

## UK pension accounting update

### Credit crunch reduces accounting deficits at 31 Dec 2007 but relief could be temporary

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The recent 'credit crunch' has pushed up corporate bond yields leaving many pension schemes with an accounting surplus as at 31 December 2007. Companies and their stakeholders should be cautious, however, about making decisions based on these valuations, which may be temporary and mask remaining underlying risks associated with the company's pension scheme

#### What you need to know

1. Pension disclosures are becoming increasingly important as they potentially impact:
  - what agreements you make with the trustees on scheme funding;
  - when and how you seek clearance from the Pension Regulator for intended corporate activity;
  - your credit rating; and
  - how the market values your business.
2. Accounting assumptions are the responsibility of the directors after taking actuarial advice.
3. One of the key determinants of pension accounting liabilities (under IFRS, UK GAAP and US GAAP) is corporate bond yields, used to determine the discount rate to calculate liabilities. As these yields have increased considerably in 2007, 31 December 2007 year-end accounting liability valuations are likely to be lower than a year ago.

#### Year end discount rates

4. You will be able to use a higher discount rate for calculating your pension accounting liabilities at the end of 2007 compared to 2006. This is because yields on long-dated AA rated corporate bonds rose by around 0.7% during 2007.
5. Using a higher discount rate will reduce your pension accounting liabilities and may create an accounting surplus.
6. However this may not impact cash demands from trustees, which are often determined by reference to gilt yields. As gilts yields have remained broadly unchanged, cash demands may be unaffected.

7. Much of the rise in corporate bond yields over 2007 appears to have been caused by the 'credit crunch'. The average risk premium on AA rated corporate bonds (the corporate bond yield less the gilt yield) has risen by 0.6%, from around 0.6% at the start of the year to around 1.2% by the end of the year.
8. It is not clear whether this is a durable change. To the extent that the higher risk premium on corporate bonds is temporary, the improvement in disclosed accounting numbers may be short-lived.
9. Based on assumptions used at the end of 2006, most companies are likely to use a discount rate between 5.6% and 6.0% to value their pension accounting liabilities at the end of 2007.

#### Retail Price Inflation (RPI)

10. The Bank of England's published data shows the market at the end of 2007 is forecasting an average RPI over the next 20 years of 3.4% pa, much higher than the government's 2.5% target. Some argue the market overstates RPI due to demand for index-linked gilts. Most companies will use an RPI assumption between 3.1% and 3.5% for pension accounting.

#### Longevity

11. The assumption for future longevity of pension scheme members is key and may need to be revised in light of recent guidance issued by the actuarial profession.
12. In general we are living longer and longevity is expected to further improve. However, there are wide differences depending on industry, geography, salary and size of pension, and careful thought and analysis is required in selecting appropriate assumptions.

### Impact on your pension accounting results

13. After allowing for the above changes in assumptions, accounting liabilities are likely to have fallen by between 5% and 10% over 2007.
14. Together with increases in asset valuations and cash contributions in 2007 compared to 2006, many schemes are likely to be in an accounting surplus as at 31 December 2007.

### IFRIC 14

15. A new accounting interpretation (IFRIC 14) applies for IFRS accounts beginning on or after 1 January 2008 (see Pension File of 24 August 2007, [http://www.pwc.co.uk/pdf/PwC\\_Pension\\_file\\_Accounting-aug24-07.pdf](http://www.pwc.co.uk/pdf/PwC_Pension_file_Accounting-aug24-07.pdf)).
16. IFRIC 14 may change the amount of surplus that you can include as an asset on the balance sheet. You must have an 'unconditional right' to this surplus to include it as an asset. In general, this means you must have access to a surplus at some point during the lifetime of the pension scheme. You will need to review your scheme rules and scheme funding agreements to verify this.
17. If you are funding your UK pension scheme to a higher target level than that determined under IFRS (IAS19), IFRIC 14 may mean you need to increase your accounting liabilities to take into account your higher level of target scheme funding – thus reducing accounting surpluses or increasing accounting deficits. This applies if you do not have an 'unconditional right' to the surplus.
18. You will need to also review the impact of IFRIC 14 on overseas plans.
19. If you are using UK GAAP at the subsidiary level, different (FRS 17) rules apply for accounting surpluses. These rules are complex.
20. IFRIC 14 has yet to be endorsed by the EU.

### What you need to do

1. Ensure that you have a robust methodology in place for setting each pension accounting assumption. As part of this, ensure that:
  - the discount rate appropriately reflects the term of your pension scheme liabilities, and
  - you are comfortable that the longevity assumptions reflect the nature of your scheme membership and make sufficient allowance for future improvements in longevity.
2. Ensure the directors formally take responsibility for setting assumptions.
3. Agree the approach with your auditors.
4. Assess the impact of IFRIC 14 on your disclosed accounting surplus or deficit. Be in a position to provide justification to your auditors, if necessary.
5. Ensure that you disclose your material assumptions and sensitivities of liabilities and pension expense to changes in these.
6. Consider whether the impact of the credit crunch needs separate comment in your accounts.
7. Consider how future funding requirements and associated trustee negotiations may be impacted by the credit crunch and/or your pension accounting numbers

The PricewaterhouseCoopers pensions team has a highly successful track record in addressing complex pension issues, given our breadth of commercial, financial, HR and pensions expertise.

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