# IAS19: A Quarterly Guide For Finance Directors

JLT PENSION CAPITAL STRATEGIES

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## The PCS Guide to IAS19 Assumptions as at 30 September 2011

In association with:

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 30 September 2010:

- The FTSE All-Share Total Return Index has decreased by 4.4%
- The MSCI World Index (GBP) has decreased by 5.3%
- The yield on long-dated fixed gilts has decreased from 3.80% to 3.30%
- The yield on long-dated index-linked gilts has decreased from 0.55% to 0.30%
- The yield on long-dated AA bonds has increased from 4.95% to 5.10%
- The Bank of England 15-year spot inflation rate has decreased from 3.20% to 3.10%

Following the recent UK Government's announcement that the quantitative easing programme from a couple of years ago is to be re-started with a £75bn buyback of gilts, gilt yields have fallen significantly. Longer term we expect interest and inflation rates to rise, but in the short to medium term there is great uncertainty.

With rising corporate bond yields and falling inflation trends, we expect the overall average IAS19 funding level to have improved slightly from the position 12 months ago.

## Recent Developments

### IAS19 Changes

The IASB published the IAS19 amendment on 16th June 2011. The main elements of this amendment are as follows:

*Elimination of smoothing ("corridor approach")*

Some entities (companies) opted for their actuarial gains and losses (usually in excess of a limit/corridor) to be spread over a number of years, rather than realise them immediately. It will no longer be permitted to use this approach.

*Change to the expected return on assets*

The expected return on assets (EROA), together with interest on the pension obligation (the pension scheme's liability) net off to provide the IAS19 financing item within the P&L. Presently an entity chooses the EROA based on expected long term asset returns on a "best estimate" basis. The change will effectively require the EROA to be set equal to interest rate applied to the pension obligation (the discount rate).

*Extra disclosures*

There are quite a lot of extra disclosures including:

- Specifying main risks
- Stating expected future employer cash contribution requirements
- Stating main employer and trustee responsibilities
- Stating extra detail on settlements, curtailments and other amendments
- Splitting asset values up into more categories, including whether based on quoted market prices in an active market
- Stating any risk matching investments, e.g. longevity products
- Stating the regulatory framework that the scheme falls under, and whether any asset ceiling has been applied
- Sensitivity analysis of the major assumptions
- Stating any changes in methodology from previous periods disclosures
- Stating average duration of liabilities
- Stating that other disclosures may be required to ensure the reader has sufficient details to understand the financial impact of the scheme, e.g. active/deferred/pensioner split, conditional/discretionary benefits, timings of benefit outgo, vested/non-vested benefit splits, aggregation/non-aggregation of schemes
- The changes in assumptions item now needs to show separately the demographic effects and the financial effects
- Where applicable, more detail would be required on multi-employer plans so the reader can better access the potential costs and risks of such an arrangement

*Non-investment management administration costs*

Non-investment management administration costs should not be deducted from the return on plan assets. They should appear in the reconciliation disclosure if appropriate. They should be recognised when they are provided, but it is not stated where they should go; e.g. they could go in the IAS19 Profit & Loss (P&L) or they could be shown elsewhere in the accounts away from the pensions section.

*Implementation & impacts*

The changes will be effective for periods beginning 1 January 2013. Prior year comparatives will be required except on specified items, e.g. sensitivity analysis. Early adoption of the changes is permitted.

These amendments are subject to EU endorsement, which could typically take 6 months.

Currently these apply solely to entities who account under IFRS (the International standard). There is no change for entities who account under FRS (the UK standard). However, the whole UK standard is under review and is likely to move more in line with IFRS, but there is still a long way to go on this.

The overall impacts for a particular entity's accounts will very much depend on the scheme/s it sponsors. The elimination of the smoothing approach only affects those entities that have previously adopted this method, and then the main effect is likely to be a negative balance sheet impact. The change in respect of the expected return on assets is likely to affect the vast majority of entities' P&Ls negatively. The worst affected will be those with a large percentage holding of equity type assets, and in particular where larger equity risk premiums are employed. Practically all entities will require additional disclosure. There could be longer-term impacts of these changes. For example, the investment strategy could be altered as a result of this IAS19 amendment. This could then affect investment returns, risk profiles and resulting costs of providing the scheme benefits.

### IAS19 Asset Ceilings – IFRIC14

IFRIC14 clarifies the recognition of surpluses and also the effects of "minimum funding requirements" on balance sheets. Depending on a pension scheme's circumstances, surpluses may have to be reduced or ignored, and "minimum funding requirements" could reduce surpluses or even increase deficits.

The "minimum funding requirements" is expected to have more impact than previously, because more companies are being subjected to higher funding requirements.

### Inflation

The government announced last July the replacement of the inflation index previously used (the Retail Price Index, RPI) by the Consumer Price Index (CPI) to be applied going forward. Forecasts for CPI are presently 50–90 basis points (bps) per annum lower than forecasts for RPI and this has also been the case historically. This replacement is only applied in specific circumstances dependent on scheme documentation, and arguably, also dependent on the accounting standard being used.

# Latest Information from FTSE 100 Company Disclosures

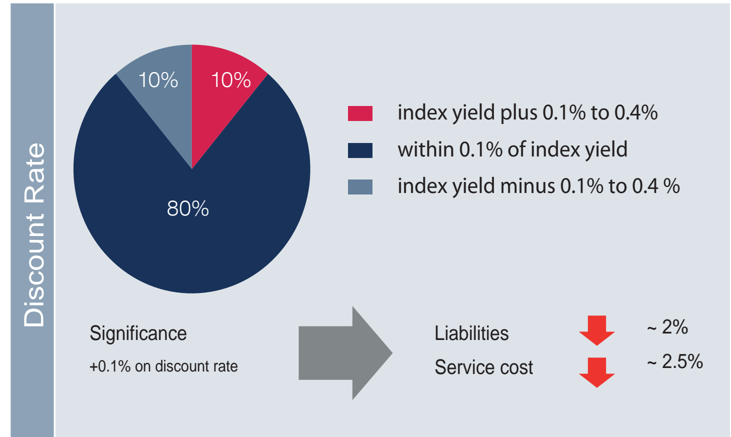
This analysis is based on the most recent annual report available at 30 September 2011 for each of the FTSE 100 companies.

## Discount Rate

IAS19 requires that the discount rate used for a particular company should reflect the duration of the pension liabilities for that company. In 2009, there was a considerable increase in the spread of corporate bond yields in general and at the different durations, and different interpretations of these durations and spreads led to a much wider range of assumptions being chosen.

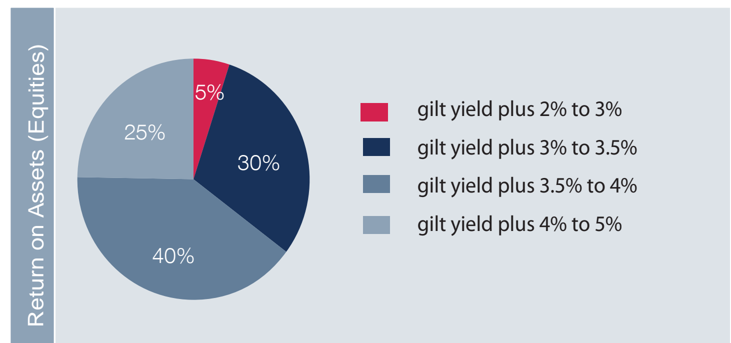
The duration of pension liabilities are typically greater than the duration of most long-dated bonds and a case can be made that the yield curve for AA corporate bonds isn't level, and this affects auditors' views. So, for companies that consider the duration of the liabilities, discount rates may be different to the index yield. However, more recently projected yield curves at the longer ends are expected to be relatively flat. This has, further to the comments in the previous paragraph, led to accounts that have been released over the past year showing that most companies are now using rates closer to the index yield on long-dated AA corporate bonds.

The approximate spread of discount rates is shown in the pie chart opposite.




## 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. The approximate spread of equity return assumptions (relative to the return available on Government bonds) is shown in the pie chart opposite.

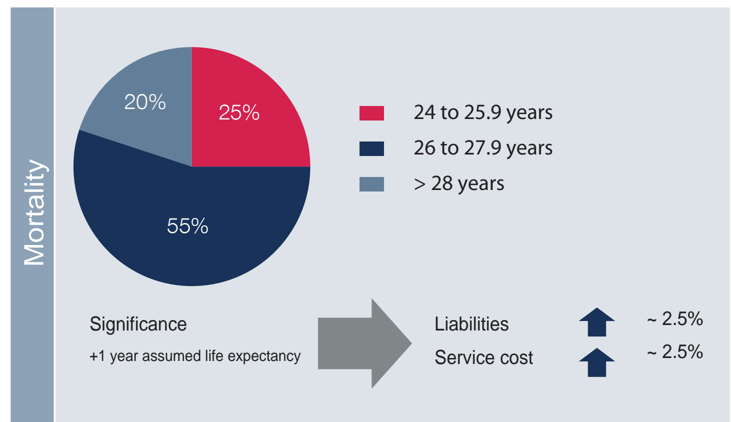



## Mortality

The increase in the assumed life expectancy of a pensioner has continued, but the rate of change is now slowing. 70 of the FTSE 100 companies have now adequately disclosed their mortality assumptions. Of these, 69 have disclosed a figure for the previous year. On average, the assumed life expectancy of a male aged 60 increased by 0.3 years from the previous year's figure. Only three companies increased their assumed life expectancy by more than two years. Most companies also quote a life expectancy for future pensioners – this is, on average, 2.2 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. Recent studies indicate conflicting ideas; therefore we are expecting to see a wider range of assumptions used. Companies most frequently 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.

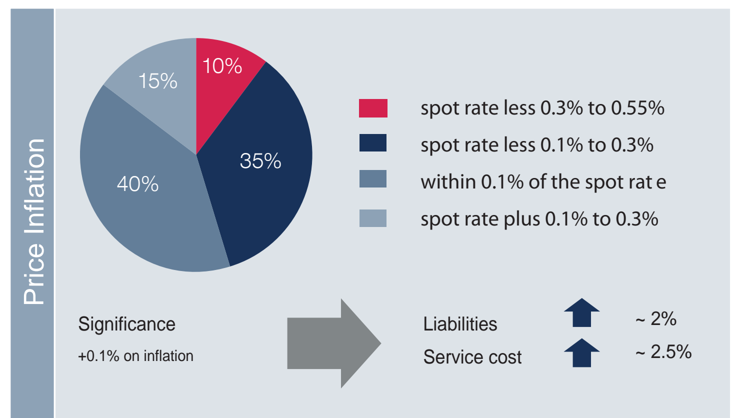
We estimate that around 50% of companies have adopted mortality assumptions that are at least as strong as including long cohort improvements (with an up-to-date table).




## 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, but also to reflect the shape of the curve when applied more directly to the actual cash outflows. The Bank of England publishes spot inflation rates implied by the market, with projections up to 25 years. The approximate spread of price inflation assumptions, relative to the annualised 15-year spot rate, is shown in the pie chart opposite.

It should be noted that these assumed inflation rates will be affected by the government's announcement (mentioned earlier under recent developments) to use CPI rather than RPI. The present analysis in this section does not take account of this development.

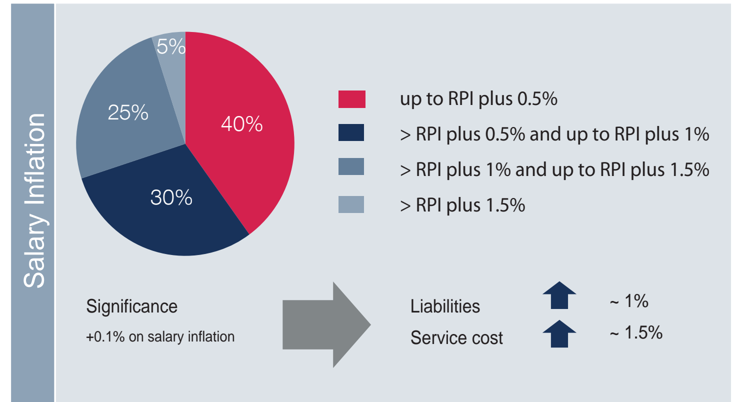


### Salary Inflation

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 shown in the pie chart opposite.

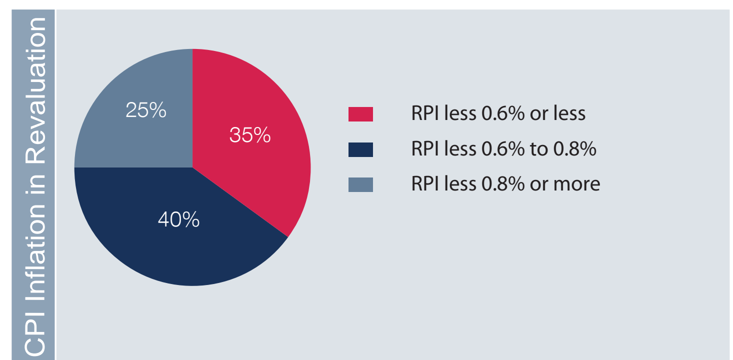
Recently, a large number of companies have begun setting salary increases equal to RPI, with others using an addition of 1%. Very few companies used a rate higher than 1.5% above RPI. Marks & Spencer's most recent disclosure sets salary inflation 2.4% below price inflation. This is based on the salary increase being used for pensionable purposes being capped at 1% per annum. ITV, Royal Bank of Scotland and Lloyds Banking Group have also capped increases in pensionable salary, assuming salary inflation will be 2.5%, 1.5% and 1.4% below price inflation, respectively.

As indicated for inflation there are likely to be some effects on the use of CPI, but these have not been considered for the above analysis.




### CPI Inflation in Revaluation

There has only been a limited number of disclosures where analysis was possible. This relatively small sample has indicated that the most common deductions from RPI for CPI have been 50bps and 70bps with the overall average at 70bps. The spread of deductions is indicated by the following graph, the range of deductions being from 50bps to 100bps.




## PCS Expected Assumptions at 30 September 2011

**The expected range of assumptions at 30 September 2011 is as follows:**

| | | |
|---|---|---|
| Discount rate | - | 4.85% to 5.35% |
| Price inflation (RPI) | - | 2.70% to 3.20% |
| Price inflation (CPI) | - | 2.00% to 2.70% |
| Salary inflation | - | 3.20% to 5.10% |
| Return on equities | - | 5.70% to 7.30% |
| Assumed life expectancy | - | 25 to 29 years for a man now aged 60 (justified by nature of employee population or experience). 1 to 2 years higher for a male retiring 20 years from now. |

The expected assumptions noted above are based on the following market conditions (corresponding figures at 30 September 2010 are shown in brackets):

| | | |
|---|---|---|
| FTSE 20yr fixed gilt index yield | - | 3.30% (3.80%) |
| FTSE >15yr IL gilt index yield | - | 0.30% (0.55%) |
| The Bank of England 15-year spot inflation rate | - | 3.10% (3.20%) |
| Yield on long-dated AA corporate bonds | - | 5.10% (4.95%) |

# 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 larger 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 (but note the IFRIC14 amendment effect mentioned in the Recent Developments section).

## 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.
- Curtailment 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 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 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 and 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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