Report by the Financial Reporting Review Panel on the results of its review into defined benefit disclosures by companies under both IFRS and UK GAAP

Table of contents

1. Introduction

Defined benefit pension schemes are currently the subject of much discussion, particularly concerning the deficits often found in such schemes and the disclosures companies make about those deficits. For public companies, 2005 marked a move to international accounting standards and a consequent change in the way in which pension obligations were disclosed. The Accounting Standards Board (ASB) is currently considering possible amendments to FRS 17 and has issued an exposure draft containing proposals to bring disclosures into line with IAS 19 and a new Reporting Statement on pension accounting which seeks supplementary voluntary disclosures to address concerns not satisfied by the proposed amendments to FRS 17. This review by the Financial Reporting Review Panel complements the work being carried out by the ASB.

As promised in the Financial Reporting Council's Plan and Budget for 2006/7 the Panel has carried out a review into pension disclosures in the 2005 annual accounts of UK companies. This report summarises the results of that review, which considered the pension disclosures of twenty listed groups that prepared their December 2005 accounts under IFRS and of ten large private companies that prepared accounts under UK GAAP. The aim of the review was to evaluate the completeness and clarity of disclosures about pension obligations under IAS 19 and FRS 17. The Appendix contains an analysis of compliance with the disclosure requirements of IAS 19.

2. Summary of results and conclusions

The Panel was encouraged by the results of its review and by the generally high level of compliance with the complex disclosure requirements of IAS 19 and FRS 17.

2.1. IAS 19 Compliance

IAS 19 was amended by the IASB late in 2004 and additional disclosure requirements were added at that point. These new disclosures were not mandatory for 2005 reporting unless a company elected to adopt early. Companies in the UK tended to adopt early in order to take advantage of a provision in the amendment that allows actuarial gains and losses to be taken to the Statement of Recognised Income and Expense (SORIE), a treatment consistent with FRS 17. Within the review sample, 18 out of 20 companies adopted the revised accounting policy and so were required to make the additional disclosures. One company that did not adopt this approach nevertheless made the majority of the new disclosures on a voluntary basis.

The review also looked at the disclosures made under IAS 1 about principal assumptions and uncertainties to the extent that companies included information on pension obligations.

The general level of compliance with the detailed disclosure requirements of IAS 19 was good, but there were some omissions, which are described in the following sections and in the appendix. The Panel considers that reporting under IFRS could be improved by:

- Fuller disclosure (narrative or quantified) of the uncertainties surrounding estimates and the impact of changes to these estimates in relation to pension liabilities, in accordance with IAS 1 paragraphs 116 – 124.

- More consistent interpretation between companies of what is meant by the principal assumptions, particularly the inclusion of inflation and mortality assumptions, in accordance with IAS 19 paragraph 120 (A) (n). The Panel believes that divergence has arisen because IAS 19 does not name inflation or mortality assumptions as principal actuarial assumptions to be disclosed, although both might be expected to qualify.

- Greater clarity on the nature of the disclosures required. Actuarial assumptions in particular are complex and disclosures about mortality assumptions tend to be highly technical and to vary considerably between companies. Narrative descriptions tended to contain references to specific actuarial tables used and to technical (eg short cohort) adjustments. Example mortality figures, such as that for a man presently at retirement date, may be intended to help users understand the adequacy of the provision but the information is partial and the assistance limited. IAS 19 provides no guidance on the type of disclosure required and the question arises as to who is intended to benefit from disclosures of this nature. Do they assist the expert? Do they make matters clear to the lay reader?

- Clearer description of how the expected return on assets has been calculated, including comment on property returns where these are material. Although descriptions provided by some companies were clear, others tended to be vague and there is a danger that such disclosures can become boiler plate. It is hoped that best practice will evolve in this area.

- More information, as indicated in paragraphs 24-28 of the Reporting Standard, on non-standard types of asset held, such as derivatives and hedge fund investments, together with the associated risks and reasons for inclusion within the fund.

- Disclosures about the maturity of the scheme, in line with the ASB recommendations [paragraphs 17-23], although this is not a requirement under IAS 19.
- Avoidance of unnecessary disclosure of immaterial amounts. Given the number and complexity of the disclosures listed under IAS 19, companies should be conscious of materiality in making disclosures and avoid very detailed disclosure about small amounts.

Although some companies in the sample omitted certain of the detailed disclosure requirements in no case were these sufficient in number or significance to warrant intervention by the Panel.

2.2. FRS 17 compliance

The FRS 17 review was limited to private companies which these have a longer period in which to make their accounts publicly available. As a result, the accounts reviewed were mostly 31 December 2004 year ends and all of the companies had taken advantage of the transitional provisions of FRS 17 to continue to account under SSAP 24, supplemented by the transitional disclosures required by FRS 17. The SSAP 24 disclosures have not been considered in this review. The most common FRS 17 omission was a failure to provide three years' information where required. The transitional provisions allow companies to build up comparative numbers over several years and by 2004 companies should have been reporting three years' data for some items. There were a number of other minor omissions which are described in section 4 below.

3. Issues arising under IAS 19

3.1. IAS 19 Assumptions

IAS 19 requires the disclosure of principal actuarial assumptions, specifically (where applicable) discount rates, expected rate of return on plan assets and reimbursement rights, expected rates of salary increases, and medical cost trend rates. It also requires the disclosure of 'any other material actuarial assumptions used'. Most companies responded to this by also disclosing their inflation assumptions (17/20 companies) and providing some information about their mortality assumptions (14/20). Expected rates of pension increases were also split out from salary increases in most cases. A number of companies provided separate assumptions for UK and various overseas schemes.

3.1.1. Mortality assumptions

Ten companies in the sample provided example mortality rates, some with accompanying narrative, whilst a number of others provided a narrative description only. Six companies did not provide any information on their mortality assumptions. Narratives, where given, tended to be technical in nature and to comprise references to the specific mortality tables used with further comment on items such as short cohort adjustments and scaling factors. To be meaningful to users, this requires both an understanding of the tables used and the nature of the adjustments applied to it. The suitability of the tables chosen and the adjustments then need to be assessed in the light of knowledge about the company.

Specific examples of mortality were given by approximately half the companies in the sample. Typical disclosures were of remaining life expectancy of a current or future pensioner of a specified age, for example of a man aged sixty at balance sheet date or of a woman who would be sixty in fifteen years time. There was no consistency between companies in which specific examples were quoted so that direct comparisons between companies are not usually possible.

3.1.2. Inflation assumption

Long term inflation assumptions disclosed varied between 2.5% and 2.8%, with an average of 2.7%. This is not a wide spread but there was some inconsistency in the trend, with a number of companies decreasing their inflation assumption from 2004 to 2005 while others increased it. Long term expected inflation rates can be calculated in a number of ways and variations in the expected maturity of different schemes could also have an impact. One company explained that its inflation assumption was based on the yield gap between long term index linked and fixed interest gilts but most companies did not describe their method of estimation. Although useful, there is no requirement to do so. From the sensitivity analysis that was provided (see below 3.1.5) it is clear that a difference of 0.3%, although not a large variable, could have a significant impact on the size of deficit disclosed.

3.1.3. Other assumptions

The other assumptions disclosed by companies were those listed by the standard: discount rates; rates of return on assets; rates of salary and pension increases. Discount rates assumed in 2005 ranged from 4.6% to 4.9%, with an average of 4.78%. These had dropped from a range of 5.25% to 5.5% the previous year, reflecting a fall in the long term bond yields. Variations in rates can occur, depending on the specific bonds and maturities selected as well as the valuation date. Small movements in discount rates can have a significant impact on the level of liability calculated.

Expected returns on assets showed a high degree of variation between companies. As there are a number of ways of calculating expected returns the standard requires that the company explain its selected method. The various explanations were variable in quality and are discussed in more detail in section 3.3 below. There is room for judgement and this can be seen from the range of assumptions. Returns on equities, for example, where a common method is to start with a gilt yield and add a risk premium, ranged from 6.7% to 8.2% while returns on gilts ranged from 3.95% to 4.6%. Expected returns on assets is a critical figure as it is this, rather than actual returns, that affects the income statement charge. Most companies in the sample elected to take differences between actual and expected returns directly to equity.

Expected salary and pension increases showed variations between companies but these assumptions are partly company specific and also based on its inflation expectations. A number of companies sub-analysed the information in this category between pensions already in payment and deferred pensions where these were expected to differ.

3.1.4. Volatility of assumptions

Financial assumptions are mostly market rate driven and so changes from year to year are to be expected. All companies within the sample changed most of their significant assumptions between 2004 and 2005 as described in 3.1.3. above.

The fall in discount rates between 2004 and 2005 was a major contributor to the increase in company pension deficits in the year. Changes in assumptions caused almost all of the deficit increases between 2004 and 2005, exceeding market gains from a rising stock market on the fair value of assets. Although most of this volatility is kept outside the income statement under IAS 19, the reported surplus or deficit figures in company balance sheets are likely to remain highly volatile.

3.1.5. Disclosures about the volatility of assumptions

In their IAS 1 disclosures about critical accounting estimates, a number of companies in the sample commented on the assumptions made in estimating the valuation of defined benefit pension assets and liabilities, highlighting the uncertainty that exists. IAS 1 requires disclosures about the key assumptions that have a significant risk of causing a material adjustment to the carrying amount of assets or liabilities within the next financial year. A number of companies commented that small changes in principal assumptions could have a very significant effect on the level of liability, but only three provided any sort of quantitative or sensitivity analysis. Where sensitivity analysis was provided, it showed that very small movements in major assumptions, such as discount rates or inflation, could have a very significant effect on the level of liability estimated.

3.1.6. Conclusions about assumptions

All companies in the sample made disclosures about principal assumptions underlying their pension liability. Disclosure allows users to consider whether the assumptions used by a company are in line with those used by its peers or whether they are more or less conservative. Assumptions however require the exercise of judgement and therefore varied from company to company. Although evidence would suggest that inflation and mortality assumptions are material to the level of the pension provision, not all companies included these in their disclosures, perhaps because they are not specified in IAS 19. Except in the case of returns on assets, no explanation is required of how assumptions have been calculated and in most cases, little explanation was given.

3.2. IAS 19 Explanation of movement in net deficit

A few companies provided an explanation of the movement (usually an increase) in the deficit reported compared to that of the previous year. Although these tended to be short and general, they are not a requirement of IAS 19 and were provided voluntarily by companies as useful supplementary information. Some highlighted increases in mortality assumptions as having a major impact in the year. The impact of one-off cash contributions was also mentioned.

3.3. IAS 19 Plan assets

IAS 19 requires companies to make a number of disclosures about the assets held within the pension plan, including an analysis of plan assets into various asset types, specifically equities, bonds, property and other. Most companies further split bonds between government and corporate. One company analysed assets into more than ten categories and was one of two companies within the sample to disclose that its pension fund used derivatives. Both companies provided an explanation of their reason for holding derivatives in the pension fund. A third company stated that the other assets category included investments in hedge funds.

The standard does not clearly contemplate the holding of derivatives or other non-traditional investments by pension plans and there are no required disclosures about these sorts of assets. In addition to the explanations provided by companies holding derivatives, a few companies commented on the reasons underlying the relative weightings of different assets within the fund. One commented that its large bond holding reflected the maturity of the scheme, as the vast majority of scheme members were already pensioners. Others pointed out that the scheme assets were not intended to be realised in the short term and that the market value could change materially before realisation. These explanations all exceeded the requirements of the standard.

The standard asks for disclosure of the number of shares in the sponsoring company held within the fund, or any fund property used by the company, but this applied to only a few companies within the sample.

Companies must provide a narrative explanation of the basis used to determine the overall expected rate of return on assets, including the effect of the major categories of plan assets. In most cases, the expected return for each class of asset was disclosed as well as the total expected return, but some companies only provided rates by class and did not provide an overall rate of return. Seventeen companies within the sample provided a narrative, which varied in the level of detail. Whilst a few provided a reasonable explanation of the methodology employed, others were for example, no more than a statement that the expected rate of return on plan assets is based on market expectation at the beginning of the period for returns over the entire life of the benefit obligation adds little to users' understanding.

No company made any meaningful comment on how property returns had been estimated, although these require the application of judgement. Some companies stated that returns were based on expected bond yields and a few further quantified the risk premium added on for equities. Only two companies for whom this was relevant stated that a deduction had been made for allowable expenses.

3.4. IAS 19 Income statement charges

The standard requires that companies disclose the income statement charge, split between various categories of expense, and state the line items in which amounts are reported. No guidance is provided in the standard on which income statement lines should be used and, as might be expected, this has resulted in variation in practice. Under FRS 17, the expected return on assets and the interest cost from the unwinding of the discount were charged (net) to finance costs and a number of companies have continued with this approach, although others have not, and include the amounts elsewhere e.g. in cost of sales or operating expenses.

3.5. IAS 19 General description of the scheme

The standard asks for a general description of the type of plan, distinguishing between, for example, flat and final salary plans as well as providing details of any informal practices that give rise to constructive obligations. The standard does not require a detailed description. The disclosures tended to be brief and did not always state whether or not a scheme was a final salary scheme. Common descriptions were that the schemes were funded, that assets were held separately from the company, that there were fund trustees, whether or not the scheme was closed, and that benefits depended on factors such as the length of service.

3.6. IAS 19 Other issues arising from review

Other areas of disclosure where omissions were noted were in the requirements to:

- analyse obligations between funded and unfunded schemes

- disclose the amount of cumulative actuarial gains and losses
- disclose the actual return on plan assets
- give a best estimate of the contribution to the plan in the next year

4. Issues arising under FRS 17

The FRS 17 sample was smaller (10 companies) and the latest accounts available were mainly for the 2004 year end. All companies selected had continued to account in accordance with SSAP 24, providing the additional disclosures required under FRS 17 transitional provisions. A number of disclosure omissions were found in some companies accounts within the sample including:

- The omission of any information on future contribution rates (3 companies) even where, in one instance, there was a statement that future rates had been agreed between the company and pension fund trustees.
- No statement in respect of closed schemes and those in which the age profile of the active membership is rising significantly (4 companies) where the schemes were stated to be closed. In these circumstances, the company should disclose that the current service cost will increase as the members of the scheme approach retirement.
- No sub-analysis of the 'other' category of plan assets (2 companies) where the amount was material. In other cases, however, supplementary analysis was provided, usually of property or cash held.
- The transitional disclosures require three years' information to be provided in some instances in 2004 accounts. 3 companies disclosed only two years' data.
- No analysis of reserves to distinguish the amount relating to the defined benefit asset or liability net of related deferred tax (2 companies). A third company analysed shareholders' funds rather than reserves.
- Where a company has more than one defined benefit scheme, disclosures may be made in total, separately, or in such groupings as are considered to be most useful. Whilst the standard does allow disclosures to be made in total, the grouping of assumptions into ranges to cover different geographic areas as found in one case (eg discount rate 2.8% - 6.3%) would not appear to be particularly useful.

FRS 17 disclosures tended to be shorter than those under IAS 19, which contains a number of additional disclosures. There is no requirement to show movement tables separately for liabilities and assets, nor is there a requirement to provide an explanation of the basis for calculating expected returns on assets. Nor does UK GAAP require a discussion of major estimates and uncertainties equivalent to IAS 1. Only one company in the sample made any voluntary comment on the uncertainty inherent in the use of assumptions. One other company commented on what it considered to be the most relevant assumptions in calculating the provision level. FRS 17 specifically requires disclosure of the inflation assumption, but only asks for financial assumptions, which excludes mortality.

Appendix - Detailed analysis of IAS 19 disclosure requirements

Paragraph 120A (a) accounting for actuarial gains and losses

All companies in the sample disclosed their accounting policy for actuarial gains and losses. 18 companies took advantage of the ability to early adopt the revision to IAS 19 allowing them to recognise the whole amount of any actuarial gains or losses immediately through the SORIE. These companies are therefore obliged to comply with all the additional disclosure requirements of the revision to IAS 19. 2 companies adopted the corridor approach.

Paragraph 120A (b) a general description of the plan

The standard asks for only a brief description of the plan but does suggest that the description should distinguish between flat salary and final salary plans as an example of the type of disclosure that would be appropriate. All companies provided some description but in most cases these were extremely short and few actually disclosed whether or not pensions were based on final salary. The most common disclosures were:

- That the plans were funded or unfunded
- That, for funded plans, the assets were held separately from company assets
- That the funds were administered by Trustees
- The countries in which the plans operated
- Where a company had more than one plan, the name and geographic / employee coverage of all plans
- If plans were closed to new entrants

Paragraph 120A (c) movement table for defined benefit obligation

This is one of the requirements of the amendment to IAS 19 and so was not mandatory for 2005 except for companies that chose early adoption. 19 out of 20 companies in the sample produced this table, with one of the two companies not required to comply with this disclosure until 2006 providing it voluntarily. The standard lists ten items that should be shown in the table, where relevant. Some, such as the current service cost, interest cost and actuarial gains and losses, applied to all companies, whereas others, such as settlements, acquisitions and curtailments, applied to only a few companies.

Paragraph 120A (d) analysis of obligations between funded and unfunded plans

This analysis was not specifically disclosed in seven cases. In each of these cases it was clear that the obligations were funded (wholly or partly) either because there was only one defined benefit scheme which had plan assets attached or because it was stated elsewhere within the note that the scheme was funded. Unfunded schemes are most commonly found in overseas schemes operated by companies and in post retirement healthcare benefit schemes, often in the US.

Paragraph 120A (e) movement table for plan assets

This is another of the requirements of the amendment to IAS 19 that is not required until 2006 for companies that chose not to adopt early. The standard lists ten items that should be shown in the table, if relevant. 19 out of 20 companies in the sample produced the table. There were some variations in the disclosures. One company chose to show the actual return on plan assets rather than showing separately the expected return and then actuarial gains and losses. This does not, strictly, comply with the standard. A number of companies disclosed only one contributions figure, rather than specifying contributions by the employer and by plan participants separately. These plans may be non-contributory for employees, but this was not stated.

Paragraph 120A (f) reconciliation of present value of obligations and fair value of assets to amount on balance sheet, showing various specific items, if relevant

The reconciling items listed in the standard are:

- *Net actuarial gains or losses not recognised in the balance sheet*
- *Past service cost not recognised in the balance sheet*
- *Any amount not recognised as an asset because of limit in paragraph 58(a)*
- *Fair value of any reimbursement right recognised as an asset*
- *Any other amount recognised on the balance sheet*

For most companies in the sample there were no reconciling items as the net of the present value of obligations and fair value of assets was the amount recognised on the balance sheet.

Paragraph 120A (g) analysis of total expense recognised in income statement

All companies in the sample provided this information. Most included interest costs and the expected return on assets within finance costs in the income statement, but not all have done so. One company chose to show both amounts separately on the face of the income statement. Others included these amounts within cost of sales or other operating costs. There is no specific requirement to include the amounts within finance costs, nor is it clear that, where they are so included, the expected return on assets should be netted against finance costs (mostly unwinding of discount) rather than shown gross. This, however, was the treatment under FRS 17 and most companies have chosen to continue it.

Paragraph 120A (h) analysis of amounts recognised in SORIE

This disclosure was relevant to 18 of the companies within the sample. The two companies adopting the corridor approach did not take actuarial gains or losses to the SORIE. One company did not provide any information in the notes but the line item was shown within the SORIE itself and appeared to be only the actuarial loss with no adjustment. In most cases the disclosure was straightforward as only actuarial gains and losses had been recognised in the SORIE

Paragraph 120A (i) cumulative amount of actuarial gains and losses recognised in statement of recognised income and expense

Companies that recognise actuarial gains and losses in the period in which they occur in the SORIE are required to disclose the cumulative amount so recognised. Six companies omitted this disclosure. It was not applicable for a further two companies. This was one of the most commonly omitted disclosures.

Paragraph 120A (j) analysis of plan assets by category

All companies provided this analysis, using the categories listed by the standard. Most companies further analysed between gilts and other bonds. One company provided thirteen categories of asset. Two companies disclosed derivative holdings, one investments in hedge funds and one insurance policies. Pension plans appear to be holding a greater variety of asset types than may have been anticipated by the standard. Disclosure of the different types of asset held provides valuable information to users on the risk profile of the portfolio but is not, strictly, required by the standard.

Paragraph 120A (k) entity's equity or entity occupied property included within pension assets

Three companies provided details of the number of company shares held within the pension fund or of pension owned property occupied by the group. Two further companies stated that there were no such assets within the pension fund. Fifteen made no comment, which has been taken to indicate that they had no such assets.

Paragraph 120A (l) narrative description of basis for calculating return on assets

This narrative should describe the basis used to calculate the overall expected rate of return, including the effect of the major categories of plan assets. This requirement was added as part of the latest amendment to IAS 19 to assist users to assess the level of risk inherent in the plan so was mandatory only for those companies early adopting the revision. The standard of description was variable but in many cases too vague to provide any useful information. Two companies that had early adopted the amendment to IAS 19 failed to make any disclosure of the basis for calculating expected returns. Some companies said little more than that the overall rate was based on long term expected rates of return for the individual asset classes with no indication of how these were calculated. There were general references to *market expectations*, *historic and projected rates*, and advice from *market professionals and actuaries*. In a number of cases, it was explained that long term bond or gilt yields were used as a basis with various premia added to reflect risk or expected returns on other classes of asset. In two cases, the amount of the equity risk premium was quantified. Two companies mentioned making a deduction for expenses and one quantified the amount of the deduction.

Paragraph 120A (m) actual return on plan assets

Two companies in the sample did not disclose the actual return on plan assets.

Paragraph 120A (n) principal actuarial assumptions used at the balance sheet date

All companies in the sample disclosed actuarial assumptions. Some companies published both those used for the last full valuation plus those used to update the valuation to the latest year end. Inflation and mortality assumptions, which are not specifically listed by the standard, were disclosed by most companies as falling within the category of 'other material assumptions'. These assumptions are likely to be material for a defined benefit pension scheme. 17 out of 20 companies disclosed their **inflation assumptions**. Inflation estimates ranged from 2.5% to 2.8%. For mortality assumptions, some companies (6) referred to tables, some (5) gave illustrative examples and some (5) provided both. Mortality assumptions can be difficult for non-specialists to understand and the standard provides no guidance on what should be disclosed.

Most companies commented on the volatility surrounding assumptions but few companies provided any sensitivity analysis. There was consistency in assumption levels between companies, especially on the discount rate and inflation; less so on mortality assumptions and returns on assets. Most companies assumed a **discount rate** of 4.75 - 4.8% although one company had a rate of 4.6% .

There is no reason why **assumptions about salary or pension increases** should be consistent between companies but there is generally a strong link to the inflation assumption. No information is given about how salary assumptions are estimated.

Assumed returns on equities varied between companies from 8.2% to to 6.7%. The 6.7% was based on the 'actuary's recommendation' whilst the 8.2% used 'investment manager's forecasts'. No further reasons were given that might explain this difference.

Mortality rates show considerable variation, with life expectancies for a male aged 60 ranging from 81 to 85.8 and for a female aged 60 from 84 to 89.5. Some companies gave a narrative description only, rather than any example rates. For example, *'Mortality rates are based on tables PMA 92 and PFA 92 with short cohort adjustment and scaling factor of 125% applied, projected to 2015 for current pensioners and 2025 for future pensioners..'*

Paragraph 120A (o) the effect of an increase of one percentage point and the effect of a decrease of one percentage point in the assumed medical cost trend rates on

This disclosure applies only to those companies that operate post retirement health care schemes. No issues arose on the disclosures, which were made by all the companies to whom they were applicable.

Paragraph 120A (p) Experience adjustments over last five years

Transitional provisions apply in respect of this disclosure that allow experience history to be built up from the date of transition to IFRS. This information is important in comparing actual with expected returns on assets and in considering the accuracy of the actuarial assumptions employed. All companies provided the required information, although it is of limited use until a longer history is available.

Paragraph 120A (q) the employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the annual period beginning after the balance sheet date.

Only one company failed to disclose this. One company projected out payments to 2015, but most provided information on the next year only, as required by the standard.