THERE IS NO ESCAPE FROM FRS 17

FRANCIS FERNANDES OF LANE CLARK & PEACOCK LOOKS AT HOW LIFE WILL BE FOR COMPANY PENSIONS UNDER THE NEW TOUGHER ACCOUNTING REGIME OF FRS 17 – SUFFICE TO SAY, IT WON'T BE EASY.

FRS 17 magnifies the importance that defined benefit pension schemes assume within companies' accounts. It is a big departure from SSAP 24, the previous accounting standard covering retirement benefits. FRS 17 reflects the trend towards balance sheet-driven accounting compared with SSAP 24, where more emphasis was placed on the company's profit and loss (P&L) account.

Under SSAP 24, actuaries were able to estimate pension costs based on the investment strategy underlying the scheme. As most UK pension schemes hold around 60%-70% of their portfolios in equities, this allowed actuaries scope to anticipate the higher expected returns from equities to be taken into account when calculating costs. FRS 17 is more prescriptive, in that it measures liabilities by reference to AA rated bond yields on one specific day.

The difference between the market value of the assets and the liabilities based on a AA bond discount rate gives rise to a FRS 17 surplus or deficit.

SWINGS AND ROUNDABOUTS. Under FRS 17, the surplus goes straight to the balance sheet (net of deferred tax), whereas under SSAP 24, any surplus was spread over the future working lifetime of employees, typically 15 years and this was included in the P&L, not the balance sheet. Under FRS 17, there is no spreading over 15 years and the measurement is marked-to-market. Consequently, FRS 17 magnifies the importance of the pension scheme in the context of the company accounts and is why FRS 17 is suddenly such a big issue.

Measurement by references to market conditions on one day means that, unless the assets of the scheme are invested only in AA corporate bonds, the results will be extremely volatile. If the assets are invested predominantly in equities, the assets and liabilities have no reason to move in line together. Large surpluses in one year could become equally large deficits the following year, simply because of market movements. The wild swings from one year to the next makes planning company budgets a nightmare.

FRS 17 also requires that the full cost of any benefits improvements granted is recognised in the P&L account for the year in which the award is granted. Under SSAP 24, these costs were spread. Because of the one-off hit to the P&L, I believe that companies are unlikely to grant any significant benefit improvements to pension scheme members ever again.

KEY FINANCIAL FEATURES. FRS 17 is clear that the assumptions are the responsibility of the company directors after having taken advice from an actuary. The assumptions should reflect the company's best estimate of the future cashflows from the pension scheme. Assumptions fall into two groups: financial and demographic. Financial assumptions have more significance for the results and include the returns on investments, salary growth and price inflation. The demographic assumptions include factors such as rates of mortality and turnover.

'IT IS PARTICULARLY IMPORTANT IN PLANNING FOR FRS 17 JUST WHO AT THE COMPANY WILL HAVE THE FINAL SAY ON THE ACTUAL ASSUMPTIONS TO BE ADOPTED'

It is particularly important in planning for FRS 17 just who at the company will have the final say on the actual assumptions to be adopted. Although FRS 17 is already in force, there is a staggered implementation. For year-ends after 22 June 2001, the notes to the account should include the balance sheet item and certain other disclosures, such as the assumptions. For year-ends after 22 June 2002, the notes will also need to include the P&L and Statement of Recognised Gains and Losses (STRGL) items as well. Year-ends after 22 June 2003 see full adoption of FRS 17.

Despite the transitional arrangements, it is important to consider FRS 17 carefully this year, as the approach adopted will have an impact on future years. For example, the notes for this year will include the expected return on assets for the coming year, which will then feed directly into the P&L item for the notes to the accounts.

FRS 17 requires additional work, not least the need for annual updates of pension figures – this was not previously a requirement under SSAP 24. With tight reporting deadlines, this will create additional pressures on those preparing accounts.

How much extra work will need to be carried out depends upon materiality. As we are looking at pensions which will be paid in 50 or 60 years' time, it is impossible to calculate liabilities with complete precision. We need to decide how important or material the scheme is in the context of the company accounts, before deciding how accurately we need to perform our calculations.

Many companies have pension scheme liabilities which are large when compared against the market capitalisation of the sponsoring employers. One in 10 of the FTSE 100 companies has liabilities in excess of 50% of their own market capital.

Because the previous results are magnified under FRS 17 and the greater level of disclosure, more information will be needed. Disclosure notes about pensions in the accounts could run to a couple of pages – even if no one reads them. If materiality is a real issue, actuaries might need to prepare detailed calculations based on individual membership data. This will require time for the companies (and schemes) to provide the data. If updating previous valuation results is all that is required, the actuary would still need information about the scheme for the intervening period.

'IT HAS TAKEN FRS 17 TO BITE THE BULLET BY PROVIDING A REASONABLY OBJECTIVE ASSESSMENT OF THE RISKS BEING RUN WITHIN PENSION SCHEMES'

The two critical financial assumptions which a company needs to understand and think about are the AA corporate bond discount rate and the expected rate of return on equities. As regards the former, FRS 17 seems quite prescriptive. In reality, there is some scope for manoeuvre due to the lack of a liquid market in AA bonds at the durations required to match pension scheme liabilities. When it comes to equity returns, no one knows what the future will hold and the best we can do is to look back at historical returns. The problem here is that one could probably justify just about any figure based on a carefully selected period.

MORE TO THINK ABOUT. It seems hard to believe that an accounting standard can drive change, and many people are unhappy with FRS 17. My own view is that it has taken FRS 17 to bite the bullet by providing a reasonably objective assessment of the risks being run within pension schemes. Companies are going to have to think about the shareholders' perspective of the pension scheme's finances. Following the introduction of FRS 17, readers of accounts will begin to look more closely at the risks being run when deciding whether to buy or sell shares.

Swings in the balance sheets may impact on market confidence and, for some companies, FRS 17 could impact directly on share prices through increased volatility. At one extreme, directors could be forced by FRS 17 into reducing their intended dividend payments, as was recently the case for agricultural manufacturer Eliza Tinsley. For many companies, the pension scheme is like an elephant sitting in a rowing boat (the company).

The secret is to try and manage the defined benefit risk. Many finance directors do not appreciate the volatility of the pension figures until they see a few examples. If they can live with the wild swings, that's fine. If not, something needs to be done, and closing the defined benefit scheme to new entrants is an option. However, remember that it will be many years before the defined benefit scheme starts to dwindle. You can put the elephant on a diet, but it will take a while to see the effects.

Many companies have already said they cannot live with wild swings and they have opened new defined contribution pension scheme for new hires. For a pure defined contribution, or money purchase scheme, the accounting requirements are straightforward: simply record the employer's contributions during the year in the P&L.

However, defined contribution schemes pose other risks that could come back to haunt employers unless they address the key issue of educating employees about risk. With a defined contribution scheme the volatility is transferred to the employees, who need to understand the implications for their retirement planning.

INVESTMENT STRATEGY. One area where companies might be able to control the volatility is through the pension scheme's investment strategy.

There has been much coverage of schemes switching into bonds. As well as the highly-publicised move by Boots to 100% investment in bonds (see *The Treasurer* December 2001), both ICI and Coats Viyella have also increased their holding of bonds at the expense of equities. While FRS 17 was probably a factor, the move reflects the growing maturity of pension schemes and the need to back guaranteed liabilities with similar assets. Moving into bonds will reduce FRS 17 risk but also removes the chance to achieve extra returns. Investing totally in corporate bonds could carry other risks, not least the lack of a diversifying investment strategy.

Under the Pensions Act 1995, it is clear that the investment strategy of the pension scheme is the responsibility of the trustees. However, the same Act is also clear that there is a duty on the trustees to consult with the employer. Such a discussion could give rise to a new investment objective being considered: to protect the company from FRS 17 risks. Taking this into account would undoubtedly lead to higher bond allocations, all other things being equal.

LIVING WITH FRS 17. The figures under the new accounting regime are impossible to predict. Companies should be made aware of how exposed their accounts are to the wild swings of FRS 17. Companies need to think about: reviewing the defined benefit scheme risks; any future benefit improvements; consider the shareholders' perspective; and review the investment strategy of the defined benefit scheme. And then take action – before it's too late.

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