Emerging Issues

Change Of Pensions Inflation Index Measure

CR Emerging Issues summarise changes in companies' reporting practice and collate changes identified previously in our CR Monitors. These reports address the most immediate issues facing companies reporting under IFRS, identify trends and highlight areas of evolving or divergent practices. The sample of companies covered reflects a mix of country, auditor and industrial classification. An Extract focusing on each company's disclosure accompanies the report.

This report reviews the accounting treatment adopted by those companies that have moved to CPI as the inflation measure on which pension increases are based.

It is too early to establish any trend as only four companies have discussed this issue.

Introduction

The rate of inflation upon which retirement benefit increases are based is one of the assumptions used in calculating a company's pension obligations. Some pension schemes base increases explicitly on changes in the Retail Price Index (RPI) whilst others may refer to an unspecified Index. As there can be differences in the way rates are calculated, there is a potential for significant variation in the benefits paid to scheme members.

Summary

There are indications that the announcement by the government of its intention to replace the RPI by the Consumer Price Index (CPI) as the measure to which future pension increases would be linked will have a beneficial impact on companies' financial statements. As CPI has historically been lower than RPI, the change has the potential to reduce pension scheme liabilities and we have noted two companies that disclose reduced obligations as a result of moving to CPI as the inflation measure.

Reporting framework

The Urgent Issues Task Force of the UK Accounting Standards Board has published an Abstract that provides guidance on the accounting treatment of the change. Its consensus is that the presentation of a reduction in scheme liabilities is dependent on whether the obligation is to pay benefits with increases based on RPI, or more generally with inflation–linked increases. Where benefit increases are based on RPI, the change in scheme liabilities is a change in benefit and gives rise to a past service cost. The past service cost should be recognised in the accounting period when any necessary consultations have been concluded or employees' valid expectations have been changed. If there is no obligation to pay benefit increases based on RPI then a change to CPI is a change in the financial assumption about inflation used to measure the liabilities and represents an actuarial gain or loss.

There is no IFRS that applies to this issue which is specific to the UK. In such a case, IAS 8 "Accounting policies, changes in accounting estimates and errors" states that management may consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards in developing an accounting policy. In this respect, companies may refer to the Abstract as a source of guidance under IAS 8.

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Companies under review

All the companies reviewed are UK based. Builder *Kier* was the first company we analysed that made reference to the change in Index which impacted employees in a local authority scheme. It treated the change as a change in benefit and recognised in the income statement a £16 million past service credit and noted also that the impact on another scheme had yet to be determined. Food producer *Associated British Foods* recognised in equity a £28 million benefit as a change of assumption after disclosing that deferred pensions would increase by reference to the CPI as its pension scheme rules specified that such pensions increase in line with the annual statutory order published by the UK government. In contrast, pub companies *Punch Taverns* and *Marston's* disclose that they are seeking legal advice on how the change may impact pension benefits. *Punch Taverns* states that it is likely that the change would result in a reduction in the present value of scheme liabilities but *Marston's* makes no further comment.

Conclusion

As only four companies have discussed this issue, it is too early to establish any trend but we will continue to review companies' disclosures to identify the impacts on their financial statements.

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KIER GROUP PLC

Period End: 30 June 2010

Industry classification (ICB): 2357 Heavy Construction
Line of business: Construction, property development and investment
Listing status: FTSE Mid 250
Auditors: KPMG, London

In addition to its main defined benefit pension scheme, Kier recognises pension obligations in respect of employees who participate in a local authority pension scheme. This year, the company explains the UK government has announced changes in the budget which require public sector pension schemes to determine future pensions increases using the Consumer Price Index (CPI) instead of the Retail Price Index (RPI) as previously, with a consequent reduction in Kier's pension liabilities. As a result, the company recognises £16 million past service credit, representing 28% of pre-tax profit, in the income statement which it classes as an exceptional item. In the pensions note, it discloses inflation assumptions for the local authority scheme of 2.5% for CPI in addition to 3.2% for RPI; the RPI rate remaining the only assumption for the main pension scheme. The change falls under the definition of past service cost in IAS 19 "Employee benefits" and thus immediate recognition is required where benefits are already vested following a change.
The company states also that it agreed during the year to make an additional "special cash contribution" of £13.2 million to the main scheme which it has settled through the transfer of residential land at market value determined by external valuers. It states that the land was previously included in inventory at less than market value and thus a gain is included in operating profit. It accounts for this as a contribution to the scheme. There is no indication of this asset in the pension assets table. The company tells us that it is included in the 'equities' line, which is more fully described by its actuaries as 'equities, property and other return-seeking assets'. In our view, the heading leads to a significant lack of clarity.

In December 2009 the Group agreed to make a special cash contribution to the Kier Group Pension Scheme amounting to £13.2m which was settled through a transfer of residential land at market value as determined by DTZ an independent firm of chartered surveyors. This amount has been included as a contribution received by the Scheme.

The past service credit in the current year arose in the Kier Sheffield LLP Pension Scheme due to changes announced in the budget in June 2010 to use the CPI in place of the RPI to determine pension increases. This has been accounted for as a change in benefits and recognised in the income statement as an exceptional item. The potential effect of the change in the RPI to CPI on the Kier Group Pension Scheme is yet to be determined.

The credit on the benefit curtailment in the prior year arose in the Kier Group Pension Scheme as a consequence of the Board's decision to restrict pensionable salary increases to the lower of actual pay increases and the annual rate of increase in RPI. The previous valuations were based on salaries increasing at 1.5% above the rate of increase in RPI.

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ASSOCIATED BRITISH FOODS PLC

Period End: 18 September 2010

Industry classification (ICB): 3577 Food Products
Line of business: Processing of food and retailing of textiles
Listing status: S&P Europe 350, FTSE 100
Auditors: KPMG, London

Associated British Foods discloses that its current UK defined benefit pension scheme rules specify that pensions in deferment will increase in line with the annual statutory order published by the UK government. It states also that the UK government announced in July 2010 that it will in future use the Consumer Price Index (CPI) rather than the Retail Prices Index (RPI) to determine statutory minimum pension increases for private sector occupational pension schemes.

The company states that as a result it has reduced its assumption for increases to UK pensions in deferment from 3.5% last year to 3% this year. Consequently, it recognises £28 million resulting benefit as a change of assumption in the statement of other comprehensive income and reduces the UK net pension deficit by 49% and the total net pension deficit by 22%. The company tells us that there is no change to benefit amounts in payment nor to the statutory revaluation of deferred benefits to date, but only to the level of expected future statutory increases and that there has been no change to its defined benefit scheme structure, but only to its calculation. It adds that its view is supported by a proposed Abstract issued by the Urgent Issues Task Force (UITF) of the UK Accounting Standards Board that distinguishes, in the context of UK GAAP, cases where a link to RPI is replaced with the trustee's agreement and past service cost is recognised from those where scheme liabilities were not linked to RPI and a change of assumption arises. The UITF draft recommends its analysis as a source of guidance to those developing policies under IAS 8 "Accounting policies, changes in accounting estimates and errors" and has now been issued as a full Abstract.

12. Employee entitlements

The group operates pension schemes, the majority of which are of the defined benefit type. The group also operates a small number of unfunded overseas post-retirement medical benefit schemes.

UK schemes

The group's principal UK defined benefit pension schemes are funded schemes and are closed to new members, with defined contribution arrangements in place for other employees. The pension costs in the UK for the defined benefit schemes are assessed in accordance with the advice of independent qualified actuaries using the projected unit method. For defined contribution schemes, the pension costs are the contributions payable.

Actuarial gains and losses arising over the financial year are recognised immediately in other comprehensive income and are reflected in the balance sheet at 18 September 2010. Past service cost is recognised immediately in the income statement to the extent that the benefits have already vested.

The last actuarial valuation of the Associated British Foods Pension Scheme was carried out as at 5 April 2008. At the valuation date the total market value of the assets of the Scheme was £2,223m and represented 93% of the benefits that had accrued to members after allowing for expected future increases in earnings. Following completion of the actuarial valuation, the group agreed to make five annual payments of £30m in order to eliminate the deficit at 5 April 2008. The first two of these payments were made in March 2009 and March 2010.

The UK government announced on 8 July 2010 that it will in future use the Consumer Price Index rather than the Retail Prices Index for the purposes of determining statutory minimum pension increases for private sector occupational pension schemes. The group's current UK defined benefit pension scheme rules specify that pensions in deferment will increase in line with the annual statutory order published by the UK government. The group has therefore amended its assumption for increases to pensions in deferment to reflect this. The resulting reduction in the present value of scheme liabilities of £28m is included as a change in assumptions within other comprehensive income.

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PUNCH TAVERNS PLC
Period End: 21 August 2010

Industry classification (ICB): 5757 Restaurants & Bars
Line of business: Operation of public houses
Listing status: FTSE Mid 250
Auditors: KPMG, Birmingham

The company discloses that the UK Government announced in July 2010 a proposal to replace the Retail Price Index (RPI) with the Consumer Price Index (CPI) for pension increases in the private sector on the basis that the CPI is a more appropriate measure of the change in cost of living for pensioners. In contrast to Kier and Associated British Foods, Punch Taverns states only that it is currently in the process of seeking legal advice on how this change might impact the benefits payable under the three defined benefit pension schemes but adds that it is likely that the change would result in a reduction in the present value of scheme liabilities. We noted that, according to the Office for National Statistics, the most recent CPI figure, which was 3.2% in October 2010, was 1.3% lower than RPI.

In July 2010 the Government announced a proposal to replace the Retail Price Index (RPI) with the Consumer Price Index (CPI) for pension increases in the private sector on the basis that the CPI is a more appropriate measure of the change in cost of living for pensioners than RPI. The Group is currently in the process of seeking legal advice on how this change might impact the benefits payable under the three defined benefit pension schemes. The impact of changing from RPI to CPI is likely to result in a reduction in the present value of scheme liabilities.

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MARSTON'S PLC

Period End: 2 October 2010

Industry classification (ICB): 5757 Restaurants & Bars
Line of business: Operation of public houses, brewing and wholesaling alcoholic drinks
Listing status: FTSE Mid 250
Auditors: PricewaterhouseCoopers, Birmingham

Marston's discusses the UK government's decision to change from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI) the measure of inflation for pension schemes. It states that the Urgent Issues Task Force (UITF) has reached a draft consensus that recognition of the change depends on whether this is a legal or constructive obligation to pay pensions with increases based on at least RPI or more generally to inflation linked increases. The company adds that it is currently considering the implications of this change. This disclosure is similar to that of Punch Taverns which states that it is currently in the process of seeking legal advice on how the change might impact its pension schemes but adds that it is likely that there would be a reduction in the present value of liabilities. The UITF has recently published a full Abstract on the matter.

1 ACCOUNTING POLICIES

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The UK government recently announced its intention to change the measure of inflation for the purposes of statutory minimum rates at which pensions must increase for public and private sector defined benefit schemes. This change would reference the consumer prices index ('CPI') as the measure of inflation rather than the retail prices index ('RPI') as is currently the case. The UITF has reached a draft consensus that recognition of the change depends on whether there is a legal or constructive obligation to pay pensions with increases based on at least RPI or more generally to inflation linked increases. The Group is currently considering the implications of this change with regards to its defined benefit pension scheme.

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