



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:

- Markets, background and recent developments
- Latest information from FTSE 100 company disclosures
- PCS expected IAS19 assumptions
- Simple guide to IAS19.

Markets

The year has been a good one for pension schemes in the financial markets. Since 31 December 2005:



- The FTSE All Share Total Return Index has increased by 15%
- The FTSE Global (ex-UK) total return index has increased by 21%
- The yield on long dated fixed gilts has increased from 4.05% to 4.4%
- The yield on long dated index linked gilts has increased from 1.05% to 1.1%
- The yield on long dated AA bonds has increased from 4.75% to 5.1%

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 may be 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

December 2006 – ASB issues amendment to FRS17

The Accounting Standards Board (ASB) issued an amendment to FRS17 "Retirement Benefits" which aligns the disclosures in FRS17 with those of IAS19. The amendment also amends the asset values of quoted securities allowed to be taken as fair value under FRS17 from mid-market value to bid value, in a further alignment with IAS19. The amendment is effective for financial statements covering periods beginning on or after 6 April 2007, although early adoption is encouraged. In issuing this amendment the Chairman of the ASB also commented, "The ASB is also continuing its work in relation to its research project which is a more fundamental review of pension accounting. It is anticipated that a Discussion Paper setting out the ASB views will be issued in the first half of 2007."

August 2006 – IFRIC issues draft interpretation on the asset ceiling

The International Financial Reporting Interpretations Committee (IFRIC) issued draft interpretation D19 IAS19 – The Asset Ceiling: Availability of Economic Benefits and Minimum Funding Requirements. This draft interpretation clarifies when the net balance sheet asset under IAS19 must be limited to the "present value of any economic benefits available in the form of refunds from the plan or reduction in future contributions to the plan."

July 2006 – IASB and FASB issue views on a common conceptual framework

The International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) issued a preliminary views discussion paper on the first phase of their joint project to revisit and develop a common conceptual framework. Some of the key issues considered are the objective of financial reporting, principles for financial reporting outside the

framework of financial statements, the primary users of financial reports and whether the principle of reliability should be replaced by one of faithful representation.

June 2006 – Update on European pensions project

Update published on the major research project on accounting for pensions led by the ASB. This is a Proactive Accounting Activities in Europe (PAAinE) project in conjunction with the European Financial Reporting Advisory Group (EFRAG).

May 2006 – ASB issues proposals for new pension disclosures

The ASB issued proposals for a new Reporting Statement: Retirement Benefits – Disclosures. The draft statement is designed to represent best practice disclosure rather than mandatory requirements. The proposals cover a number of areas including the possibility of disclosing the amount of the PPF levy, the amount of compensation that might be required from the PPF in the event of insolvency and also the solvency buy-out cost of the liabilities.

May 2006 – ASB issues convergence proposals

The ASB issued its tentative proposals for the convergence of UK accounting standards with International Financial Reporting Standards. The ASB has deferred any final decisions on convergence but supports a two-tier approach with the lower level potentially based on the outcome of the International IASB's IFRS SME project.

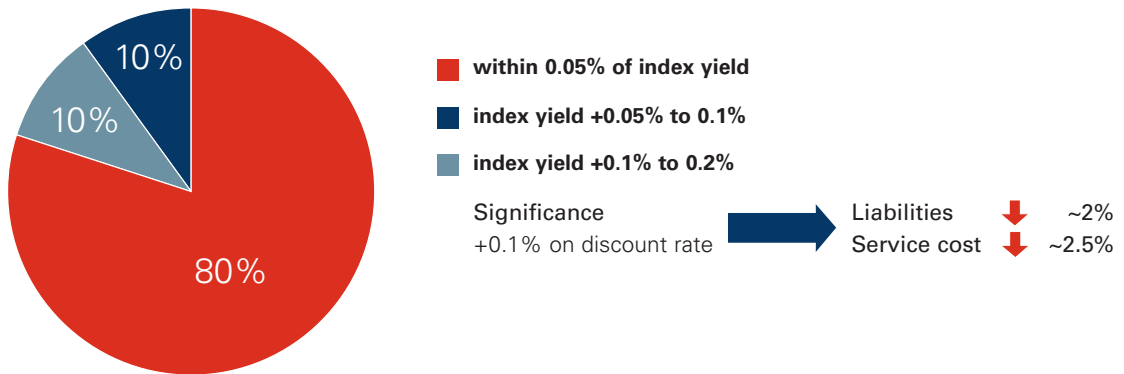
January 2006 – Letter to the FT on mortality assumptions

A letter was published in the FT from 12 of the top equity research analysts from major City firms calling for the disclosure of mortality assumptions in the IAS19 information provided by companies on their defined benefit pension obligations.

Latest Information from FTSE 100 Company Disclosures

Discount Rate

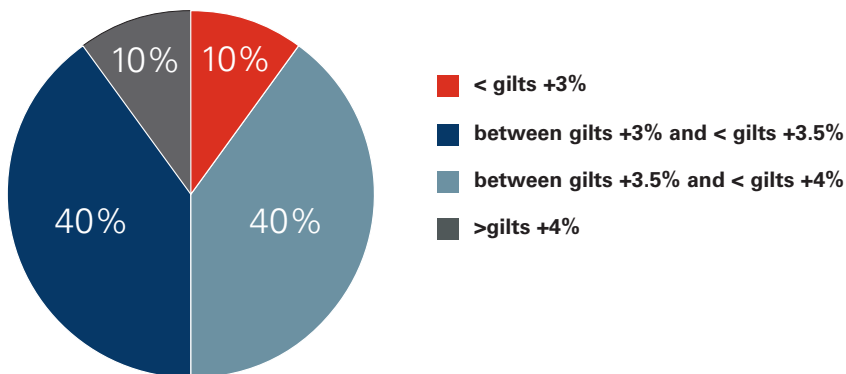
Not surprisingly the discount rates used were all very close to the index yield on long dated AA corporate bonds. The approximate spread of discount rates is as follows:



IAS19 requires that the discount rate used for a particular company should reflect the duration of the pension liabilities for that company. This can be used to justify a discount rate which is slightly higher than the index yield. However, there is little evidence that more mature plans have used higher discount rates in the last twelve months which is what the yield curves should suggest. We believe that auditors are beginning to question more closely the appropriateness of the discount rate for the duration of the liabilities.

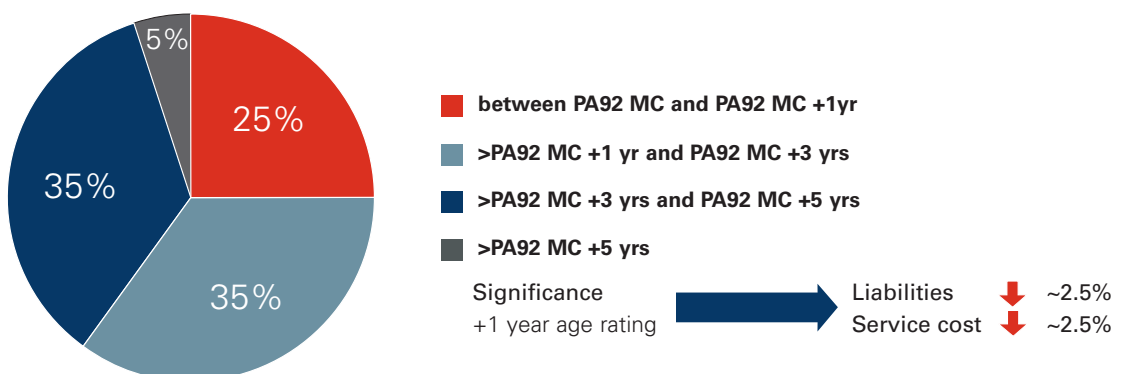
Return on Assets (Equities)

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:



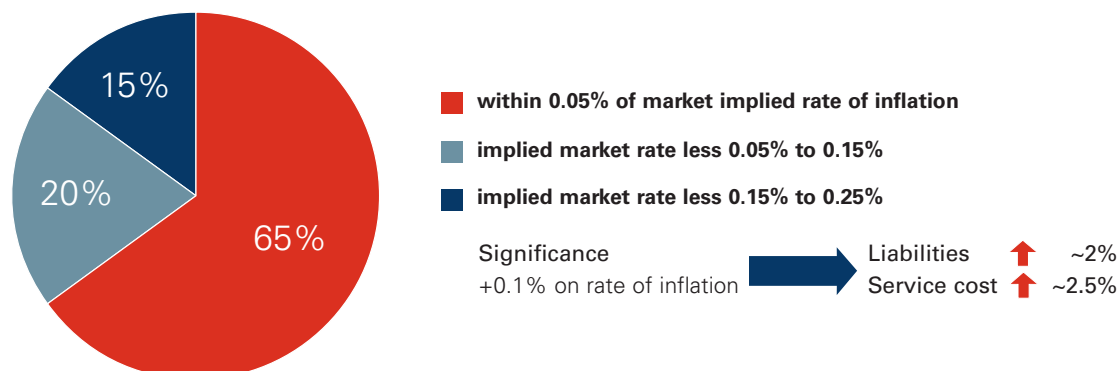
Mortality

It is clear that mortality assumptions are a key component of the overall assumptions chosen. To date 51 FTSE 100 companies have disclosed their mortality assumptions (but some with only limited disclosure). We believe that next year there will be significant increase in this figure and also that with increased disclosure will come increased pressure to adopt more up to date projections of improvement in longevity. There are many different mortality tables used. The most common is the PA92 table with medium cohort (MC) allowance for future improvement. Where possible we have adjusted other mortality assumptions in terms of an age rating to the PA92 MC table (a + 1 year age rating means that the assumed life expectancy of a 60 year old is equal to the life expectancy of a 61 year old on the standard table). The approximate spread of mortality assumptions is then as follows:



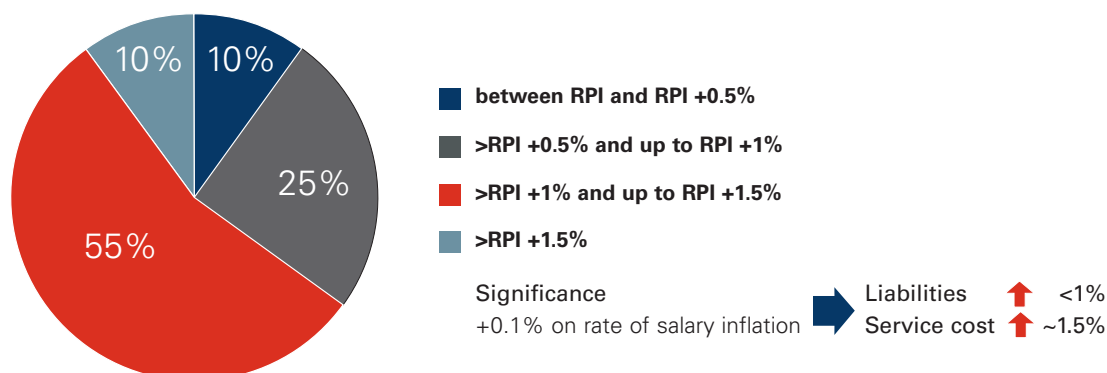
Price Inflation

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. A case is sometimes made for using a rate of inflation which is lower than the rate implied by the yield curves and some companies have clearly done this in setting their assumptions. 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 December 2006

The expected range of assumptions at 31 December 2006 is as follows:

| | | |
|--------------------|---|---|
| Discount rate | - | 5.0% to 5.3% |
| Price inflation | - | 2.8% to 3.2% |
| Salary inflation | - | 3.0% to 5.0% |
| Return on equities | - | 4.5% to 8.5% |
| Mortality* | - | PA92 MC to PA92 MC + 3 years (up to PA92 + 7 years when justified by nature of employee population or experience) |

** whilst the MC level of allowance for future improvement in longevity is the most commonly used by companies today, it understates the current level of longevity improvement. We believe that there will be increasing pressure to adopt mortality assumptions which build in greater allowance for future longevity improvement.*

The expected assumptions noted below are based on the following market conditions (corresponding figures at 31 December 2005 are shown in brackets):

| | | | |
|---------------------------------------|---|------|---------|
| ■ FTSE 20yr fixed gilt index yield | - | 4.4% | (4.05%) |
| ■ FTSE >15yr IL gilt index yield | - | 1.1% | (1.05%) |
| ■ Market implied inflation | - | 3.2% | (2.9%) |
| ■ Yield on long dated corporate bonds | - | 5.1% | (4.75%) |

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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.
- **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, 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 the contributions it expects to pay in the following year