Pension scheme financial reporting – a way forward?

April 2017

Introduction to Pension scheme financial reporting – A way forward

We are now into our second year of financial reporting for pension schemes under FRS 102 and the revised SORP. The changes introduced in 2015 were the most significant in the last 30 years and I am sure many will welcome the relative calm of second year reporting compared with the somewhat unchartered and choppy waters of first year adoption. This is helped by there being no new requirements for the 2017 reporting season compared to 2016.

So this publication is not an update on our full pension scheme accounts guide publication and is not intended to be a comprehensive set of example accounts. Instead we have taken the opportunity to take stock of how the changes went, taking feedback from pension scheme accountants, pension managers and trustees. In a nutshell, some thought the changes were a step in the right direction; others that the new disclosures were too lengthy; and some felt that the changes had not made pension accounts more relevant to users. And this is the big challenge, how to make pension accounts more relevant and useful.

The introduction of FRS 102 and the revised SORP has given us the opportunity to go some way to meet this challenge. We now have a more principles based standard in FRS 102 and the SORP provides options in a number of areas. Compared to the strict statutory disclosure regime we have worked under for many years we now have greater flexibility. Therefore this publication seeks to take the first step in exploring this flexibility, building on pension disclosures we have seen emerging combined with best practice in general financial reporting whilst seeking to make the content of the financial statements more relevant to trustee investment strategy. We have done this by:

- Adopting a format for the notes to the financial statements that groups disclosures by common area, for example all information about contributions is contained in one note covering accounting policies, numerical analysis and SORP disclosures;
- Disclosing investment market risks by reference to trustee strategic portfolio allocations at a summary level; and
- Distinguishing the disclosure of investment market risks from investment credit risks on the basis that market risks relate to fair value and cash flow exposures whereas credit risk relates to security of investments.

We have not prepared this publication to promote further change in the short term, but to stimulate discussion and debate which we hope will eventually lead to further improvements in pension scheme financial reporting. However, if you did want to adopt some or all of the disclosures herein we believe they meet the requirements of FRS 102 and the SORP.

I hope you find this publication of interest.

Kevin Clark
Associate Partner

ABC Pension scheme

Fund account

	Notes	Total	Total
		2018	**2017**
		£'000	£'000
Contributions receivable:	3		
employer		6,786	66
employee		70	400
Individual transfers in		18	7
Other income		25	-
		6,899	473
Benefits payable	4	(10,730)	(9,629)
Payments to and on account of leavers		(80)	(106)
Other payments		(38)	(37)
Administrative expenses		(36)	(41)
		(10,884)	(9,813)
Net (withdrawals) from dealings with members		(3,985)	(9,340)
Investment income	5	4,587	3,574
Change in market value of investments	7.5	7,683	536
Investment management expenses		(378)	(381)
Taxation	6	(14)	(12)
Net return on investments		11,878	3,717
Net increase/(decrease) in the fund during the year		7,893	(5,623)
Net assets of the scheme at 6 April		73,844	79,467
Net assets of the scheme at 5 April		81,737	73,844

The notes on pages X to X form part of these Financial Statements.

ABC Pension scheme

Statement of Net Assets (available for benefits)

At 5 April 2018	Notes	2018	2017
		£'000	£'000
Investment assets:	7.5		
Equities		20,636	17,411
Bonds		48,306	44,224
Property		4,700	3,844
Pooled investment vehicles	7.6	7,386	7,685
Derivatives	7.7	355	345
AVC investments	7.10	316	260
Cash		27	26
Other investment balances	7.9	407	314
		82,133	**74,109**
Investment liabilities:			
Derivatives	7.7	(25)	(13)
Other investment balances	7.9	(400)	(307)
Total investments		81,708	73,789
Current assets		67	152
Current liabilities		(38)	(97)
Total net assets of the Scheme at 5 April		**81,737**	**73,844**

The notes on pages X to X form part of these Financial Statements.

The Financial Statements summarise the transactions of the Scheme and deal with the net assets at the disposal of the Trustees. They do not take account of obligations to pay pensions and benefits which fall due after the end of the Scheme year. The actuarial position of the Scheme, which does take account of such obligations, is dealt with in the Report on Actuarial Liabilities included on page […] and these Financial Statements should be read in conjunction with that Report.

Signed for and on behalf of the Trustees of the ABC Group Pension Scheme on 16 September 2018.

A Rook
B Dane

Notes (Forming part of the financial statements)

1 Basis of preparation

The Financial Statements have been prepared in accordance with Financial Reporting Standard 102 – the Financial Reporting Standard applicable in the UK and Republic of Ireland issued by the Financial Reporting Council and with the guidance set out in the Statement of Recommended Practice (SORP) (revised November 2014).

2 Core Accounting policies

i. The accounts are prepared on an accruals basis.

ii. The functional and presentational currency of the Scheme is Sterling. Balances denominated in foreign currencies are translated into Sterling at the rate ruling at the year-end date. Asset and liability balances are translated at the bid and offer rates respectively. Transactions denominated in foreign currencies are translated at the rate ruling at the date of the transaction. Differences arising on investment balance translation are accounted for in the change in market value of investments during the year.

3 Contributions receivable

The Scheme closed to future accrual from 6 April 2017 and normal contributions have therefore ceased. Deficit funding contributions are being paid by the Employer into the Scheme for a period of three years in accordance with a recovery plan in order to improve the Scheme's funding position. The amounts to be paid are: 2018: £6,786,000; 2019: £5,800,000; 2020: £5,800,000.

Accounting policies:

i. Employee normal contributions are accounted for when deducted from pay, with the exception of contributions deducted from auto-enrolled members during the opt out period which are accounted for on the earlier of receipt or the expiry of the opt out period. Employer normal contributions which are expressed as a rate of salary are accounted for on the same basis as employees' contributions, otherwise they are accounted for in the period they are due under the Schedule of Contributions.

ii. Employer deficit funding contributions are accounted for on the due dates on which they are payable in accordance with the Schedule of Contributions and Recovery Plan under which they are being paid.

Contributions receivable comprise:

	2018	2017
	£'000	**£'000**
Employer:		
Normal	-	66
Deficit Funding	6,786	-
Members:		
Normal	-	331
Additional Voluntary Contributions	70	69
	6,856	**466**

Employer normal contributions include £nil (2017: £49,000) of contributions payable to the Scheme under salary sacrifice arrangements made available to certain members by the Employer.

Current assets include £50,000 (2017: £40,000) of contributions due from the Employer.

4 Benefits payable

Benefits payable comprise benefits due to Scheme members and their dependents under the Deed and Rules of the Scheme. These comprise mainly monthly pensions and lump sums on retirement. Taxation arising on benefits paid or payable is in respect of members whose benefits exceeded the lifetime or annual allowance and who elected to take lower benefits from the Scheme in exchange for the Scheme settling their tax liability.

Accounting policies:

i. Benefits are accounted for in the period in which they fall due for payment. Where there is a choice, benefits are accounted for in the period in which the member notifies the Trustees of their decision on the type or amount of benefit to be taken or, if there is no member choice, they are accounted for on the date of retirement or leaving.

ii. Opt outs are accounted for when the Scheme is notified of the opt out.

iii. Individual transfers in or out are accounted for when paid or received which is normally when member liability is accepted/discharged.

Benefits payable comprise:

	2018	2017
	£'000	£'000
Pensions	10,345	9,379
Commutations and lump sum retirement benefits	245	250
Purchase of annuities	45	-
Lump sum death benefits	75	-
Taxation where lifetime or annual allowance exceeded	20	-
	10,730	**9,629**

Current liabilities include £25,000 (2017: £35,000) in respect of benefits payable to members.

5 Investment income

Investment income comprises mainly dividends from equities and interest on bonds held directly by the Scheme. Investment income arising from the underlying investments of pooled investment vehicles is rolled up and reinvested within the pooled investment vehicles. This is reflected in the unit price and reported within 'Change in Market Value'. Investment income includes interest bought and sold on bond transactions.

Accounting policies:

i. Dividends from quoted securities are accounted for when the security is declared ex-div.

ii. Rents are earned in accordance with the terms of the lease.

iii. Interest is accrued on a daily basis.

iv. Investment income is reported net of attributable tax credits but gross of withholding taxes which are accrued in line with the associated investment income. Irrecoverable withholding taxes are reported separately as a tax charge.

Investment income receivable comprises:

	2018	2017
	£'000	£'000
Dividends from equities	1,413	379
Income from bonds	3,074	3,087
Net rental income	99	107
Interest on cash deposits	1	1
	4,587	**3,574**

Net rental income is stated after deduction of £10,000 (2017: £10,000) of property related expenses.

6 Tax

The ABC Group Pension Scheme is a registered pension scheme for tax purposes under the Finance Act 2004. The Scheme is therefore exempt from taxation except for certain withholding taxes relating to overseas investment income. Tax charges are accrued on the same basis as the investment income to which they relate (see Note 5(iv) above).

7 Investments

7.1 Strategy

The main investment objective of the Scheme is to maintain a portfolio of suitable assets of appropriate liquidity which will generate investment returns to meet, together with future contributions, the benefits payable under the Trust Deed and Rules as they fall due.

The Trustees set the investment strategy taking into account considerations such as the strength of the Employer covenant, the long term liabilities and the funding agreed with the Employer. The investment strategy is set out in its Statement of Investment Principles (SIP).

The current strategy is to hold broadly:

— 60% in investments that move in line with the long term liabilities of the Scheme. This is referred to as Liability Driven Investment (LDI) and comprises UK and overseas government and corporate bonds and interest rate swaps the purpose of which is to hedge against the impact of interest rate movement on long term liabilities.

— 40% in return seeking investments comprising UK and overseas equities, equity futures, investment property, hedge funds and private equity.

— 15% of the above in overseas currencies. To achieve this the Trustees have put in place a currency hedging strategy using forward foreign exchange rates.

The actual allocations of investments measured at fair value will vary from the above due to market price movements and intervals between rebalancing the portfolio which takes place quarterly. Actual allocations at the Scheme's year-end are shown below:

	2018	2017
	%	%
LDI portfolio	63	64
Return Seeking portfolio	37	36
	100	100
Overseas Currency exposure	17	14

The Trustees have authorised the use of derivatives by their investment managers for efficient portfolio management purposes as part of their investment strategy for the Scheme.

7.2 Investment risks

FRS 102 requires the disclosure of information in relation to certain investment risks. These risks are set out by FRS 102 as follows:

Market risk: this comprises currency risk, interest rate risk and other price risk.

— Interest rate risk: this is the risk that the fair value or future cash flows of a financial asset will fluctuate because of changes in market interest rates.

— Other price risk: this is the risk that the fair value or future cash flows of a financial asset will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

— Currency risk: this is the risk that the fair value or future cash flows of a financial asset will fluctuate because of changes in foreign exchange rates.

Credit risk: this is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

The Scheme has exposure to these risks because of the investments it makes to implement its investment strategy. The Trustees manage investment risks, including credit risk and market risk, within agreed risk limits which are set taking into account the Scheme's strategic investment objectives. These investment objectives and risk limits are implemented through the investment management agreements in place with the Scheme's investment managers and monitored by the Trustees by regular reviews of the investment portfolios.

Further information on the Trustees' approach to risk management and the Scheme's exposures to market and credit risks are set out below. This does not include AVC investments, as these are not considered significant in relation to the overall investments of the Scheme.

a. Market risk

A summary of Scheme market risk exposures by strategic asset allocations is set out below:

	2018	2017	Market risk		
	£'000	£'000	Interest rate risk	Other price risk	Foreign exchange risk
LDI portfolio	51,173	46,929	●	●	●
Return seeking portfolio	30,219	26,600	●	●	●
Total investments	**81,392**	**73,529**			

Significant exposure ●	**Some exposure** ●	**No exposure** ●

i. Interest rate risk

Interest rate risk arises principally in relation to the LDI Portfolio. The LDI Portfolio comprises investments whose value changes with interest rates changes and is intended to match changes in member liabilities.

ii. Other price risk

Other price risk arises principally in relation to the Scheme's Return Seeking Portfolio. The Scheme manages the exposure to other price risk by constructing a diverse portfolio of investments across various markets.

iii. Currency risk

The Scheme is subject to currency risk because some of the Scheme's investments are held in overseas markets. The Trustees limit overseas currency exposure through a currency hedging policy. At the year-end, the unhedged proportion of Scheme net assets held in currencies other than Sterling was 15% (2017: 10%).

b. Credit risk

The Scheme is subject to credit risk as the Scheme invests in bonds, OTC derivatives and has cash balances. The Scheme also invests in pooled investment vehicles and is therefore directly exposed to credit risk in relation to the instruments it holds in the pooled investment vehicles and is indirectly exposed to credit risk arising on the financial instruments held by the pooled investment vehicles.

Analysis of direct credit risk

2018	Investment grade £'000	Non-investment grade £'000	Unrated £'000	Total £'000
Bonds	30,500	17,806	-	48,306
OTC Derivatives	255	-	-	255
Cash	27	-	-	27
PIVs	-	-	7,386	7,386
	30,782	**17,806**	**7,386**	**55,974**

2017	Investment grade £'000	Non-investment grade £'000	Unrated £'000	Total £'000
Bonds	31,548	12,676	-	44,224
OTC Derivatives	260	-	-	260
Cash	26	-	-	26
PIVs	-	-	7,685	7,685
	31,834	**12,676**	**7,685**	**52,195**

Credit risk arising on bonds held directly or through pooled investment vehicles is mitigated by investing in government bonds where the credit risk is minimal, or corporate bonds which are rated at least investment grade.

Credit risk arising on derivatives depends on whether the derivative is exchange traded or over the counter (OTC). OTC derivative contracts are not guaranteed by any regulated exchange and therefore the Scheme is subject to risk of failure of the counterparty. The credit risk for OTC swaps is reduced by collateral arrangements (see note 7.7 (i)). Credit risk also arises on forward foreign currency contracts. There are no collateral arrangements for these contracts but all counterparties are required to be at least investment grade.

Cash is held within financial institutions which are at least investment grade credit rated.

The Scheme's holdings in pooled investment vehicles are unrated. Direct credit risk arising from pooled investment vehicles is mitigated by the underlying assets of the pooled arrangements being ring-fenced from the pooled manager, the regulatory environments in which the pooled managers operate and diversification of investments amongst a number of pooled arrangements. Trustees carry out due diligence checks on the appointment of new pooled investment managers and on an ongoing basis monitor any changes to the regulatory and operating environment of the pooled managers. An analysis of pooled investment vehicles by type and legal nature is given in note 7.6.

7.3 Investment Fair Value Hierarchy

The fair value of financial instruments has been determined using the following hierarchy:

Level 1: the unadjusted quoted price in an active market for identical assets or liabilities which the entity can access at the measurement date;

Level 2: inputs other than quoted prices included within Level 1 which are observable (i.e. developed using market data) for the asset or liability, either directly or indirectly;

Level 3: inputs which are unobservable (i.e. for which market data is unavailable) for the asset or liability.

A fair value measurement is categorised in its entirety on the basis of the lowest level input which is significant to the fair value measurement in its entirety.

Investment Fair Value accounting policies:

The approach to fair value determination in accordance with the above hierarchy for the main investment types is:

i. The majority of listed investments are stated at the bid price at the date of the Statement of Net Assets.
ii. Fixed interest securities are stated at their clean prices. Accrued income is accounted for within investment income.
iii. Unquoted securities are included at fair value estimated by the Trustees based on advice from the investment manager.
iv. Pooled investment vehicles are stated at bid price for funds with bid/offer spreads, or single price where there are no bid/offer spreads as provided by the investment manager.
v. Properties are included at open market value as at 5 April 2016 determined in accordance with the Royal Institution of Chartered Surveyors' Appraisal and Valuation Standards and the Practice Statement contained therein. The properties have been valued by George and Co Ltd, Chartered Surveyors, who have recent experience in the locations and class of the investment properties held by the Scheme.
vi. Exchange traded derivatives are valued using market quoted prices.
vii. Over the counter (OTC) derivatives are valued using pricing models and relevant market data as at the year-end date

The Scheme's investment assets and liabilities fall within the above hierarchy categories as follows:

	Level (1)	Level (2)	Level (3)	Total
	£'000	£'000	£'000	£'000
At 5 April 2018				
Equities	20,636	-	-	20,636
Bonds	-	48,306	-	48,306
Property	-	2,350	2,350	4,700
Pooled investment vehicles	2,533	4,533	320	7,386
Derivatives	75	255	-	330
AVC investments	153	-	163	316
Cash	27	-	-	27
Other investment balances	7	-	-	7
	23,431	**55,444**	**2,833**	**81,708**

	Level (1)	Level (2)	Level (3)	Total
	£'000	£'000	£'000	£'000
At 5 April 2017				
Equities	17,411	-	-	17,411
Bonds	-	44,224	-	44,224
Property	-	1,500	2,344	3,844
Pooled investment vehicles	2,545	4,691	449	7,685
Derivatives	72	260	-	332
AVC investments	136	-	124	260
Cash	26	-	-	26
Other investment balances	7	-	-	7
	20,197	**50,675**	**2,917**	**73,789**

7.5 Investment reconciliation

Reconciliation of investments held at the beginning and the end of the year.

	Value at 6 April 2017	Purchases at cost and derivative payments	Sales proceeds derivative and receipts	Change in market value	Value at 5 April 2018
	£'000	£'000	£'000	£'000	£'000
Equities	17,411	36	(5)	3,194	20,636
Bonds	44,224	387	(233)	3,928	48,306
Property	3,844	-	-	856	4,700

	Value at 6 April 2017	Purchases at cost and derivative payments	Sales proceeds derivative and receipts	Change in market value	Value at 5 April 2018
Pooled investment vehicles	7,685	219	(200)	(318)	7,386
Derivatives	332	5	(17)	10	330
AVC investments	260	50	(7)	13	316
	73,756	**697**	**(462)**	**7,683**	**81,674**
Cash deposits	26				27
Other investment balances	7				7
Net investment assets	73,789				81,708

Receipts and payments arising from derivative instruments are reported as sale proceeds or purchase of investments.

The change in market value of investments during the year comprises all increases and decreases in the market value of investments held at any time during the year, including profits and losses realised on sales of investments during the year.

7.6 Pooled Investment Vehicles (PIVs)

Scheme holdings of PIVs comprise:

	2018	2017
	£'000	£'000
Fixed Interest funds	2,625	2,455
Equity funds	3,824	4,358
Absolute Return fund	30	27
Property funds	503	480
Private Equity funds	320	300
Cash funds	52	34
Diversified Growth funds	32	31
	7,386	**7,685**

The Scheme is the sole investor in the Absolute Return fund. The assets underlying this PIV comprise:

	2018	2017
	£'000	£'000
Equities	21	19
Bonds	8	7
Other	1	1
	30	**27**

A summary of pooled investment vehicles by type of arrangement is as follows:

	2018	2017
	£'000	**£'000**
Unit linked insurance contracts	800	750
Authorised unit trusts	5,965	5,860
Open ended investment companies	363	426
Shares of limited liability partnerships	258	649
	7,386	**7,685**

7.7 Derivatives

Derivatives held at the year-end comprise:

Total derivatives				
	2018		**2017**	
	Assets £'000	**Liabilities £'000**	**Assets £'000**	**Liabilities £'000**
Swaps – LDI portfolio	252	(10)	250	-
Futures – Return Seeking portfolio	88	(13)	80	(8)
FX – Return Seeking portfolio	15	(2)	15	(5)
	355	**(25)**	**345**	**(13)**

i. Swaps

The Scheme had derivative contracts outstanding at the year-end relating to its LDI fixed interest investment portfolio. These contracts are traded over the counter (OTC). The details are:

Nature	Nominal amount	Duration	Asset value at year end	Liability value at year end
	£		**£**	**£**
Interest rate swap (Pay 5% for LIBOR)	10,000,000	Expires June 18	152,000	-
Interest rate swap (Pay 3% for RPI)	5,000,000	Expires July 18	100,000	-
Interest rate swap (Pay 5% for LIBOR)	800,000	Expires Aug 18	-	(10,000)
Total 2018	**15,800,000**		**252,000**	**(10,000)**
Total 2017	13,600,000		250,000	-

Under the OTC interest rate swaps, the counterparties had deposited £250,000 of cash collateral at the year-end. This collateral is not reported within the Scheme's net assets.

ii. Futures

The Scheme had exchange traded overseas stock index futures outstanding at the year-end relating to its return seeking overseas equity portfolio as follows:

Nature	Notional Amount	Duration	Asset value at year end	Liability value at year end
	£		£	£
Nikkei stock future bought	368,000	May 2018	88,000	-
Nikkei stock future sold	(10,000)	June 2018	-	(13,000)
Total 2018	**358,000**		**88,000**	**(13,000)**
Total 2017	225,000		80,000	(8,000)

iii. Forward Foreign Exchange (FX)

The Scheme had open FX contracts at the year-end relating to its currency hedging strategy as follows:

Contract	Settlement date	Currency bought	Currency sold	Asset value at year-end	Liability value at year-end
				£	£
Forward OTC	One month	£50	$100	15,000	-
Forward OTC	Three months	£100	$200	-	(2,000)
Total 2018				**15,000**	**(2,000)**
Total 2017				15,000	(5,000)

7.8 Transaction costs

Included within the purchases and sales are direct transaction costs of £50,000 (2017: £46,000) comprising fees, commissions and stamp duty. These costs are attributable to the key asset classes as follows:

				2018	2017
	Fees	**Commission**	**Stamp Duty**	**Total**	**Total**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Equities	25	3	1	29	27
Bonds	1	5	10	16	15
Other	2	1	2	5	4
	28	**9**	**13**	**50**	**46**
2017	23	7	16	-	46

Transaction costs are also borne by the Scheme in relation to transactions in pooled investment vehicles. Such costs are taken into account in calculating the bid/offer spread of these investments and are not separately reported.

7.9 Repurchase and reverse repurchase agreements

Under repurchase (repo) arrangements, the Scheme continues to recognise and value the securities that are delivered out as collateral and includes them in the Financial Statements. The cash received is recognised as an asset and the obligation to pay it back is recognised as a liability.

Under reverse repurchase (reverse repo) arrangements, the Scheme does not recognise the collateral securities received as assets in its Financial Statements. The Scheme does recognise the cash delivered to the counterparty as a receivable in the Financial Statements.

At the year-end, within other investment assets and liabilities, amounts payable under repurchase agreements amounted to £400,000 (2017: £307,000) and amounts receivable under reverse repurchase agreements amounted to £407,000 (2017:£314,000). At the year-end £415,000 of bonds reported in Scheme assets are held by counterparties under repurchase agreements.

7.10 Additional Voluntary Contributions (AVCs)

The Trustees hold assets invested separately from the main fund to secure additional benefits on a money purchase basis for those Scheme members electing to pay AVCs. Members participating in this arrangement each receive an annual statement made up to 5 April confirming the amounts held in their account and the movements in the year. The aggregate amounts of AVC investments are as follows:

	2018	2017
	£'000	£'000
Smith Investments Ltd – Unitised fund	153	136
Jones & Jones plc – Unitised fund	163	124
	316	**260**

7.11 Concentration of Investment

No investment is valued at more than 5% of the net assets of the fund.

8 Related party transactions

Contributions received in respect of Trustees who are members of the Scheme have been made in accordance with the Trust Deed and Rules.

All Trustees receive an annual fee for services as Trustee of £1,000 (2017: £750).

The Scheme is administered by ABC Group Administration Ltd, an ABC Group company. Fees payable in respect of administration and processing of £21,000 (2017: £21,000) are included within administrative expenses. At the year-end creditors include £7,000 (2017: £ nil) in respect of administration expenses payable to ABC Group Administration Ltd.

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