

Accounting for pensions

Time for a new approach
to annual reporting

June 2020



XPS Corporate

Introduction and key findings

In our third annual accounting for pensions survey we explore new processes for pensions accounting, the growing Accounting Gap and trends in accounting assumptions.

Following Financial Reporting Council (FRC) reviews, auditors have sought to extend audit processes. This is welcome, but the interaction between advisers, companies and auditors as a result, needs to change. To date, the approach has differed across auditors, been necessarily reactive and been uncoordinated between auditors and advisers. This has come at a time when companies have had to manage a number of events (e.g. GMP equalisation and uncertainty on inflation measures). Now there is unprecedented market volatility driven by COVID-19, and legislative changes on the horizon. A consistent approach across all auditors using industry standard online tools to introduce efficiencies is critical. This will allow reporting for pensions to focus on emerging issues and key messages to stakeholders – ever more important at a time when pension funding moves further away from accounting numbers.

The key findings:

1. Requirement for an efficient audit interaction process for pension accounting

To help companies we believe that a standard online tool is needed that:

- a) sets out common audit data needs and a standard format for submitting data to auditors; and
- b) collates audit guidance on assumptions and emerging issues (e.g. inflation measure changes).

Through a more joined-up process, we believe that companies can reduce the amount of management time spent on pensions reporting, getting to the right outcome more quickly.

2. The Accounting Gap widens

Market volatility driven by COVID-19 has led to improvements in balance sheet positions for many pension schemes whilst their cash funding position has worsened at the same time.

This Accounting Gap could now be over £500bn* across all UK companies, double the gap in our 2019 survey.

A widening Accounting Gap risks pension actions companies have to take as a result of COVID-19 seeming contrary to stakeholders' understanding of pension costs and risks. Disclosure narratives are key to managing this.

3. Key assumptions regarding inflation, life expectancies and discount rates

We have seen a shift in the inflation assumptions being adopted, driven by the anticipated future changes to RPI.

Average life expectancies remained fairly similar to last year even though trends in national data led to a fall in implied life expectancies.

There remains a wide range of discount rates adopted as companies continue to use a variety of approaches.

The survey includes 150 of our clients with pension scheme assets ranging in size from £10m to over £2bn.



We believe that the industry should be working closely with auditors to create an agreed, centralised process that puts clients first and meets the FRC's requirements – this is the real key to a seamless year-end.

Simon Reddish

Head of Accounting for Pensions

* Source: The Purple Book 2019 membership statistics combined with XPS' analysis



1. New efficient audit interaction process required

The financial year end is a busy time for finance teams, with tight reporting deadlines to be met and defined benefit (DB) pensions only forming one small part of the wider annual reporting process. It is, however, often the case that a lot of time is spent on DB pensions reporting, especially when it comes to audit testing. This is to be expected to some extent due to the large numbers involved, the uncertainties around the eventual costs and the increasing requirements placed on auditors by their regulators.

We strive to anticipate issues and create a smooth process for our clients. We think now is the time to take the experience gained over the last few years to go further and work in partnership with audit firms to agree a centralised information 'clearing' process to cover audit information sharing requirements. This process should put clients first, reducing management time and fees spent on pensions accounting, while also meeting the FRC's standards on scrutiny. This could be the key to a seamless accounting process for all our clients.



We saw both scope for improvement and good practice in the same areas of the audit procedures performed at the same firms.

FRC – audit quality review findings

Early engagement between all parties

Bringing forward the dialogue between actuaries and auditors ahead of the year end should be standard practice, avoiding any 'last minute rush' and ensuring everyone is on the same page from the outset.

Most audit queries are foreseeable, even those that may be classed as 'one off' and not routine. Mapping out any potential one off queries in conjunction with auditors ahead of the year end will help to ensure reporting and clearance deadlines are not compromised.

- Have any special events happened over the year which would lead to additional information being required for audit?
- If the Directors are considering changing the approach to setting a particular assumption, what level of evidence will be required for the audit?

Pre-agreed central audit processes

More needs to be done to bring all parties together and explore the most efficient way to tackle this growing headache for finance teams.

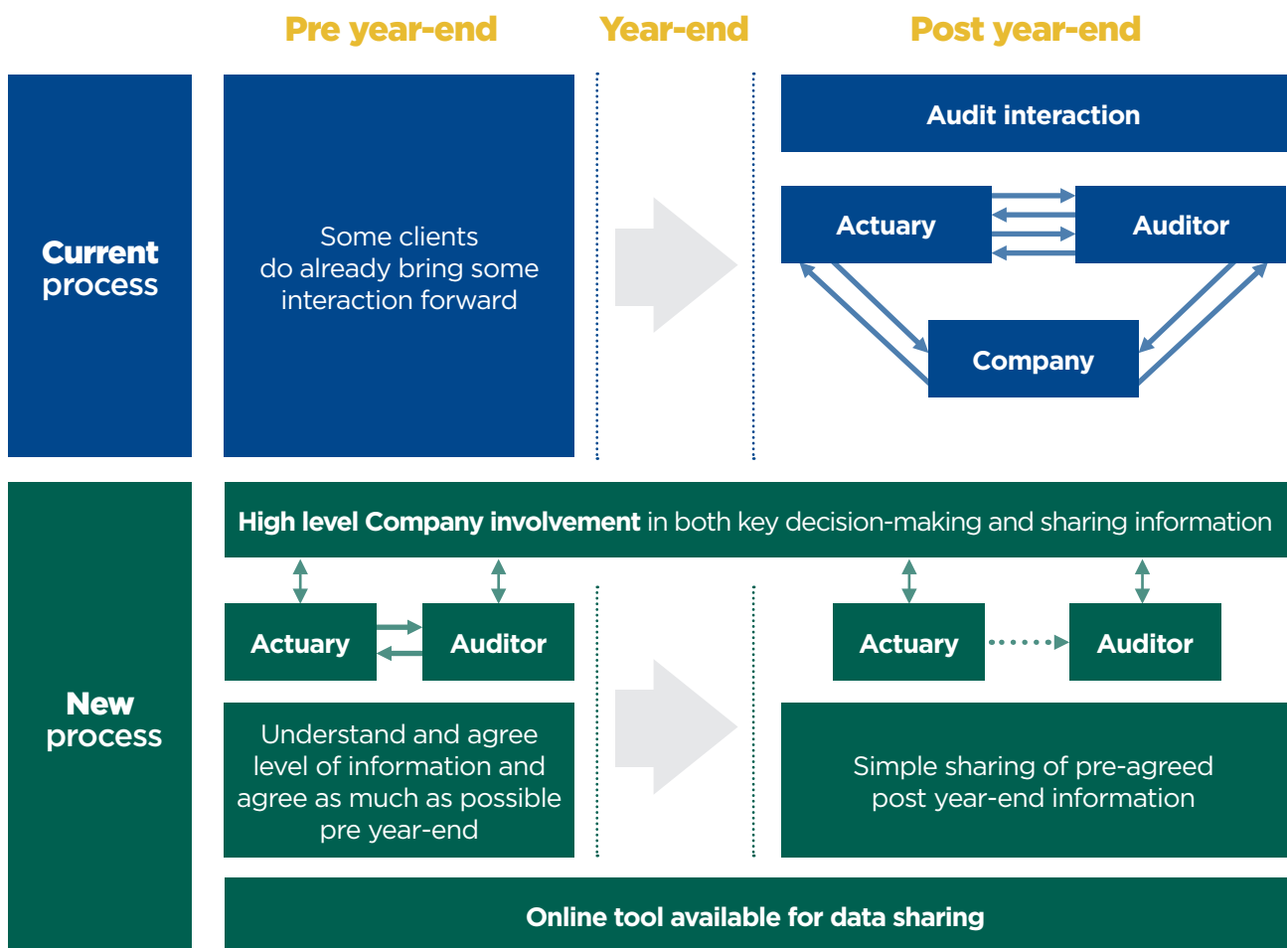
The FRC highlighted differences in the practices being followed within the same audit firms. Standard online tools where data can be uploaded to cover off pre-agreed checklists of routine items agreed centrally between actuarial advisers and audit firms could be the answer to ensure a consistent and transparent approach across the industry.

There has been an ongoing debate between actuaries and auditors on the level of information necessary for audit in recent years, with items such as individual member data up for question. Agreeing reasonable data needed to complete audit testing upfront and centrally would eliminate the need to debate at the individual client level, benefiting all companies. This will lead to a streamlined audit process, with companies safe in the knowledge that the necessary level of audit testing is being completed in the most efficient way possible.

Our proposed approach does not compromise the independence of the advice provided by actuaries, or the independence of the audit itself, but instead will allow auditors and actuaries to come together to agree on a consistent and efficient approach to pensions audit, bringing the company into the audit process at the key points where decision-making and judgment is needed.

Working together for better client outcomes across the industry

We believe a consistent approach across all auditors using industry standard online tools will ensure a clear and more efficient process for companies reporting on DB pensions.



Current process

- Some clients do already bring some interaction forward (for example, agreement on assumptions setting methodology or the treatment of one-off special events) although audit evidence requirements on assumptions still tend to come later in the process.
- Most audit interaction comes after the year-end even on standard, expected requests.
- Unnecessary company involvement, often with senior management caught in the middle acting as an intermediary to pass on simple data requests.
- Often a last minute rush in order to meet reporting and clearance deadlines.

New process

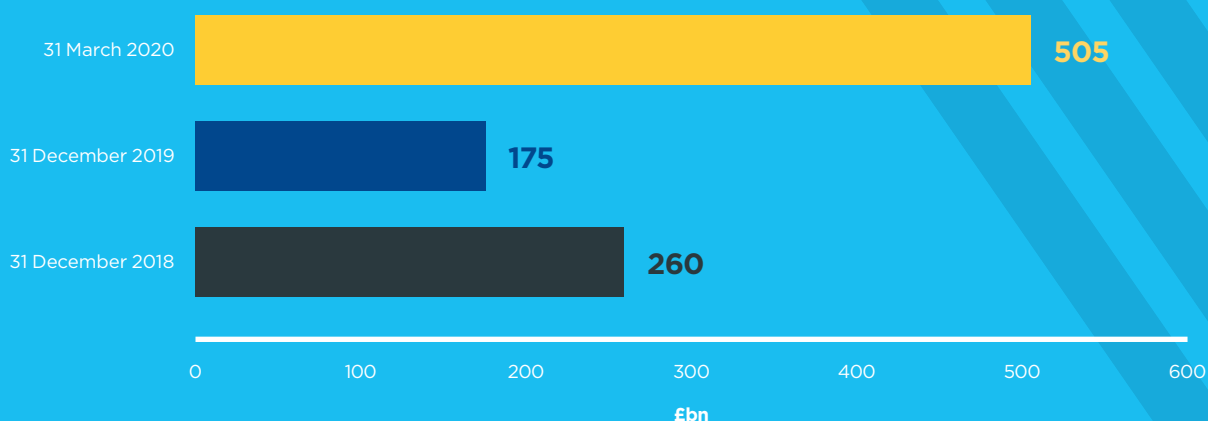
- Bringing forward interaction as much as possible.
- The Company retains control of the process, but the approach allows Company input to focus on where value is added in setting assumptions, determining the treatment of special events and making judgements on materiality.
- Online tool with suite of pre-agreed audit checklists and guidance on areas of audit interest for particular reporting periods, ready in advance of the planning stages.
- Bulk of audit information submitted ahead of, or alongside, provision of disclosures, rather than after.
- Not a one size fits all approach – detail required depends on specific materiality levels agreed at outset between all parties.

2. The Accounting Gap widens

We introduced the concept of the Accounting Gap in our 2019 survey as the difference between balance sheet positions reported in financial statements and the funding positions set in line with the UK regulatory requirements which drive cash contributions.

The volatile market movements seen over recent months set out on page 11 have likely led to a significant widening in the gap for many schemes. **We estimate that this gap has grown from £260bn across all UK companies at 31 December 2018 to over £500bn at 31 March 2020.**

Accounting Gap across all UK companies



Source: The Purple Book 2018 and 2019 combined with XPS analysis



Recent market disruption has highlighted how volatile accounting positions can be. An accounting surplus emerging at 31 March 2020 could have easily turned into a deficit over the following weeks in April. At the same time, funding positions have moved in the opposite direction to accounting, exacerbating the Accounting Gap.

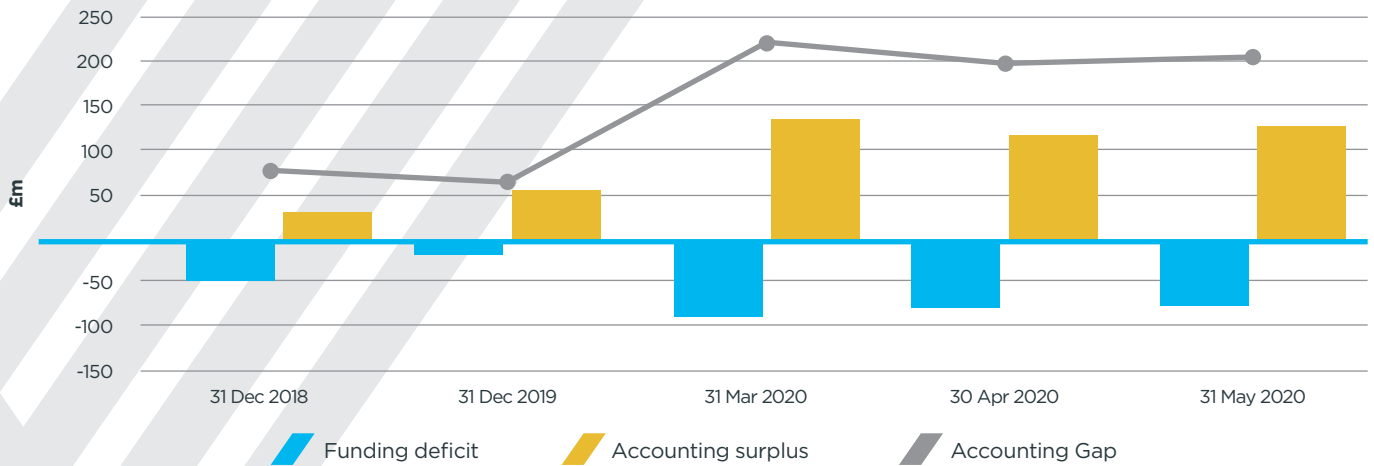
Vicky Randhawa
Senior Consultant



Market volatility could triple your Accounting Gap

The chart below shows how the Accounting Gap for a typical sample scheme has evolved since 31 December 2018. The sample scheme has assets of £450m and liabilities measured on the scheme funding basis of £500m at 31 December 2018. Liabilities measured on the accounting basis were £420m at 31 December 2018. As you can see, the resulting Accounting Gap has been very volatile, widening significantly as a result of the COVID-19 outbreak.

Sample scheme – Accounting Gap progression



Source: XPS analysis with market statistics

▶ **The Accounting Gap more than tripled** for this sample scheme from 31 December 2019 to 31 March 2020, and although market volatility reduced over April and May, the gap continues to be substantially higher than it was last year.

Do you know how wide your Accounting Gap is?

A lot of companies have been negatively impacted by COVID-19. We have seen cases where deficit contributions due in line with agreed recovery plans have been reduced or even suspended, dividend payments have been cut and many are seeking to put in place contingent payment structures.

At the same time we have seen balance sheet improvements being reported, giving shareholders a confusing message. It is important for companies to understand the extent of their own Accounting Gap and how sensitive this is to changes in market conditions, particularly how this may have fared over recent months.

Consideration can then be given as to whether clearer messaging is needed in disclosures to help stakeholders understand the true risks and costs of DB pension schemes, which seem more than ever to be at odds with the balance sheets being disclosed.



Depending on their funding basis, some schemes may actually see better funding positions compared to their accounting positions at the same date. However, it is still important to ensure users of accounts understand the differences between the accounting position being disclosed and the funding position driving cash contributions.

3. Survey results

Key assumptions regarding discount rates, inflation and life expectancy

This is our third annual accounting survey. Here we review assumptions and market practice of reporters at 31 December 2019. The survey covers 150 of our clients with pension scheme assets ranging in size from £10m to over £2bn.

Discount rate

The discount rate assumption often has the greatest impact on liabilities. Pensions are effectively a long term series of cash flows and the discount rate is used to calculate the present value of those cash flows.

The distribution of discount rate assumptions adopted at 31 December 2019 based on our survey is set out in the chart below:

Discount rate distribution



Source: Survey results

2.00% p.a.

Average discount rate assumption of 2.00% p.a. adopted by 47% of schemes

Adopted by schemes with durations ranging from 14 to 30 years, reflecting that the current shape of AA corporate bond yield curves leads to little variation by duration in single equivalent weighted discount rates.

0.45% p.a.

Up to 0.45% p.a. gap between discount rates at similar durations which could result in a 9% difference in liability value

Between a narrow duration range we saw schemes use the highest (2.30% p.a.) and lowest (1.85% p.a.) observed discount rates.

1.85% – 2.30% p.a.

Discount rate range at 31 December 2019

Discount rates range from 1.85% p.a. to 2.30% p.a. across schemes ranging in duration from 12 to 30 years.

Those with rates above 2.15% p.a. are more likely to have used non-standard discount rate methodologies.

0.80% p.a.

Fall in average discount rate adopted compared to the previous year end

This is due to the fall in corporate bond yields over the year. For a scheme with a duration of 20 years, this would result in a significant increase in liabilities of around 16%.

Alternative methods: The Single Agency Approach

With accounting standards leaving some elements of assumption setting open to interpretation there are a wide range of options for companies to consider, particularly when it comes to the discount rate.

XPS produces a corporate bond yield curve constructed by modelling forecasted future cash flows from the universe of corporate bonds that have an AA (or equivalent) rating from at least one ratings agency. This alternative method is generally acceptable to auditors and often results in discount rates slightly higher than the more standard approaches. However, at 31 March 2020 unusual market conditions meant this method actually resulted in marginally lower rates than a standard AA corporate bond yield curve.

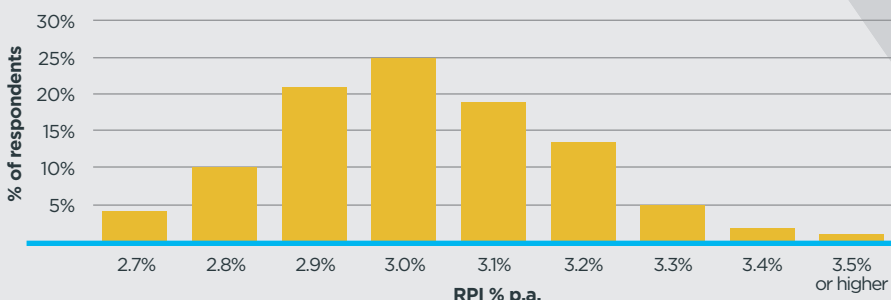
Our survey results show a small proportion of reporters adopted a single agency curve approach at 31 December 2019, and we expect this proportion to grow as more companies explore the use of alternative methods.

Inflation

The inflation assumption is used to estimate future increases to pensions both before and during payment. Increases to pensions as a result of inflation linkage is an important part of benefits and the assumption is often material to disclosed pension costs.

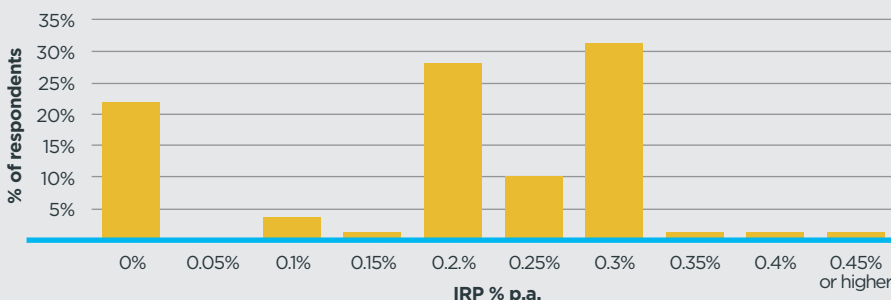
The chart below shows the RPI inflation rates assumed by companies at 31 December 2019:

RPI - distribution



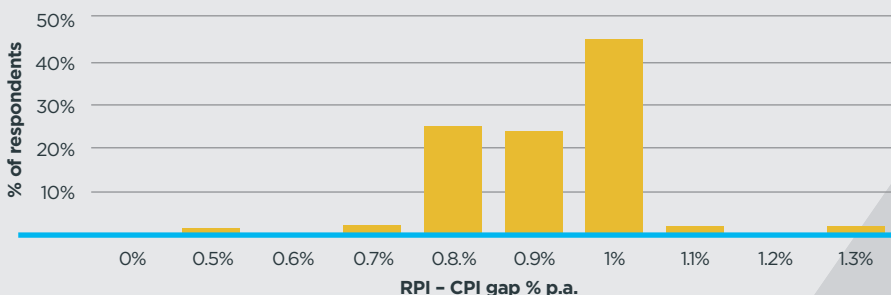
Source: Survey results

Inflation risk premium - distribution



Source: Survey results

Assumed gap between RPI and CPI - distribution



Source: Survey results

On 4 September 2019, the Chancellor of the Exchequer and the UK Statistics Authority announced a consultation on aligning RPI inflation with CPIH inflation (where CPIH is CPI that includes owner occupied housing costs), with any change proposed to happen sometime between 2025 and 2030. The Chancellor opened a formal consultation as part of the Spring Budget and the consultation period has now been extended to August 2020 following COVID-19.

As expected, we saw a narrowing in the assumed gap between RPI and CPI as reporters took these future changes into account, with the average gap moving from 1.0% p.a. at 31 December 2018 to 0.9% p.a. at 31 December 2019, and an overall 45% of reporters assuming a different gap to the previous year end.

We also saw an increase in the proportion of companies adopting higher IRPs at 31 December 2019 compared to the previous year-end, with a 10% increase in the proportion adopting an IRP above 0.2% p.a.. This reflects the fact that the markets may now be overstating future RPI possibly due to beliefs around a reversal in policy or compensation.

78%

of schemes included an allowance for an inflation risk premium (IRP)

28% adopted the average IRP of 0.2% p.a. while 31% adopted an IRP of 0.3% p.a.

0.9% p.a.

average gap between RPI and CPI

This was 0.1% lower than the average gap adopted last year.

45% of respondents assumed a gap of 1.0% p.a. compared to 76% last year.

More companies using a gap of 0.8% p.a. and 0.9% p.a. this year.

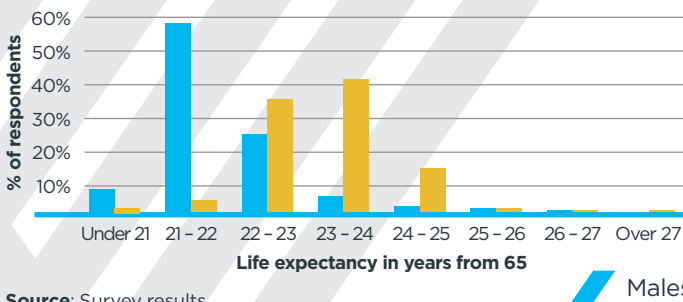
10% increase in proportion of reporters assuming an IRP above 0.2% p.a.

Life expectancy

How long we expect members of a pension scheme to live determines how long their pensions are expected to be paid for. This involves estimating not only how long current pensioners might live, but how life expectancies might improve for pension scheme members yet to retire.

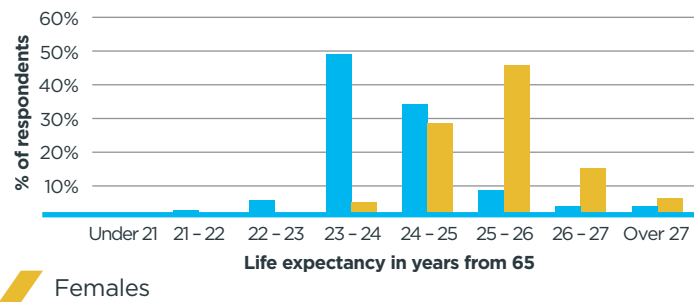
More frequent updates to longevity models and an increasing number of scheme-specific adjustments that can be made to better suit your pension scheme population, along with increased audit scrutiny, means that the mortality assumption requires more consideration than ever before.

Distribution of life expectancy from 65 for a 65 year old



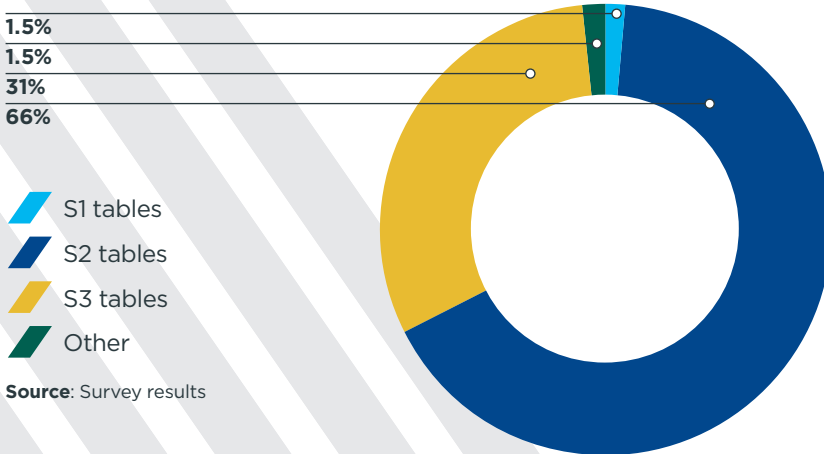
Source: Survey results

Distribution of life expectancy from 65 for a 45 year old



Average life expectancies based on assumptions adopted at 31 December 2019 have on the whole remained fairly similar compared to those adopted last year. This reflects the fact that while many reporters updated to adopt the newer CMI 2018 life expectancy improvement tables, a number also adjusted the core parameters within the model leading to a smaller difference between life expectancies assumed under CMI 2017.

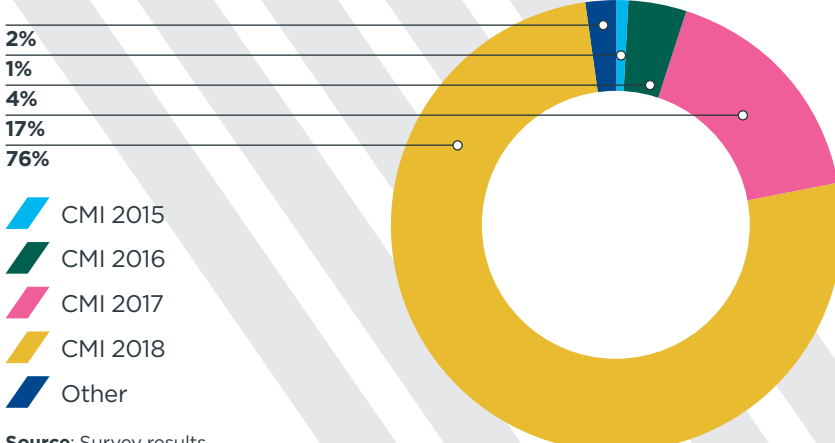
Base tables - distribution



Source: Survey results

▶ As expected, there was an increase in use of the S3 tables which were published in December 2018. However, a number of companies are still using the S2 tables, particularly those where scheme-specific weightings have been applied to the S2 tables following mortality studies, which are likely to form a better 'best estimate' table than simply moving to the S3 tables. We have noticed a rise in auditors asking for evidence for updates to base tables after the FRC's guidance.

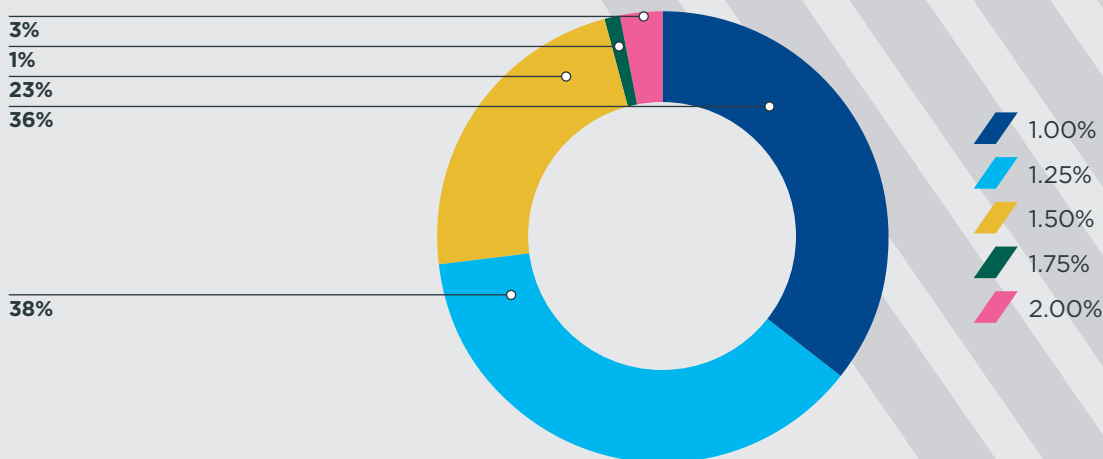
Projection method - distribution



Source: Survey results

▶ CMI 2018 was released in March 2019. As well as allowing for actual deaths up to the end of 2018, the core model puts more weight on recent trends in life expectancy seen in the general population which show more deaths than expected. This means that CMI 2018 (with core parameters) projects lower future improvements in longevity than CMI 2017.

Long-term future improvements - distribution



▶ **93% of schemes** used a mortality assumption that differs from their funding mortality assumption. The most common difference was an adjustment for a more up-to-date CMI projection model, but many also adjusted the long-term rate of improvement. With audit scrutiny on mortality assumptions in particular increasing, it is often a good starting point to consider the funding assumption and any explicit prudence that is included in this, e.g. the long-term rate or weightings to base tables. This can help to provide justification for auditors when it comes to accounting assumptions.

76%

of schemes adopted the most up-to-date projection model

This was CMI 2018 at 31 December 2019, which lowers the value placed on liabilities compared to CMI 2017 when core parameters are adopted.

94%

of schemes used the default smoothing parameter

This is 7 for CMI 2018 and 7.5 for CMI 2017 and CMI 2016. A handful of schemes adopted a higher parameter of 8 which would increase the value of liabilities by around 1% - 3% (using CMI 2018).

40%

of schemes used the default initial addition parameter (A) of 0.00%

For those who did not adopt the default, A ranged from 0.2% p.a. to 1.00% p.a. with over half of those not adopting the default setting A to 0.5%.

A new parameter was added to CMI 2018, the initial addition to mortality improvements (A). This parameter is intended to be used to reflect differences in demographic characteristics between a pension scheme's actual population and the wider England & Wales population on which the CMI models are based, by adjusting the starting point for the longevity improvement trend.

Unlike the smoothing parameter, where the majority of reporters adopted the default, we saw 60% of reporters who adopted CMI 2018 adjusting A from the default parameter of 0%. The CMI highlighted that the smoothing parameter should no longer be used to approximate for any differences in longevity improvements between populations, as it is intended to be used to alter the model's level of responsiveness to new data.

As expected, this year we saw a rise in the number of audit queries around the appropriateness of mortality assumptions adopted and requests for evidence or justification for assumptions, in particular any adjustments made to the default parameters in the CMI 2018 model.

CMI 2019 was released in March 2020. The model is the same as **CMI 2018** but allows but allows for deaths in England and Wales to the end of 2019. The number of deaths in 2019 were the lowest there have ever been, which has led to life expectancies predicted by CMI 2019 to be longer than those predicted by CMI 2018.

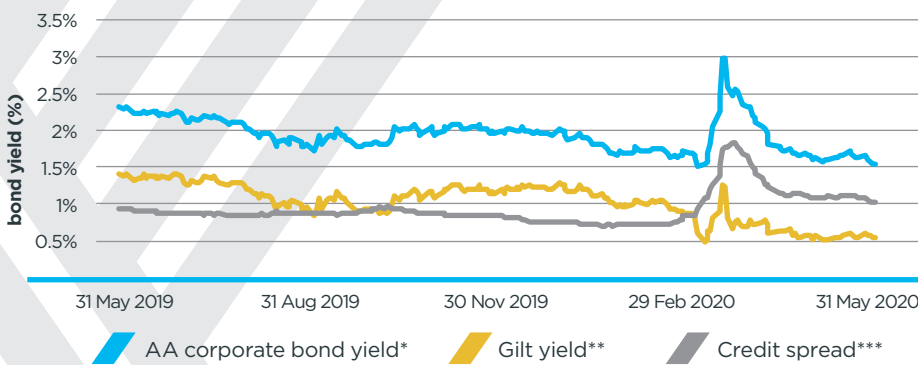


Recent balance sheet volatility highlights need for clear disclosures

Our survey covers assumptions adopted at 31 December 2019. Since then, we have seen unprecedented market volatility due to COVID-19. This volatility impacts both the assets and the value placed on the liabilities of the pension scheme.

While funding levels for many clients took a big hit over this period due to falling gilt yields and poor asset returns, the majority of employers reporting at the end of March 2020 actually saw an improvement in their accounting positions as corporate bond yields rose sharply and implied inflation fell over the same period. This highlighted the fact that accounting disclosures typically do not reflect the measures that drive cash funding and in times of market disruption the Accounting Gap can widen substantially.

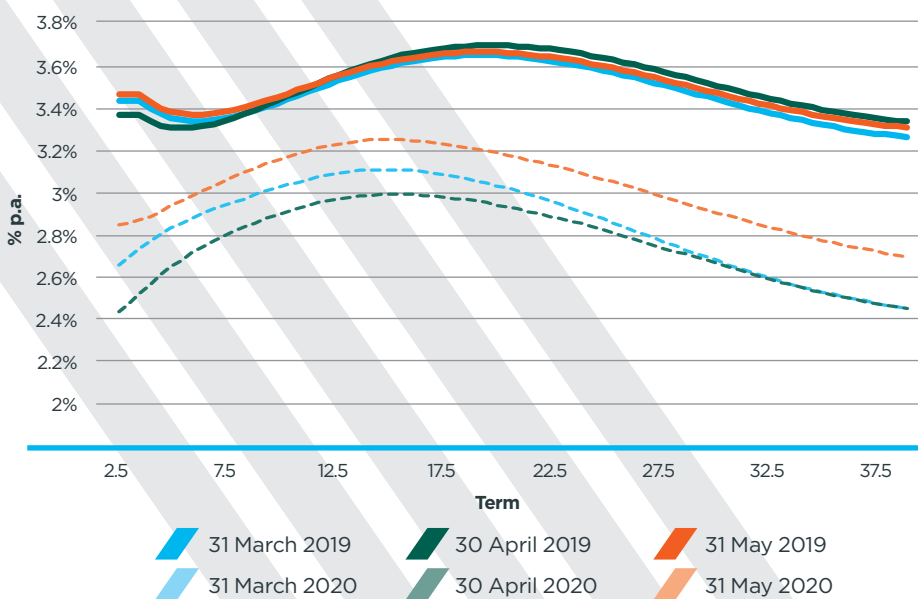
Corporate bond market volatility over the year to 31 May 2020



- ▶ **Discount rates** for accounting purposes are set with reference to the yields on 'high quality corporate bonds', generally taken to be AA corporate bond yields.
- ▶ **Uncertainty** in this volatile time led to a significant drop in confidence in corporate bond markets. This led to much higher spreads over gilts, with the AA credit spread widening by over 1% p.a. in the space of a week or so in March.

However, the positive balance sheet positions for many at 31 March 2020 may be short-lived. Corporate bonds became less volatile as markets digested the impact of COVID-19 over April and May, and AA yields have reduced considerably since the end of March. This will lead to lower implied discount rates and so higher values placed on pension scheme liabilities.

Bank of England implied RPI inflation



Falling inflation expectations

RPI inflation expectations have fallen since the end of 2019 and are now significantly lower than they were a year ago. This is likely to be partly due to markets pricing in the impact of the worsening economic outlook and the high likelihood of a UK recession, but it may also be reflecting the recent consultation on the future of RPI opened by the Chancellor as part of the March Budget, which adds more evidence to the case that RPI will indeed be reformed.

The results of our survey show a shift in the inflation-related assumptions, showing that December reporters had already begun to take the future changes to RPI into consideration.

Lower implied inflation will lead to a lower value placed on pension scheme liabilities.

Source: Bank of England

* iboxx AA Corporates over 15 year index yield
 ** FTSE Actuaries UK Conventional Gilts Over 15 Years Index
 *** Difference between corporate bond yield and gilt yield

Technical accounting hot topics

Further audit issues arising due to COVID-19

Although the increase in audit scrutiny we have been observing in recent years is now becoming more routine, COVID-19 has exacerbated this somewhat. Over April we saw signs of investment managers either withholding or caveating asset valuations at the end of March due to material uncertainties about the value of funds. We also saw a rise

in the audit queries on funds where out-of-date valuations are ordinarily used to meet reporting timescales.

This has the potential to cause significant difficulties for clients in getting certainty for internal reporting, and also for auditors to sign off accounts.

Working closely with investment managers to understand or quantify any uncertainty in valuations and engaging with auditors early to understand their views is therefore key to ensure a smooth accounting process in the current climate.

IAS 19 – reminder of remeasurement on past service costs

This narrow scope amendment to IAS 19 was applicable for accounting periods beginning on or after 1 January 2019, and so any schemes with changes during the year which either changed the value of liabilities or removed past service liabilities would have had to recalculate the balance sheet position at the point this change was contractually binding. In this circumstance, the interest cost Profit and Loss (P&L) item is then based partly on the assumptions set at the start of the

year and partly on the assumptions set at the date of the event, leading to less predictable P&L charges.

This approach may also lead to the impact on the interest cost item being larger than the impact of the event itself, and so can produce unexpected results. For example, a scheme closure may release a P&L credit in itself, but the timing of the remeasurement might lead to a higher interest cost charge than had no event occurred.

IAS 19 reporters should bear this change of treatment in mind if such an event occurs over the next accounting period.

IFRIC 14 – the saga continues...

Under IAS 19, the right for sponsors to take credit for a pension scheme on their balance sheet is covered by the IFRIC 14 interpretation. On 26 February, the International Accounting Standards Board ('IASB') decided not to proceed with the proposed 'principles based' reworking of IFRIC 14, bringing to a halt a process that has been going on since 2015.

The proposals would change how a sponsor is deemed to have an 'unconditional right to a refund' from a DB pension scheme. The unconditional right typically flows from assuming the scheme runs on until the last member has drawn their benefits and then any surplus reverts back to the sponsor.

The IASB intended to amend IFRIC 14 so that the unconditional right is not deemed to exist if another party (in the UK, the trustees) has a unilateral power to use the surplus. This could be via benefit improvements, insuring the scheme or triggering a wind up. The powers that Trustees have are governed by their individual Trust Deed and so this could be a lottery, although it common for Trustees to be able to increase or insure benefits.

This will be a relief to sponsors of a lot of UK pension schemes as it had the possibility to have a more significant impact here than in many other territories. Unfortunately, there is still a possibility this might come back to life as a vote to abandon these changes altogether was narrowly defeated.

As such, there is still a risk that sponsors of some UK pension schemes may not be able to recognise an IAS 19 surplus on their balance sheet, and further, they may have to recognise an additional 'onerous' liability if their recovery plans require cash contributions with a higher value than the accounting liabilities.

About us

XPS Pensions Group is the largest pure pensions consultancy in the UK, specialising in actuarial, investment consulting and administration. The XPS Pensions Group business combines expertise, insight and technology to address the needs more than 1,200 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over 930,000 members and provide advisory services to schemes of all sizes including 25 with over £1bn of assets.

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