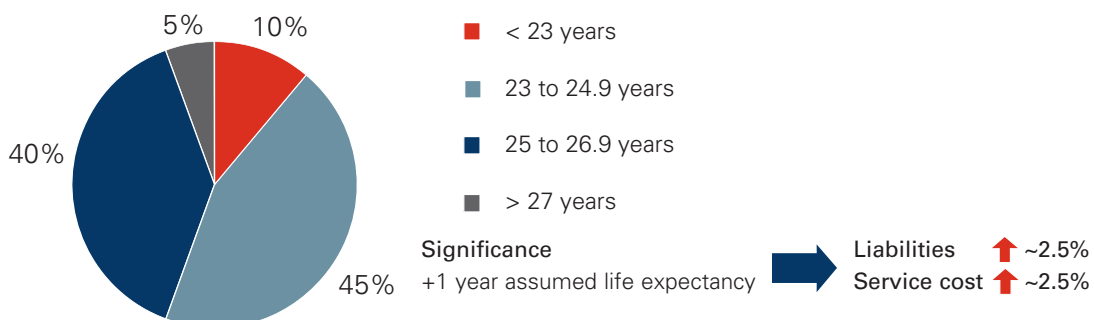
The key component of the return on assets assumption is the assumed return on equities. Under FRS17, separate assumed returns were required for different asset classes. However, under IAS19 it is permitted to use an overall assumed asset return. Although it could be argued that these returns should have increased to reflect bond yield increases, there is little evidence of this. The approximate spread of equity return assumptions (relative to the return available on Government bonds) is as follows:



Mortality

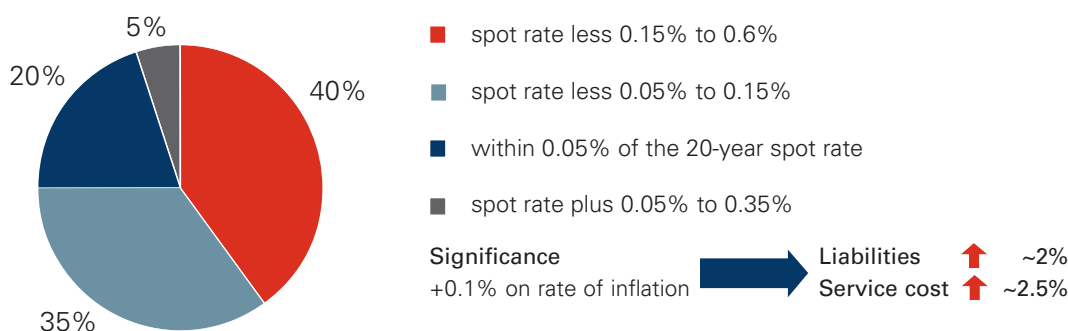
The increase in the assumed life expectancy of a pensioner has continued. 69 of the FTSE 100 companies have now adequately disclosed their mortality assumptions. Of these, 57 have disclosed a figure for the previous year; on average, the assumed life expectancy of a male aged 60 increased by 0.8 years from the previous year's figure. A number of companies increased their assumed life expectancy by two or even three years. Some companies also quote a life expectancy for future pensioners – this is, on average, 1.3 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. 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.



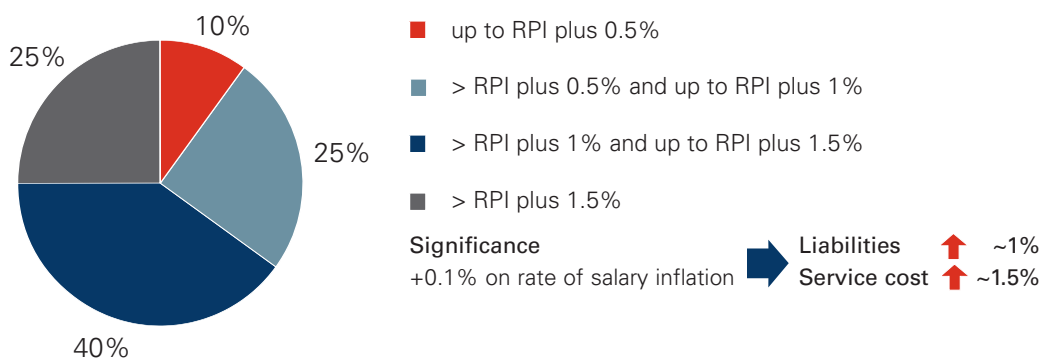
Price Inflation

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. The rates of inflation that companies use are drifting further below the rate implied by the yield curves possibly to reflect a "risk premium" on index-linked gilts. The Bank of England publish spot inflation rates implied by the market, with projections up to 25 years. The approximate spread of price inflation assumptions, relative to the 20-year spot rate, 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 (i.e. assumed price inflation), is as follows:



PCS Expected Assumptions at 31 December 2007

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

Discount rate	-	5.6% to 6.0%*
Price inflation	-	2.9% to 3.5%
Salary inflation	-	3.4% to 5.4%
Return on equities	-	6.9% to 8.5%
Assumed life expectancy	-	24 to 27 years for a man now aged 60 (down to 21 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.

* Following a major rebalancing of the iBoxx Corporate Bond indices from 1 January 2008, we can expect to see many more companies using a discount rate towards the top end of this range.

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

■ FTSE 20yr fixed gilt index yield	-	4.5% (4.5%)
■ FTSE >15yr IL gilt index yield	-	0.9% (1.1%)
■ Market-implied inflation	-	3.4% (3.1%)
■ Yield on long-dated corporate bonds	-	5.8% (5.1%)

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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 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.
- **Curtailed 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 and 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.

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We have a team with specialist skills and experience in providing financial advice on pension-related issues. We have worked with employers and trustees in relation to many well-known companies, advising on schemes valued in excess of £3.5bn. We have undertaken many employer covenant reviews, including for Scheme Specific Funding purposes and clearance applications to the Pensions Regulator. We also have a track record of devising and implementing innovative solutions in more general financial restructuring situations.

We are known for adding value to the process of determining the appropriate level of technical provisions, setting recovery periods and resolving the issue of pension deficits, usually on a consensual basis among the parties. Clients and, indeed, other stakeholders benefit from our fresh thinking, constructive partner-led approach and practical

understanding of the issues they face. We often sit side by side with our clients to assist them in negotiations, using our analysis to provide an information platform among the parties.

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