



CORPORATE REPORTING THEMATIC REVIEW PENSION DISCLOSURES

NOVEMBER 2017

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CONTENTS

1	Background	5
2	Key messages	6
3	The disclosure requirements of IAS 19 ‘Employee benefits’	8
4	Principal findings	9
4.1	Explanation of different valuations	9
4.2	Funding in future years	10
4.3	Maturity profile of obligation	12
4.4	Investment strategy risks	13
4.5	Net pension assets	16
4.6	Disaggregation of plan assets	17
4.7	Valuation methodology for unquoted assets	19
4.8	Strategic report	21
4.9	Other findings	24
5	Next steps	25

Thematic reviews supplement the FRC's monitoring work conducted by Corporate Reporting Review (CRR). CRR monitors company reports and accounts for compliance with the Companies Act 2006, including applicable accounting standards, and other reporting requirements. The aim of our thematic reviews is to identify and share examples of good practice reporting and highlight areas where improvements can be made.

Low interest rates and the economics of defined benefit pension arrangements have increased the need for companies to improve the transparency of their pension reporting. Key to this is helping users understand the factors that could affect the future expense and cash flows of the company.

This report shares our detailed findings from a targeted review of certain aspects of pension obligation reporting. Companies can use this to assess and enhance their own disclosures to ensure that they provide high quality information to investors in their annual reports and accounts.

CRR's reviews are based solely on company reports and accounts and do not benefit from detailed knowledge of each company's business or an understanding of the underlying transactions entered into. They are, however, conducted by staff who have an understanding of the relevant legal and accounting framework. The FRC provides no assurance that the reports and accounts subject to review, including the examples of good practice reporting, are correct in all material respects. The FRC's role is not to verify the information provided in a company's report and accounts but to consider the quality of compliance with reporting requirements.

1 BACKGROUND

In December 2016, the FRC wrote to 20 companies informing them that CRR would review the pension disclosures in their next annual report and accounts. The purpose of the review was to improve the quality of those disclosures and to identify good practice.

CRR had identified pension reporting as an area where there was a general need for increased transparency of the relationship between a company and its pension plans. This was primarily as a result of continued low interest rates and the economics of defined benefit pension plan arrangements.

Our sample comprised companies who disclosed significant pension deficits compared to net equity in their most recently published annual reports and others with reported pension surpluses.

One of our sample was acquired after its balance sheet date and subsequently delisted such that its annual report was not available in sufficient time to be considered for this report. We selected another company in its place but, due to timing, this company was not given advance notification of our review.

The final sample comprised four companies from the FTSE 100, one from the FTSE 250, thirteen smaller listed entities, one listed bond issuer and an unlisted company.

2 KEY MESSAGES

We were pleased that most companies responded positively to advance notification of our review by improving certain aspects of their pension disclosures. The accounting periods under review coincided with the adoption of lower discount rates applied to liabilities and higher inflation rates. Many of the companies reviewed reported sharply increased deficits. We welcomed the new or extended commentaries provided by most in their strategic reports focusing on how the deficit would be addressed.

- Most companies disclosed information about contributions expected to be paid for several years into the future, distinguishing between those made to cover the deficit and those in respect of current service. This is helpful for investors because it provides an understanding of the future cash payments that a company expects to make to its pension scheme. However, companies could usefully explain that these are reviewed as part of each funding valuation.
- In explaining the current and future cash contributions, a number of companies disclosed that, going forward, an increase in dividend payments to shareholders would trigger an increase in the pension scheme contributions. This appears to be an increasingly popular mechanism for securing the funding of pension schemes.
- Some companies used graphics creatively to present complex information.
- A small number of the companies sampled provided more informative disclosure about the assets held by their pension schemes by disaggregating the analysis of quoted and unquoted assets into further sub-classes.
- There is scope for companies to better articulate their schemes' strategy for matching assets and liabilities, in particular how they use liability driven investments. Many companies in the survey had increased their investment in such asset classes. Typically, the reasons for their use were well explained. However, whilst their purpose was clear, users were less well informed about the underlying nature of the investments and, too often, were left to infer the underlying valuation basis for such assets. We will continue to challenge companies who do not provide clear disclosures about the nature and valuation basis of all material asset classes.

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- Companies with material net pension assets explained why they considered the asset to be recoverable in terms of IAS 19 and IFRIC 14. Until the IASB's amendments to IAS 19 and IFRIC 14 are finalised, we expect companies in this position to also set out, clearly and simply, the judgements they have made about trustee rights in accordance with IAS 1¹.
 - We saw evidence of improved pension disclosures in strategic reports. Good practice was identified by those companies who:
 - provided more information about the risks and uncertainties they face arising from their pension scheme; and
 - gave a clear explanation of the reasons for the marked increase in deficits and discussed the actions being taken to remedy them.

Of the 20 reports included in the sample, we wrote follow-up letters to two companies where there was a substantive question relating to their accounting for pensions and the related disclosures. Correspondence with these companies is ongoing.

The principal findings from the thematic review are set out in section 4.

¹ IAS 1, paragraph 122.

3 THE DISCLOSURE REQUIREMENTS OF IAS 19 'EMPLOYEE BENEFITS'

IAS 19 sets out disclosure objectives and explains the considerations that a company must take into account when determining how they are to be met.

The standard² requires a company to disclose information that:

- a) explains the characteristics of its defined benefit plans and the risks associated with them;
- b) identifies and explains the amounts in its financial statements arising from its defined benefit plans; and
- c) describes how its defined benefit plans may affect the amount, timing and uncertainty of the company's future cash flows.

The standard goes on to explain that it may be necessary to provide additional information in order to meet the overarching objectives. In such circumstances, the additional disclosure will be required, rather than optional, to give users an appropriate understanding of a company's pension arrangements.

Taken altogether, pension disclosures should enable users of the accounts to understand the relationship between the pension expense, the cash payments to the scheme and the surplus or deficit. At a more detailed level, investors should also be able to appreciate the nature of the scheme's assets, the investment

strategy, the extent of its liabilities and the associated risks, including the risk that the pension cost and cash payments may change in the future.

Companies should consider the overall objectives of the standard when assessing how best to provide meaningful information. We were pleased to see that many companies appeared to make a conscious effort to build an appropriately comprehensive information set for users. This includes describing the nature of the scheme, highlighting the risks and sensitivities, identifying the detailed assets and actuarial estimate of the liabilities, setting out its expectations for future contributions and any other developments.

We will continue to challenge companies who do not provide additional information which, although not specifically required under the standard, is necessary in order to meet the disclosure objectives of IAS 19.

The disclosures given to meet the requirements of IAS 19 should be accompanied by commentary in the strategic report, if information about the company's pension schemes is necessary for an understanding of the development, performance or position of the company's business.

² IAS 19, paragraph 135.

4 PRINCIPAL FINDINGS

4.1 Explanation of different valuations

The FRC expects companies to identify and explain their bases of pension valuation.

Pension obligations are valued separately for accounting and funding purposes, which may result in materially different amounts. It is helpful to describe to users the reasons for any differences between these valuations, for example IAS 19 requires 'best estimate' assumptions to be used whereas the funding valuation uses 'prudent' assumptions.

All of the sampled companies referred to the triennial valuation of their pension schemes as well as the IAS 19 valuation. A small number of companies gave a clear explanation of the difference between these two valuations and the impact of the triennial valuation on future funding. We found the following explanation particularly helpful as it explains the uses of the different valuations.

"Which pension deficit should I be looking at?"

The accounting deficit (£1,014m) or the actuarial valuation (£479m) – what is the difference between the two measures?

The actuarial valuation deficit of £479m is used to judge the money we need to put into the pension scheme. It will always be different to the IAS 19 accounting deficit (£1,014m), which is an accounting rule concerning employee benefits and shown on the balance sheet of our financial statements.

Accounting standards require all companies to assume their pension fund grows at a standard rate reflecting a relatively low level of risk. We take slightly more risk in our pension scheme, increasing the potential fund growth, and helping to keep the overall costs lower. We are able to take this risk because of the strength of our business. Generally, because of how our fund is invested the accounting deficit will be higher than the actuarial deficit.

We must also be mindful of the different dates of the valuations. The accounting deficit figure is calculated as at the balance sheet date of 28 January 2017, and the actuarial deficit was calculated as at 31 March 2016."

John Lewis Partnership plc Annual Report and Accounts 2017^{3, 4}

³ John Lewis Partnership plc was not given advance notification of our review.

⁴ Strictly the accounting standard requires assets to be measured at their current fair value and requires discounting of the obligation at a rate equivalent to the market yield on high quality corporate bonds. This explanation compares the two valuation approaches in a way that is understandable to a reader, without getting drawn into explanation of the precise mechanics of the standard.

4.2 Funding in future years

The FRC expects companies to clearly quantify future funding requirements and describe the funding mechanisms adopted.

IAS 19 requires companies to provide information about the expected impact of their defined benefit pension schemes on future cash flows by disclosing details of:

- the funding arrangements;
- the expected contributions for the next year; and
- the maturity profile of the defined benefit obligations.

The majority of the reports reviewed provided all these disclosures.

Information about future funding is critical to a user's understanding of when the liability is likely to crystallise in terms of funding cash flows from the company to the pension scheme. Equally, as the level of cash funding is reviewed at each triennial valuation the basis of the disclosures should be made clear.

We observed the following examples of good practice which voluntarily provide detail about future contributions beyond the next reporting year.

"The cash contributions to the Scheme of £13.0m (in addition to the regular contributions outside of the revised funding plan) have been made in the current year and £13.5m will be made in 2018, increasing to £20.5m in 2019 and then rising by 4% per annum to 2022. It will be frozen at £23.0m per year between 2023 and 2028. The Group will continue to pay annual fees of £1.6m for managing the Scheme in addition to the cash contributions. In the year ended 25 March 2017, the Group made funding payments and management fees totalling £14.8m. The next triennial funding valuation is due in April 2018."

De La Rue plc Annual Report 2017

“Future funding obligations and recovery plan

Under the terms of the Trust Deed, the group is required to have a funding plan, determined at the conclusion of the triennial funding valuation, which is a legal agreement between BT and the Trustee and should address the deficit over a maximum period of 20 years.

In January 2015, the 2014 triennial funding valuation was finalised, agreed with the Trustee and certified by the Scheme Actuary. The funding deficit at 30 June 2014 was £7.0bn. Under the associated recovery plan BT made payments of £875m in March 2015, £625m in April 2015 and £250m in March 2016. BT is scheduled to make future deficit payments in line with the table below.

Year to 31 March	2018	2019	2020	2021	2022	2023	2024
Deficit contribution (£m)	688	699	711	724	670	670	670
Year to 31 March	2025	2026	2027	2028	2029	2030	
Deficit contribution (£m)	495	495	495	495	495	289	

The ordinary contribution rate to meet the benefits of current employed members is:

- 16.0% of pensionable salaries (including employee contributions) from 1 April 2015 through to 30 June 2017; and
- 16.9% of pensionable salaries from 1 July 2017. This will be reviewed as part of the 2017 triennial valuation.

Based on the 2014 funding valuation agreement, the group expects to make contributions of approximately £850m to the BTPS in 2017/18, comprising ordinary contributions of approximately £162m and deficit contributions of £688m. This will be reviewed as part of the 2017 funding valuation.”

BT Group plc Annual Report & Form 20-F 2017

We found references to a variety of mechanisms for determining future cash contributions, driven by the triennial valuations of pension schemes. Of particular interest were those where the formula for future contributions included a link to increases in dividend payments. These funding mechanisms appear to have become relatively common in recent years. Where these additional contributions are triggered by the payment of dividends they may not represent a minimum funding requirement. For this reason, they avoid the need to assess whether an additional liability is required to be recognised under paragraphs 23 and 24 of IFRIC 14.

It is important that there is clear disclosure of these arrangements and the payments which may be triggered as shown in the following example:

“Renold has agreed to make additional contributions equal to 25% of the value of any dividend paid in order to accelerate the deficit recovery plan.”

Renold plc Annual Report and Accounts for the year ended 31 March 2017

One company did not disclose the quantum of the expected value of contributions for the next financial year although it could be inferred from the narrative description of amounts paid in the current year. We consider that IAS 19 requires quantified disclosure of the expected contributions as users appreciate clear information about future cash flows.

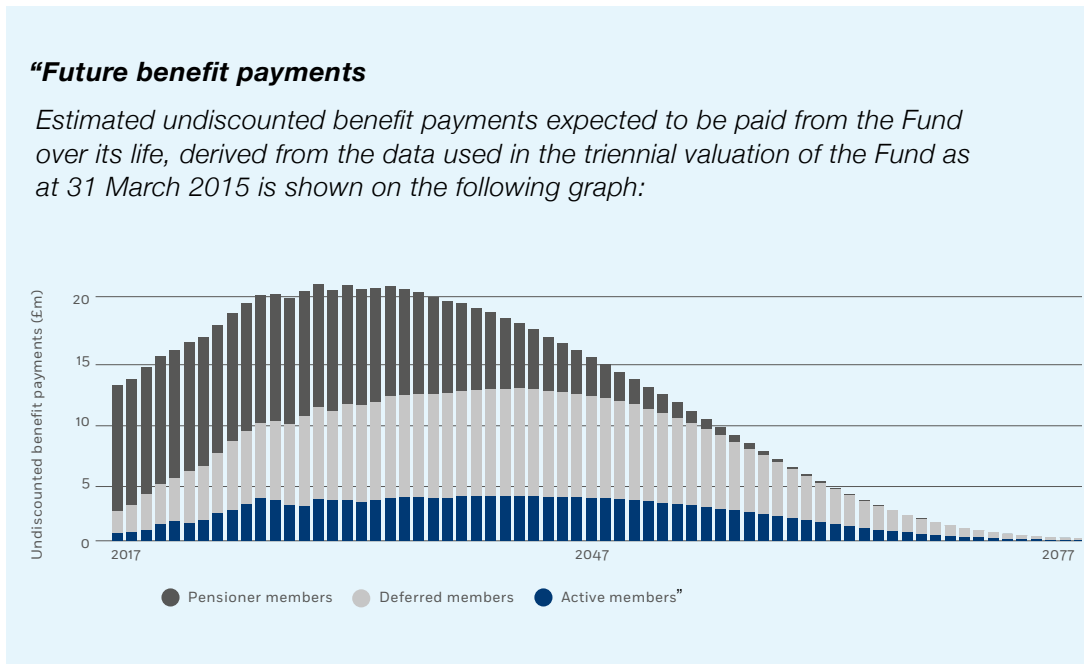
The majority of the annual reports reviewed expressed the maturity profile of the defined benefit obligation by disclosing the weighted average duration in years. However, this measure can be enhanced by providing further information about the maturity profile of the obligation. When a company has an unfunded scheme, information about the timing of a company’s future cash flows to pay these pensions is particularly helpful to users.

4.3 Maturity profile of obligation

The FRC expects companies to give clear information about the maturity profile of their obligations.

The maturity profile of a scheme’s obligations is a driver of the investment strategy and needs to be clearly explained.

The following example clearly presents the asymmetry of the obligation profile compared with the weighted average duration:



John Menzies plc Annual Report and Accounts 2016

Graphs can be an effective method of portraying the maturity profile of the obligation over the expected scheme life and provide more meaningful information than a simple average metric. We strongly encourage companies to provide information in a manner which is easy to read and comprehend.

The following disclosure about the timing of benefit payments is by a company that has exactly matched a minority proportion of its pension liabilities with insurance policies. This approach also provides context in which to understand the investment strategy discussed elsewhere in the pensions note.

“Maturity profile and cash flow

Across the schemes, the invested assets are expected to be sufficient to pay the uninsured benefits due up to 2045, based on the reporting date assumptions. The remaining uninsured benefit payments, payable from 2046, are due to be funded by a combination of asset outperformance and the deficit contributions currently scheduled to be paid by 2025. The liabilities related 50% to current pensioners and their spouses or dependants and 50% related to deferred pensioners. The average term from the year end to payment of the remaining uninsured benefits is expected to be around 20 years. Uninsured pension payments in 2016, excluding lump sums and transfer value payments, were £41 million, and these are projected to rise to an annual peak in 2039 of £75 million and reducing thereafter.”

Trinity Mirror plc Annual Report 2016

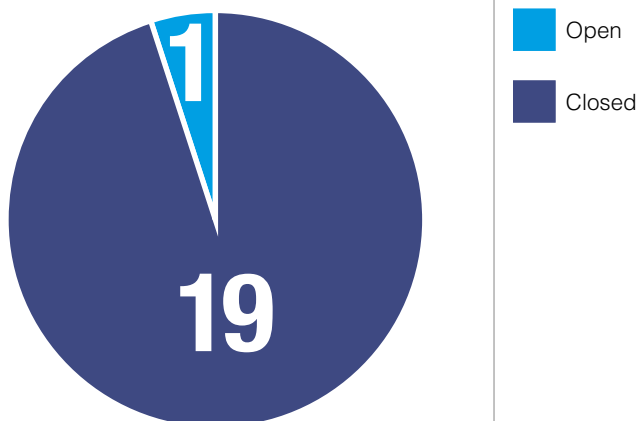
4.4 Investment strategy risks

The FRC expects companies to clearly explain their investment strategy and associated risks, including details of any asset-liability matching strategy.

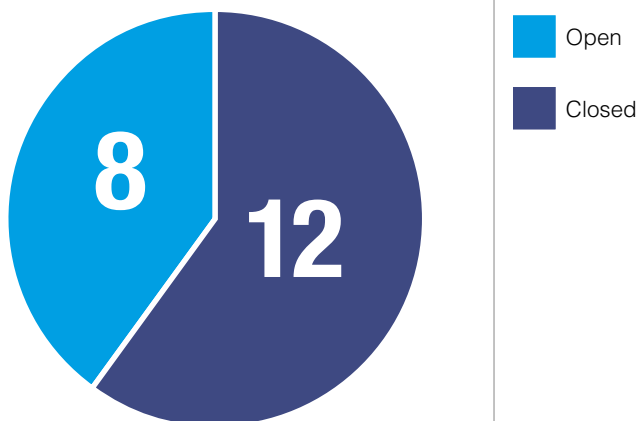
Almost all of the schemes of the companies reviewed were closed to new members. The majority were also closed to future accrual.

Status of schemes in the review

Open/closed to new members



Open/closed to future accrual



The increasing maturity of the schemes and the desire to reduce uncertainty about future contributions has led to changes in investment strategies. In particular there have been increases in liability-matching, either through the use of contracts with insurers or through the selection of assets that reduce the impact on the funding position of changes in interest rates.

The majority of reports reviewed gave a clear description of the investment strategy and its inherent risks although this was generally given in separate sections of the pensions note. The following is an example of better practice:

“The trustee aims to achieve the scheme’s investment objectives through investing partly in a diversified mix of growth assets which, over the long term, are expected to grow in value by more than low risk assets like cash and gilts. This is done within a broad liability driven investing framework that uses cash, gilts and other hedging instruments like swaps in a capital efficient way. In combination this efficiently captures the trustee risk tolerances and return objectives relative to the scheme’s liabilities. A number of investment managers are appointed to promote diversification by assets, organisation and investment style.

.... Financial derivatives risk – The scheme does not directly hold any financial derivatives but instead invests in investment funds which hold the derivatives required to hedge the scheme’s interest rate, inflation and currency risks. The scheme also permits some of the investment managers to use derivative instruments if these are being used to contribute to a reduction of risks or facilitate efficient portfolio management of their funds.

The main risks associated with financial derivatives include: losses may exceed the initial margin; counterparty risk where the other party defaults on the contract; and liquidity risk where it may be difficult to close out a contract prior to expiry. These risks are managed by monitoring of investment managers to ensure they have reasonable levels of market exposure relative to initial margin and positions are fully collateralised on a daily basis with secure cash or gilts collateral.

The AAUK scheme had hedged around 50% of interest rate risk and around 75% of inflation risk (of the liabilities) as at 31 January 2017 and hedging had been fairly constant at those levels for some years as part of a policy to reduce financial risks to the Scheme. The current longer term objective is to aim to hedge around 75% of both the interest rate risk and inflation risk of the liabilities; this will help to further reduce funding level volatility. More interest rate hedging will be added in due course as, and when, prevailing pricing is regarded as reasonable value in the circumstances, or if any other reasons drive a policy change on risk appetite.”

AA plc Annual Report and Accounts 2017

We identified opportunities for companies to improve the explanation of any asset-liability matching strategy, by including:

- a description of the specific nature, both of the risks covered and those retained. This would help investors to understand the company's exposure to risks that are not covered by the strategy; and
- information about the extent to which the reported deficit or surplus is exposed to risks that are not fully covered by the asset-liability matching and whether the pension scheme's funding basis is similarly exposed.

These descriptions should avoid terminology that may be hard for a user to understand. We observed the following examples of good disclosure which explain the risks covered and those retained:

"Risk	Description	Mitigation
<i>Interest rate risk</i>	<p><i>A decrease in corporate bond yields increases the present value of the IAS 19 defined benefit obligations.</i></p> <p><i>A decrease in gilt yields results in a worsening in the Scheme's funding position.</i></p>	<p><i>The Trustees' investment strategy includes investing in liability-driven investments and bonds whose values increase with decreases in interest rates.</i></p> <p><i>Approximately 50% of the Scheme's funded liabilities are currently hedged against interest rates using liability-driven investments and the Trustees have a step plan to incrementally increase this level of hedging as its funding position improves.</i></p> <p><i>Note that the Scheme hedges interest rate risk on a statutory and long-term funding basis (gilts) whereas AA corporate bonds are implicit in the IAS 19 discount rate and so there is some mismatching risk to the Group should yields on gilts and corporate bonds diverge. The Scheme's exposure to corporate bonds mitigates this risk to some extent.</i></p>
<i>Inflation risk</i>	<p><i>An increase in inflation results in higher benefit increases for members which in turn increases the Scheme's liabilities.</i></p>	<p><i>The Trustees' investment strategy includes investing in liability-driven investments which will move with inflation expectations and hedge 60% of total inflation linked liabilities. The growth assets held are expected to provide protection over inflation in the long term.</i></p> <p><i>Approximately 80% of the Scheme's funded liabilities are currently hedged against inflation."</i></p>

Carclo plc Annual Report 2017

“The group has de-risked its pension schemes through hedging strategies applied to the underlying interest rate and the forecast RPI. The underlying interest rate has been largely hedged through external market swaps and gilts, the value of which is included in the schemes’ assets, and the forecast RPI has been largely hedged through the IFM [Inflation Funding Mechanism], with RPI in excess of 3.0 per cent per annum being funded through an additional schedule of deficit contributions, and through external market hedges.

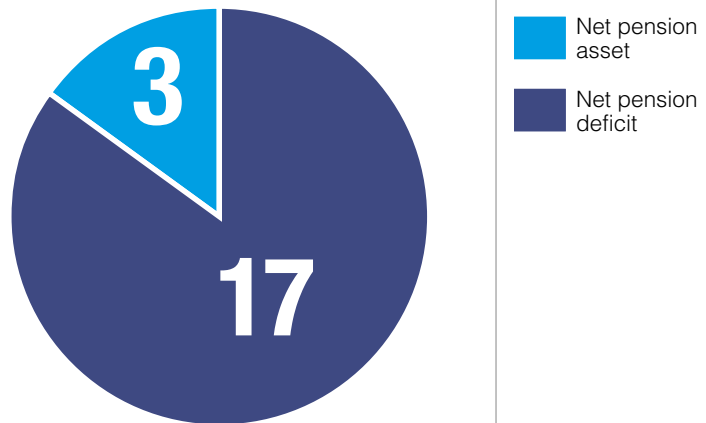
As a consequence, the reported statement of financial position under IAS 19 remains volatile to changes in credit spread which have not been hedged, primarily due to the difficulties in doing so over long durations; changes in inflation, as the IFM results in changes to the IFM deficit contributions rather than a change in the schemes’ assets; and, to a lesser extent, changes in mortality as management has decided, at the current time, not to hedge this exposure due to its lower volatility in the short term and the relatively high hedging costs.”

United Utilities Group PLC Annual Report and Financial Statements for the year ended 31 March 2017⁵

4.5 Net pension assets

The FRC expects companies to disclose any significant judgements made when assessing trustee rights.

Was there a net pension asset or deficit in schemes in the review?



A net pension asset may only be recognised when the company has an unconditional right to a refund or to reductions in future contributions. Only three of our sample of twenty disclosed an overall asset on the balance sheet whilst another showed the potential recognition of an asset in one relatively small scheme being restricted.

Nevertheless, the majority of the sample explained the policy that would apply to any potential asset. Where assets were recognised, a satisfactory explanation was given. These referred to the company having an unconditional right either to a reduction in future contributions or a refund assuming the gradual settlement of the scheme’s liabilities over its life. This is more helpful than referring to the need for legal advice or referencing specific paragraphs of the accounting standard which are unlikely to be understood by many users of the accounts.

⁵ United Utilities Group PLC was not selected for this review; the example was identified by our routine activities.

There is currently diversity in practice regarding whether a trustee's discretionary power to enhance benefits for scheme members or wind up a scheme without cause should be considered when determining a company's unconditional right to a refund from a defined benefit plan.

An assessment of trustee rights should be made when, at the balance sheet date, the fair value of plan assets plus the committed contributions under a minimum funding requirement would exceed the defined benefit obligation, as well as when there is a net pension asset.

The IASB issued an exposure draft in June 2015 to clarify this aspect of the application of IFRIC 14 and continues to consider the responses to its proposed amendments to the Interpretation and IAS 19. Until the amendments are finalised and effective, we expect companies to disclose any significant accounting judgements made, in accordance with IAS 1⁶, when assessing trustee's rights. These include whether the trustee has any rights to wind up the plan without cause or otherwise vary the benefits payable under the scheme. Clarifying the approach taken improves the information available to investors.

We observed the following example of good disclosure⁷:

"The Trust Deed provides Kingfisher with an unconditional right to a refund of surplus assets assuming the full settlement of plan liabilities in the event of a plan wind-up. Furthermore, in the ordinary course of business the Trustee has no rights to unilaterally wind up, or otherwise augment the benefits due to members of, the scheme. Based on these rights, any net surplus in the UK scheme is recognised in full."

Kingfisher plc Annual Report 2016/17⁷

4.6 Disaggregation of plan assets

The FRC expects companies to present meaningful classes of plan assets.

Large funded pension schemes have significant holdings of investments. The standard requires the fair value of these assets to be disaggregated into classes that distinguish the nature and risks of those assets. It also requires those assets that have a quoted market price in an active market to be distinguished from those that do not. It suggests a range of potential classes; for example, it may be appropriate to segregate equity investments by geographical market and property investments by market sector. Similarly, bonds might be analysed according to their risk characteristics and by geography.

The quality of disclosure in this area was mixed, with only some of the sample providing a detailed analysis. It was disappointing to see that some simply provided a total for equities with a few not even disclosing whether or not they were quoted, despite equities representing the largest class of investment.

⁶ IAS 1, paragraph 122.

⁷ Kingfisher plc was not selected for this review; the example was identified by our routine activities.

The following is an example of good disclosure provided by one company which meets the requirements through a clear and concise presentation.

"The fair value of scheme assets is represented by the following major categories:

As at 31 March	2017				2016			
	Quoted* £m	Unquoted £m	Total £m	%	Quoted* £m	Unquoted £m	Total £m	%
Equity instruments								
Information technology	142	–	142	2%	125	–	125	2%
Energy	61	–	61	1%	53	–	53	1%
Manufacturing	104	–	104	1%	98	–	98	1%
Financials	164	–	164	2%	178	–	178	3%
Other	452	–	452	5%	437	–	437	6%
	923	–	923	11%	891	–	891	13%
Debt instruments								
Government	2,929	–	2,929	34%	2,590	–	2,590	36%
Corporate bonds (investment grade)	20	2,071	2,091	25%	158	1,461	1,619	23%
Corporate bonds (Non-investment grade)	123	414	537	6%	165	280	445	6%
	3,072	2,485	5,557	65%	2,913	1,741	4,654	65%
Property funds								
UK	–	190	190	2%	67	115	182	3%
Other	–	156	156	2%	76	48	124	2%
	–	346	346	4%	143	163	306	5%
Cash and cash equivalents	93	–	93	1%	170	–	170	2%
Other								
Hedge funds	–	403	403	5%	–	373	373	5%
Private markets	–	174	174	2%	–	80	80	1%
Alternatives	327	379	706	8%	347	88	435	6%
	327	956	1,283	15%	347	541	888	12%
Derivatives								
Foreign exchange contracts	–	17	17	–	–	(9)	(9)	–
Interest rate and inflation	–	289	289	4%	–	203	203	3%
	–	306	306	4%	–	194	194	3%
Total	4,415	4,093	8,508	100%	4,464	2,639	7,103	100%

* Quoted prices for identical assets or liabilities in active markets.

Jaguar Land Rover Automotive plc Annual Report 2016/17

4.7 Valuation methodology for unquoted assets

The FRC expects companies to disclose information about their valuation methodology.

IAS 19 requires plan assets to be measured at fair value determined in accordance with IFRS 13 'Fair Value Measurement'. However, the fair value disclosure requirements of IFRS 13 do not apply to those plan assets. This often results in there being no explanation of how the fair value of unquoted plan assets, such as longevity derivatives or insurance policies that do not exactly match benefits payable, has been estimated.

We consider that a description of the approach adopted improves investors' appreciation of how the values have been determined, highlighting the degree of management judgement exercised when selecting a valuation technique in accordance with IFRS 13⁸.

The closure of pension schemes results in the average age of members increasing and, consequently, the amount of the related liability becoming more certain. Several companies in our sample have reduced risk by matching obligations relating to current pensioners and those approaching retirement with insurance policies or with 'Liability Driven Investments' (LDIs). Where use was made of insurance policies that exactly matched benefits payable, the disclosure was generally clear.

Whilst LDIs have emerged as a disclosed asset class, these vehicles are not homogenous. Some companies invest directly in an LDI fund whereas others invest in a portfolio of financial instruments which are managed together as part of their funding strategy. Companies would improve the quality of their disclosure by:

- clearly describing the nature of the components of their LDI portfolio;
- quantifying and clearly explaining how the fair value of the components has been estimated; and
- explaining why they hold those respective components.

⁸ IFRS 13, paragraph 61.

The following is an example of better practice:

“Fair value of scheme assets at 31 December

	2016			2015		
	UK schemes £m	Overseas schemes £m	Total £m	UK schemes £m	Overseas schemes £m	Total £m
Sovereign debt	7,574	335	7,909	7,283	297	7,580
Derivatives on sovereign debt	–	3	3	(5)	(1)	(6)
Corporate debt instruments	3,061	297	3,358	1,977	239	2,216
Interest rate swaps	2,063	–	2,063	1,868	–	1,868
Inflation swaps	(420)	–	(420)	(477)	–	(477)
Cash and similar instruments	(51)	18	(33)	118	21	139
Liability driven investment (LDI) portfolios¹	12,227	653	12,880	10,764	556	11,320
Longevity swap ²	(175)	–	(175)	(142)	–	(142)
Listed equities	969	82	1,051	810	1	811
Unlisted equities	214	–	214	232	–	232
Sovereign debt	–	4	4	110	3	113
Corporate debt instruments	–	–	–	24	–	24
Cash	25	9	34	68	21	89
Other	90	(1)	89	91	16	107
	13,350	747	14,097	11,957	597	12,554

¹ A portfolio of gilt and swap contracts, backed by investment grade credit instruments and LIBOR generating assets, that is designed to hedge the majority of the interest rate and inflation risks associated with the schemes' obligations.

² Under the longevity swap, the Rolls-Royce UK Pension Fund has agreed an average life expectancy of pensioners with a counterparty. If pensioners live longer than expected the counterparty will make payments to the Fund to offset the additional cost of paying pensioners. If the reverse applies the cost of paying pensioners will be reduced but the scheme will be required to make payments to the counterparty. The longevity swap is valued at fair value in accordance with IFRS 13 (Level 3).

The investment strategy for the UK scheme is controlled by the Trustee in consultation with the Company. The scheme assets do not include any of the Group's own financial instruments, nor any property occupied by, or other assets used by, the Group. The longevity swap is valued by the scheme actuaries based on the difference between the agreed longevity assumptions at inception and actual longevity experience. All other fair values are provided by the fund managers. Where available, the fair values are quoted prices (eg. listed equity, sovereign debt and corporate bonds). Unlisted investments (private equity) are included at values provided by the fund manager in accordance with relevant guidance. Other significant assets are valued based on observable inputs such as yield curves.”

Rolls-Royce Holdings plc Annual Report 2016⁹

⁹ Rolls-Royce Holdings plc was not selected for this review; the example was identified by our routine activities.

4.8 Strategic report

4.8.1 Principal risks and uncertainties

The FRC expects companies to consider whether aspects of their pension schemes constitute a principal risk or uncertainty.

Whether or not a company's pension scheme is described as one of the principal risks and uncertainties facing the business is a relative judgement – depending on the significance of the relevant amounts to the company and what else is happening in the business at that time. The majority of companies reviewed did refer to their pension schemes in the discussion of their principal risks and uncertainties but we do not expect all companies to do so.

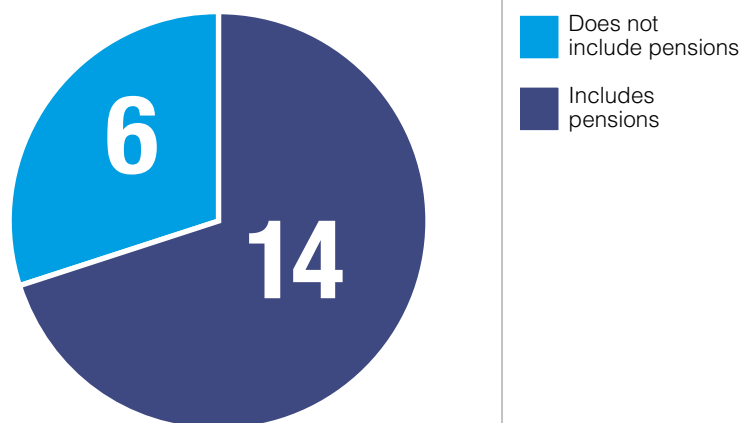
We found the following helpful examples:

“Carclo’s UK defined benefit pension scheme is very mature and is large compared with the size of Carclo. The Scheme is backed by substantial assets amounting to £176.9 million at 31 March 2017 (2016 - £173.7 million).

Small adjustments to the assumptions used to calculate the pension liability, or significant swings in bond yields or stock markets, can have a large impact in absolute terms on the net assets of the Company and Group. A decrease in the discount rate by 0.25% per annum (i.e. 2.60% to 2.35%) would increase the Scheme liabilities by 3.50% i.e. £7.331 million. An increase in the rate of inflation by 0.25% per annum (i.e. 2.35% to 2.60%) would increase the Scheme liabilities by 1.90% i.e. £3.980 million. An increase in life expectancy of 1 year would increase the Scheme liabilities by 3.3% i.e. £6.912 million.

The impact of the pension deficit on the level of distributable reserves is monitored on an on-going basis. Monitoring improves planning for any potential adverse swings and helps the group to assess the likely impact on distributable reserves. The new investment strategy (utilising diversified growth funds and

Were pensions disclosed as a principal risk and uncertainty by the companies selected?



liability driven investments) should reduce volatility and this has been seen in the first 12 months since implementation.

In addition the Company and the Trustees are exploring liability management possibilities (including Enhanced Transfer Values) with assistance from our advisers. These are designed to incentivise certain members to leave the scheme in order to reduce the uncertainty for the Company.

A triennial valuation of the scheme was undertaken as at 31 March 2015 and, based on this valuation, the Group has agreed a revised recovery plan with the Trustees. The recovery plan requires annual, index linked, contributions of £1.2 million to be made commencing 31 October 2016 for an expected period of 13 years 8 months, this will be reviewed again at the next triennial valuation which is expected to take place at 31 March 2018.

In addition the Group has in recent years offered eligible pensioners the option to switch from a pension with indexed linked pension increases to a higher fixed pension with no future increases.”

“Pensions

We have a large funding obligation to our defined benefit (‘DB’) pension schemes. The largest of these, the BT Pension Scheme (BTPS or Scheme), represents over 97% of our pension obligations. The BTPS faces similar risks to other UK DB schemes: things like future low investment returns, high inflation, longer life expectancy and regulatory changes may all mean the BTPS becomes more of a financial burden.

Potential impact

The last funding valuation of the BTPS, as at 30 June 2014, provides certainty over scheme funding until the forthcoming valuation, due to start in June 2017, is concluded.

If there’s an increase in the pension deficit at the next valuation date, we may have to increase deficit payments into the Scheme. Higher deficit payments could mean less money available to invest, pay out as dividends or repay debt as it matures, which could in turn affect our share price and credit rating.

We’re considering a number of options for funding the deficit after the next valuation, as at 30 June 2017. These options include considering whether there are alternative approaches to only making cash payments, including arrangements that would give the BTPS a prior claim over certain BT assets.

What’s changed over the last year?

The pension deficit of the BTPS is calculated as the value of the assets less the value of the liabilities. The deficit at the valuation date will influence the deficit payments we agree.

A number of things affect the liabilities, including expected future investment returns at the valuation date. When considering expected future returns, we review different factors including yields (or returns) on government bonds, which have fallen in the year and have dropped significantly since 30 June 2014. If a lower future investment return is assumed at the next valuation our liabilities would likely go up.

Asset returns have been positive over the year with strong returns from equities and government bonds.

How we’re mitigating the risks

The investment performance and liability experience are regularly reviewed by both us and the Trustee of the BTPS. We also consider the associated risks and possible mitigations. The investment strategy aims to mitigate the impact of increases in the liabilities, for example by investing in assets that will increase in value if future inflation expectations rise. The assets held are also well diversified, softening the impact of sharp drops in the value of individual asset classes. This helps us maintain a reasonable balance of risk and return.

Our financial strength and cash generation provide a level of protection against the impact of changes in the funding position of the BTPS. The funding liabilities also include a buffer against future negative experience, as legislation requires that we calculate liabilities on a prudent basis.”

4.8.2 Additional explanation in the Strategic Report

The FRC expects companies to consider, where appropriate, supplementing their pension disclosures in the accounts with additional explanation in the strategic report.

All but one of the companies reviewed included commentary in their strategic reports about the amounts recognised in the accounts for their pension schemes. Many explained the reasons for the movement in their net pension balance and how these factors impacted on the defined benefit obligation and plan assets.

The breadth of discussion about the pension scheme generally reflected its significance compared to shareholders' funds with more in-depth information being given when the net pension liability was significant. The following is a comprehensive summary of key aspects of a significant deficit in the company's strategic report:

"Pension deficit and funding

The Group's formal triennial funding valuation of the UK defined benefit pension scheme (the Scheme) was finalised in June 2016. The Group agreed a revised funding plan with the trustees to eliminate the deficit over a period of 12 years from 31 March 2016. The plan will see the existing funding payment schedule extended from 2022 to 2028. In addition, we have created a joint working group with the pension trustees to proactively manage our pension obligations.

The Group will continue to pay annual fees of £1.6m for managing the Scheme in addition to the cash contributions. In the year ended 25 March 2017, the Group made funding payments and management fees totalling £14.6m. The next triennial funding valuation is due in April 2018.

The valuation of the Scheme under IAS 19 indicates a post-tax deficit at 25 March 2017 of £196.7m (26 March 2016: £178.4m). On a pre-tax basis the net pension deficit was £237.0m (26 March 2016: £217.6m). The increase results from higher liabilities due to the

impact of a lower discount rate used to value the Scheme liabilities (2.75% in 2016/17 compared with 3.50% in 2015/16) due to significant falls in corporate bond yields in addition to an increase in the expectation for the longer term inflation rate. The increase in liabilities has been partially offset by an increase in assets which have performed strongly in the year.

In common with other final salary schemes, the Scheme valuation is very sensitive to any movement in the discount rate, with a 0.25% increase in discount rate resulting in a £55m decrease in liabilities or vice versa and hence the deficit would reduce should interest and discount rates increase in the future.

The charge to operating profit in respect of the Scheme in 2016/17 was £1.5m (2015/16: £1.2m). In addition, under IAS 19 there was a finance charge of £7.4m arising from the difference between the interest cost on liabilities and the interest income on scheme assets (2015/16: £7.1m)."

De La Rue plc Annual Report 2017

Renold plc gave a particularly comprehensive explanation with graphics of:

- the drivers of pension deficit movements;
- trends in UK scheme membership;
- UK plan assets; and
- Mortality and mortality exposure.

This information is given on pages 38 and 39 of its Annual Report and Accounts for the year ended 31 March 2017¹⁰ and has not been reproduced here due to its length.

4.9 Other findings

- All of the companies in the sample disclosed the significant actuarial assumptions together with sensitivity analyses. In several instances, there were fewer assumptions included in the sensitivity analyses than the number of significant assumptions disclosed. This suggests that one sensitivity is covering several assumptions such as the inflation rates applicable to pension payments and to salaries. However, it is helpful if this is clearly stated as in the following example:

“The inflation assumption sensitivity factors in the impact of inflation on the ‘rate of increase in final pensionable salary’ and ‘rate of increase in pensions in payment accrued after 1999’ assumptions.”

Hogg Robinson Group plc Annual Report 2017

- We were pleased to see that where the amount of the deficit was significant to the balance sheet, a small number of companies referred to the funding of the pension scheme as one of the key assumptions used in the projections for the viability statement.
- We were pleased to note that none of the companies in the sample added superfluous disclosure as a result of being given advance notification of our review and wanting to ‘err on the side of caution’. However, we did identify opportunities for two companies to reduce the length of certain disclosures by, in one case, aggregating information for several plans which, individually, were not material and, in the other, for replacing repetition in the parent entity’s pension note with a cross-reference to the same information in the consolidated accounts.

¹⁰ <http://hsprod.investis.com/ir/rno/pdf/renold-ar-2017.pdf>

5 NEXT STEPS

We will continue to question companies where:

- information in addition to that required by the standard has not been provided but is necessary to understand the risks associated with their pension schemes and how they may affect the amount, timing and uncertainty of the companies' future cash flows;

- a net pension asset has been recognised, or it appears that required future contributions may create a surplus, but there is no explanation of the judgements made when assessing trustee's rights;

- there appears to be an asset-liability matching strategy but it has not been adequately described;

- the strategic report does not refer to the pension scheme but it appears appropriate to do so;

- plan assets of different nature and risk have been aggregated into classes; and

- it is not clear how unquoted plan assets have been valued.

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