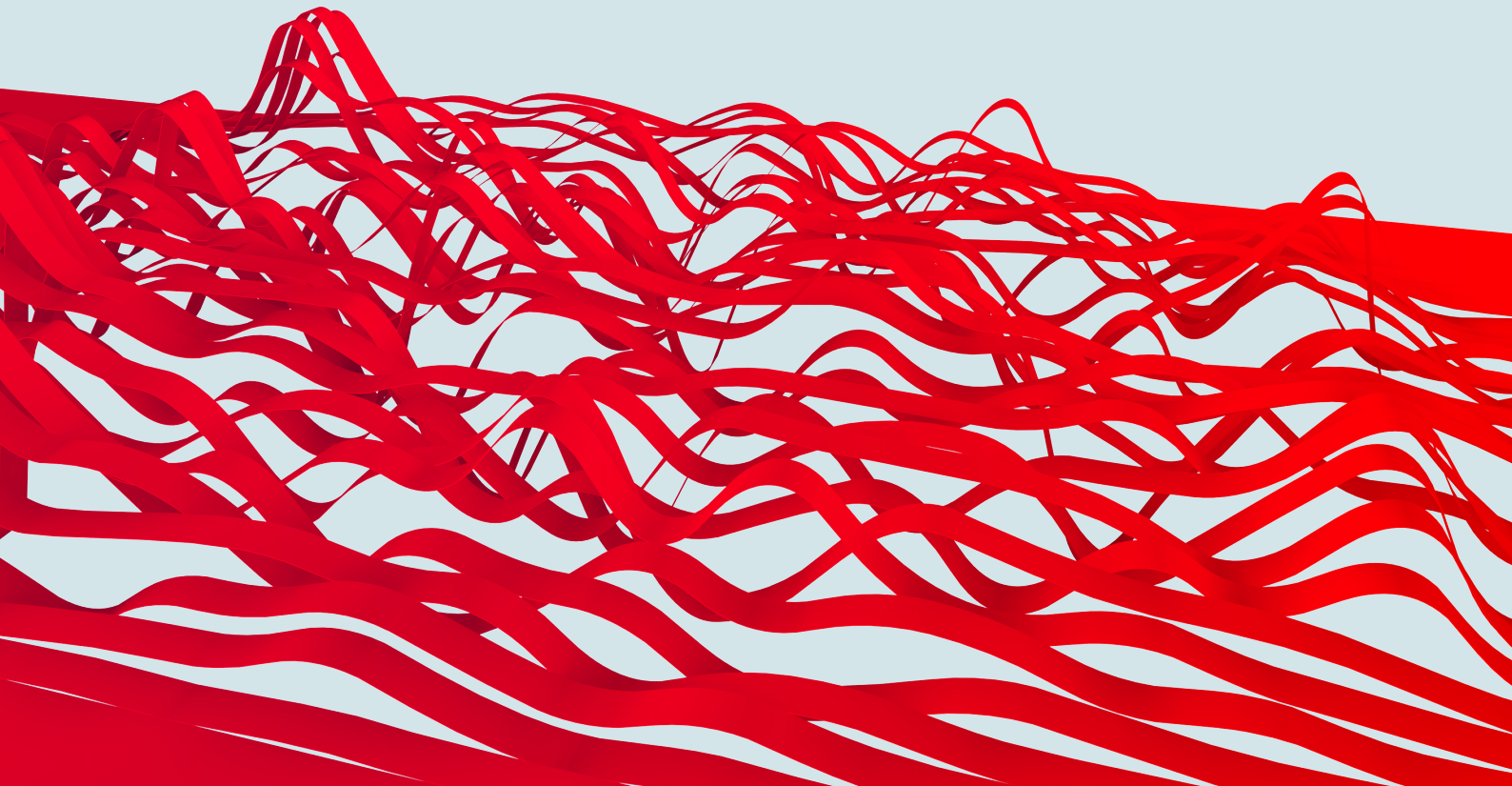

CHANGES TO PENSION SCHEME FINANCIAL STATEMENTS

APRIL 2015





BACKGROUND

The United Kingdom has adopted Financial Reporting Standard 102 (FRS 102) in order to comply with International Financial Reporting Standards. FRS replaces all previous reporting standards and for the first time ever includes Pension Scheme Accounts. Previously the form and content of Pension Scheme Accounts was delegated to and maintained by the Pension Research Accountants Group (PRAG) and set out in a Statement of Recommended Practice (SORP). The SORP has been revised and was issued in November 2014 and includes the form and content of Retirement Benefit Plans: Financial Statements which will comply with the requirements of FRS 102.



KEY CHANGES

The key changes to the form and content of Retirement Benefit Plans: Financial Statements are set out in the following paragraphs. The form and content still include a Fund Account and a Statement of Net Assets (available for benefits). These are the familiar contents, albeit with a slightly different name for the Net Asset Statement, and they remain as “Custodian Accounts” – that is they exclude the actuarial liabilities of DB schemes but now require inclusion of a Report on Actuarial Liabilities in the Trustees’ Report. FRS 102 applies to both DB and DC schemes with mixed schemes distinguishing between these sections.

INVESTMENT REPORTING

The assets at the end of the accounting period should be suitably classified – no changes there – but this should be included in the Statement of Net Asset as well as the notes to the accounts. The previous SORP recommended one line “Investment Assets”. Typically we would expect Pooled Investment Vehicles and Derivatives to be one line on the Statement of Net Assets but with further analysis in the investment note. Investments will now include Annuity policies valued at the amount of the related obligation, normally by the Scheme Actuary and new asset classes are given guidance, including special purpose vehicles, longevity swaps and repos and reverse repos.

It is also worth noting that the statutory disclosures included in the Audited Accounts Regulations are still in force. These include, for example, analysing pooled investment vehicles into:

- Unit trusts property
- Unit trusts other
- Managed funds property
- Managed funds other

Whereas the SORP recommends analysing pooled investment vehicles as:

- Equities
- Bonds
- Hedge funds
- Private equity
- Infrastructure

We understand that DWP and PRAG are working to revise the Audited Accounts Regulations to bring the historic disclosures into line with the SORP recommendations and this is expected to take place this autumn – subject of course to Parliamentary time being available post general election.

FAIR VALUE HIERARCHY AND DISCLOSURE

FRS 102 requires investment assets to be further disclosed according to their “Fair value hierarchy”. This is to give the users of the Financial Statements guidance as to the method and therefore appraisal of the valuation of different asset classes.

Investments will be analysed using a fair value hierarchy:

- Category A – The quoted price for an identical in an active market at the reporting date – e.g. listed shares, daily traded pooled investment vehicles
- Category B – The price of a recent transaction for an identical asset adjusted if necessary – e.g. some bonds, some pooled investment vehicle with non-daily/weekly pricing
- Category C – A valuation technique which the SORP allows to be split further as:
 - C1 using observable market data – e.g. most bonds, some property investment
 - C2 using non-observable – e.g. some property investment, insurance policies

For category B “recent” is given no guidance – current views are that “recent” will in most instances cover a transaction within the previous seven days and may include a transaction between seven days and one month. A transaction over one month ago is unlikely to be “recent”. For category A investments, a scheme year end falling on a bank holiday or weekend date will not require reclassification from A to B.

This means that the notes to the financial statements will include both the expected analysis of investment assets by asset type but also by fair value hierarchy – with comparative tables for both.

INVESTMENT RISK DISCLOSURES

FRS 102 requires that a “retirement benefit plan shall disclose information that enables users of its financial statements to evaluate the nature and extent of credit risk and market risk arising from financial instruments to which the retirement benefit plan is exposed at the end of the reporting period”.

These are defined as:

Credit risk – loss caused by failure of one party to a financial instrument to discharge an obligation

Market risk, comprising:

Currency risk – e.g. direct or pooled investments in overseas markets

Interest rate risk – e.g. bonds, interest rate swaps

Other price risk – e.g. return seeking portfolio

This requirement is likely to add considerably to the disclosures in the note. The requirement for disclosure, as set out above, and the scheme’s exposures, consequent upon the Trustee pursuing its investment strategy as disclosed in the Trustees’ Report, can largely be covered by narrative. However, the recommendation is also to disclose the aggregate value of direct credit risk by asset class split between Investment grade, Non-investment grade and Unrated. The recommendation for other risk is to disclose in aggregate by asset type applicable. Typically this would involve, for each of the four risks (where relevant) commentary

on what the risk is and its source, quantitative disclosure of the risk by asset type and commentary on the risk mitigation.

Again full comparative figures will be required for each disclosure.

The SORP does not recommend additional risk disclosure not directly related to investment assets, for example Employer Covenant.

VALUATION OF ANNUITIES

FRS 102 requires annuities to be included at fair value. Normally annuity policies are included at £nil which is not permitted under FRS 102.

The Trustees should adopt a reasonable basis and apply this consistently from year to year. We would normally expect the scheme actuary to supply the annuity valuation, which typically may be calculated at the scheme funding rate.

There is the override that the omission of any item normally required in financial statements may be permitted if it is not material in value and its omission is disclosed. Typically this might apply to the costs of valuing “small” annuity policies. However estimated capital values of annuity policies can easily be within the “material” ranges applied by audit firms. KPMG have indicated that a value of <2% of total assets is unlikely to be material and >5% of total assets is likely to be material. Between these guidelines capital value may be material.

TRANSACTION COSTS

SORP recommends disclosure of direct transaction costs analysed by asset class and type. Where pooled investment costs are taken into account and reflected in the bid/offer spread then this should be disclosed as narrative in the note. This recommendation is included as part of expected compliance with the Better work place pensions – DWP proposals for greater disclosure of transaction costs – all linked in with possible DC charge cap regulations due this year.

REPORT ON ACTUARIAL LIABILITIES

FRS 102 requires that a defined benefit plan discloses, in a report alongside the financial statements forming part of the Trustees’ Report, information regarding the actuarial present value of promised retirement benefits including:

- a) a statement of the actuarial present value of promised retirement benefits, based upon the most recent valuation of the scheme;
- b) the date of the most recent valuation of the scheme; and
- c) the significant actuarial assumptions made and the method used to calculate the actuarial present value of promised retirement benefits

This information is already included in the summary funding statement/ statement of funding principles.

The SORP recommends also including the net assets at date of valuation, subject to treatment of liabilities covered by annuities

Introduction and transition

Effective for accounting periods commencing on or after 01 January 2015 – year end financial statements to 31 December 2015 will be the first to apply the revised SORP and comply with FRS 102.

Comparatives will be required for the new investment disclosures – fair value hierarchy and risk disclosures.

The investment valuations will apply as if FRS 102 had always applied, therefore:

- No prior year adjustment
- Reconcile and disclose opening and closing scheme net assets at transition date (01 January 2014) and at end of comparative period (31 December 2014)
- Reconcile and disclose net increase/decrease in fund as previously reported

OTHER MATTERS

Historically the Equiniti Pension Accounts (EPS) service has been a “one stop shop” and as such has normally only needed a light touch from Equiniti Client Account and Service Delivery Managers and scheme Trustees. However EPS will not be able to provide the investment fair value hierarchy disclosure, the investment risk disclosures and the annuity valuations.

Clearly EPS will be dependent upon scheme custodians or investment managers/consultants to provide the fair value hierarchy, upon the scheme actuary for annuity valuations and upon all of these and the trustees for the investment risk disclosures. A large investment custodian has already informed us that they cannot warrant any SORP disclosures supplied by them and that the onus will be on the individual investment managers to supply the information! In addition the scheme actuaries, custodians, investment managers, and consultants will be looking to charge for advice and provision of information required for disclosure under the revised SORP. Auditors will be expecting to charge additional fees to audit the increased disclosures.

Your normal scheme accountant at EPS will be delighted to assist you if you require any further general or scheme specific information or expected requirements.

Attached is a following link to the KPMG model SORP compliant financial statements:

<http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Pages/guide-to-pension-scheme-financial-statements.aspx>





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