
Accounting disclosures under multi-employer pension schemes



Recognising pension scheme
liabilities within company
accounts under FRS 102

The Financial Reporting Council (FRC) is replacing current UK GAAP with effect from periods beginning on or after 1 January 2015.

The changes affecting occupational pension schemes are set out in *Financial Reporting Standard 102*. *Financial Reporting Standard 17 (FRS 17)* will no longer apply. This briefing paper focuses on the impact of this new standard on pension scheme accounting for organisations participating in defined benefit pension schemes with more than one employer.

Who will this affect?

FRS 102 will affect all organisations who participate in **defined benefit pension schemes** and who currently only record the value of their contributions in their annual accounts and potentially those who already recognise funding deficits/surpluses under FRS17.

How does this impact your organisation?

The introduction of FRS 102 will have a major impact on the financial statements of any entity currently preparing accounts under UK GAAP.

Presently, many employers who participate in a group defined benefit scheme or a *multi-employer defined benefit pension scheme* can comply with *Financial Reporting Standard 17* (FRS17) by accounting for the scheme as a defined contribution scheme. This treatment is required when an employer cannot determine their “share of the underlying assets and liabilities in the scheme on a **consistent and reasonable basis**”. In these circumstances the employer only recognises the contributions paid into the pension scheme over the financial year as an expense item in their profit and loss account.

For accounting periods on or after 1 January 2015 where an employer is **unable to identify** its share of the assets and liabilities of a multi-employer defined benefit pension scheme (a stricter test than is currently the case), the scheme will continue to be accounted for as a defined contribution under FRS 102, as is permitted by current UK GAAP. However, if the organisation has a funding agreement in place to eliminate a deficit in the pension scheme, the organisation must recognise:

- a liability in their balance sheet equal to the net present value (“NPV”) of the future deficit reduction payments. These payments are discounted to the present value using the market yield on high quality corporate bonds, which are currently around 4.5% per annum. Assuming deficit payments of £375,000 per annum payable over 15 years, this would result in on balance sheet liability of around £4 million.
- A finance cost in their profit and loss account equal to the unwinding of the discount rate. This will be equivalent to around the annual deficit payment i.e. £375,000 in the above example.

With many multi-employer pension schemes requiring deficit contributions there will be numerous employers who will now have to fully recognise defined benefit pension scheme liabilities for the first time. Aside from the likely impact on company balance sheets, the spotlight now being placed on any pension deficit present in the scheme could raise issues at Board level over the future financial sustainability of any scheme as well as the impact the scheme may have on bank covenants and access to future funding.

FRS 17 vs FRS 102

The value of the liabilities, and therefore the extent of any deficit recognised on the balance sheet, will be based upon the actuarial assumptions used. The main financial assumptions cover inflation, pension increases, longevity and the expected return on assets. Relatively small changes in these assumptions can have a significant impact on the value of the pension liabilities.

A funding plan established to eliminate the deficit in the pension scheme is put in place following a formal actuarial valuation of the scheme and the scheme's liabilities are calculated using a '*prudent*' set of assumptions as required by pensions legislation. It would be from these contributions that the NPV deficit would be calculated.

Under the "FRS 17 approach" i.e. accounting for the scheme as a defined benefit plan, an actuary will use financial assumptions which reflect a more current market based assessment. Assets must be valued on their market value, with liabilities valued using a discount rate equivalent to those on AA corporate bonds. Other assumptions are on a *best estimate* basis.

It is likely to be more beneficial for organisations to account for the pension scheme provision as a defined benefit plan instead as this may potentially reduce the liability figure shown on the organisations' balance sheet substantially, due to the different assumptions used to calculate the surplus/deficit.

Recognising the liability on an actuarial basis with assumptions to reflect the profile of the pension scheme membership relating to the individual employer, rather than the scheme as a whole, can have a material outcome on the organisation's balance sheet.

The table below shows the pension scheme deficit which would be disclosed in the company accounts under the "FRS 17 approach" compared to the using the NPV approach under FRS 102 (the NPV approach assumes deficit contributions of £375,000 per annum over 15 years):

	FRS 102 - NPV Approach	"FRS 17 Approach"
Liabilities	n/a	£8m
Assets	n/a	£5m
Surplus/(Deficit)	£4m	£3m

Please note the figures above are purely illustrative and any reduction in the balance sheet liability will depend on the pension scheme liabilities, the funding plan for eliminating any deficit in the scheme and the market conditions at that time as this impacts on the actuarial assumptions adopted.

If the scheme is accounted for as a defined benefit plan, a pension cost must be calculated and charged to the profit and loss account. From January 2015 under FRS 102, the pension cost is equal to:

- the service cost (i.e. the employer's cost of benefit accrual over the period)
- plus the interest on the pension scheme deficit over the period

The cost for the production and incorporation of an FRS 102 disclosure on an NPV basis is likely to be relatively small and could be attractive for organisations with smaller scheme liabilities and where the actual level of deficit disclosed is not material.

There is likely to be a higher cost incurred in following the "FRS 17 approach" and to incorporate this in the accounts. However where the value of the scheme liabilities, and therefore deficit disclosed, is material any additional cost needs to be weighed up against the potential reduction in the balance sheet liabilities as demonstrated in the example above.

It should also be noted that a "choice" may not be possible i.e. if an organisation is **able** to account for the scheme as a defined benefit plan, then it is expected to do so. However, there may be scope for interpretation on the ability to account for the scheme as a defined benefit plan, particularly where the "defined contribution approach" is currently applied.

What steps should be considered?

All organisations participating in multi-employer pension schemes, whether they are already disclosing under FRS 17 or not, need to carefully consider the options open to them.

Although FRS 102 only comes in to force for accounting periods on or after 1 January 2015 it is important to be prepared. In particular, 2015 accounts will be required to disclose comparator figures for 2014 (which will include a 2013 "opening balance"), and as such the potential impact of FRS 102 should be considered now.

Organisations should be considering the likely value of their pension deficit and how material fluctuations in this figure might be. Based upon this information they should be considering if they should be utilising an FRS 102 or "FRS 17 approach" and preparing for its implementation.

Organisations with multiple schemes also need to begin to consider how their disclosures should be provided.

Charitable organisations may also want to consider designating funds in their next financial statements to cover any agreed deficit reduction payments to minimise the effect on free reserves when FRS 102 comes into effect.

How can I find out more?

For a free initial impact assessment on how the introduction of FRS102 will impact your organisation email FRS102@spenceandpartners.co.uk providing us some basic information including your contact details, the name of the multi-employer defined benefit scheme which you participate in and either the current FRS 17 disclosure figure or a note of the deficit contributions currently being paid.

**This insight was provided by Alan Collins,
Actuary and Head of Employer Advisory
Services at Spence.**

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Glossary

Defined benefit pension scheme

A pension scheme where the amount of benefit payable to the member is determined by the member's service and salary.

Group defined benefit scheme

Where an entity participates in a defined benefit scheme that shares risks between entities under common control.

Multi-employer defined benefit scheme

Where an entity participates in defined benefit scheme where the participating employers are not under control e.g. industry wide schemes.

Defined contribution pension scheme

Pension contributions from both the employer and employee are paid into the scheme and these contributions receive investment returns. The pension that a member receives on retirement will depend on the size of a member's fund at retirement, the age at which they retire and the cost of purchasing an annuity/buying a pension at retirement.

Financial Reporting Standard 17 ('FRS 17')

An accounting standard used to assess the balance sheet impact and pension costs associated with the operation of occupation pension schemes.

Financial Reporting Standard 102 ('FRS 102')

The Financial Report Standard applicable in the UK and Republic of Ireland.

Pension scheme liabilities

The value, using actuarial methods and assumptions, placed on the obligations of a pension scheme for outgoings expected to fall on the scheme after the date to which the calculations relate.

Balance sheet asset/liability

The pension scheme *surplus/deficit* at the end of the accounting year.

Surplus/Deficit

The *pension scheme liability* subtracted from the market value of assets, defined as a surplus if this value is positive and a deficit if this value is negative.

Net present value ('NPV')

The value of outgoing cashflows, discounted back to the present date, using a *discount rate*.

Discount rate

The rate of interest used to convert future outgo from the scheme into the present value of this outgo, the *pension scheme liability*. For FRS 17 and *net present value calculations*, the discount rate is assumed to be the current rate of investment return on a high quality (AA) corporate bond appropriate for the *maturity of the scheme's liabilities*. A high discount rate leads to a low value for the *pension scheme liability* (and vice versa), all else being equal.

Deficit reduction contributions

The payments the employer must make in an attempt to eliminate the deficit in the pension scheme over a prescribed period.

Prudent estimate

An estimate where there is judged to be a better than equal probability of the eventual outcome being more favourable than assumed.

Best estimate

An estimate where there is judged to be an equal probability of the eventual outcome being higher or lower than assumed.

Spence & Partners Limited

22 Great Victoria Street
Belfast
BT2 7BA
T : +44 (0) 28 9041 2000

4 West Regent Street
Glasgow
G2 1RW
T : +44 (0) 141 331 1004

1 Berkeley Street
London
W1J 8DJ
T : +44 (0) 20 7495 5505

E : mail@spenceandpartners.co.uk
spenceandpartners.co.uk

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