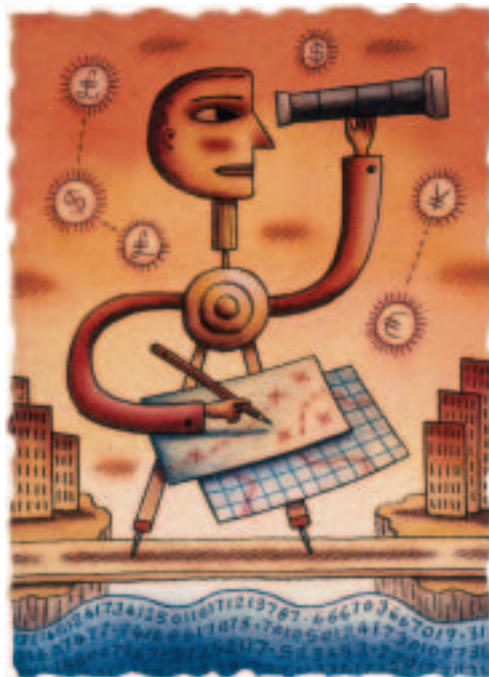


# Lane Clark & Peacock

Actuaries & Consultants



**ACCOUNTING FOR  
PENSIONS**

**ANNUAL SURVEY  
2002**

## **Accounting for Pensions**

### **Annual Survey 2002**

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## 1. Summary

- The FTSE 100 companies with defined benefit pension schemes employ between them over 4 million people in the UK. In the middle of July 2002, we estimate the aggregate deficit in these schemes under FRS17 is around £25 billion on a corresponding asset base of just under £200 billion. However, as little as a year ago there would have been an aggregate surplus in these schemes, so we discuss in this survey whether such a statistic has any relevance in the long-term business of pension provision.
- Lane Clark & Peacock's 2002 publication of "Accounting for Pensions" is the authoritative survey of practice under SSAP24, the standard that currently regulates accounting and disclosure of pensions information in UK company accounts, and also provides insight into its potential replacement, FRS17.
- Our previous surveys have focused on the level of disclosure amongst FTSE 100 companies. Under SSAP24, disclosure standards have been variable to say the least and we provide our 2002 league table of disclosure scores in Appendix 1.
- FRS17 is more prescriptive and compliance with its disclosure requirements is high. The new information gives us an exciting opportunity to assess the exposure to pension scheme risks of the UK's largest companies. Also of great interest, despite the greater prescription, is the variation that still exists in the assumptions used by different companies. These issues are discussed in Section 6 of this report.
- The full introduction of FRS17 looks set to be delayed or possibly never implemented. We comment in Section 3 upon the harmonisation of European accounting standards in 2005 and await the outcome with interest.
- The pressure on defined benefit pension schemes continues. How much longer companies will put up with spiralling costs amid plummeting markets remains to be seen. We comment in Section 4 on the future of private sector defined benefit schemes in the UK.

## 2. Introduction and main findings

In this survey we analyse the pension cost disclosures in the companies comprising the FTSE 100 index as at 1st January 2002, looking at accounting periods ending in 2001.

The companies making up the FTSE 100 index change over time - eighteen companies were new in 2001. Comparisons must be handled with care, but general trends are still evident.

### Average cost

The average pension cost disclosed in 2001 (under SSAP24) for all companies was a little under 6% of pre-tax profit. Their annual pension cost of just under £3½ billion equates to less than £900 pa for each employee.

### SSAP24 vs FRS17

The existing accounting rules, set out in SSAP24, continue to form the basis of the figures included in the primary statements. Its replacement, FRS17, remains in its transitional phase and merely requires additional items of information to be disclosed in the notes to the accounts.

For the first time in the nine year history of the LCP survey, the average standard of disclosure under SSAP24 has slipped, albeit only slightly. This may be because companies have devoted more time to the new FRS17 figures. In addition, the average score has been reduced slightly by those entering the FTSE 100 index in the year and the continued shift towards market-based valuation methods has not, in many cases, been well explained.

### Accounting aims

SSAP24 has been in existence for fourteen years. It is supposed to ensure accounting for pension costs on a systematic and rational basis over the employees' careers with sufficient disclosure of the assumptions used to allow informed readers of the accounts to understand the accounting treatment. In practice, insufficient disclosure has left UK pension accounting shrouded in a veil of mystery.

For those who understand the new FRS17 disclosures, this veil is now being lifted. FRS17 aims to give "adequate" disclosure. It is certainly adequate by volume, but concerns remain that undue credence will be given to the effect of incorporating FRS17 figures into the financial statements.

Under SSAP24, the assumptions adopted merely dictate the pace at which cost is recognised in the company's profit & loss account. Any variation between experience and the assumptions is charged against profit in subsequent years.

This contrasts sharply with FRS17, under which the cost to be charged to the profit & loss account is directly determined by the assumptions made. If experience turns out to be more favourable than assumed (for example through high investment returns) this

creates a gain. Conversely, poor experience creates a loss. Under FRS17, gains and losses feed into the Statement of Total Recognised Gains and Losses (“STRGL”), rather than impacting on the profit & loss account.

### **Interpreting FRS17 disclosures**

Under FRS17, a measure of the surplus or deficit in the pension scheme appears directly on the balance sheet for the first time.

In our interim 2002 survey, published in May, we noted that the FTSE 100 companies reporting in 2001 had disclosed an overall surplus of some £5 billion under FRS17. We estimate that if these companies had all reported in mid-July 2002 they would have disclosed a combined deficit of around £25 billion. However, to put this figure into context, the total net asset value of the same companies is of the order of £300 billion.

This change, due primarily to the fall in equity markets, looks alarming and if pension funds had to liquidate all their assets tomorrow it would represent a major issue. Realistically, however, pension funds are long-term commitments and the snapshot value of the position by reference to current market values is of limited importance. Indeed, if the assumed future equity returns are actually achieved then the deficit may never materialise.

Snapshot figures may be of interest to shareholders and analysts. However, for the members of pension schemes the FRS17 disclosures will, all too often, generate confusion. Of far greater importance for the members of schemes is the sponsoring company’s commitment to continue supporting their scheme, which cannot be ascertained from bare statistics.

### **Variations in assumptions**

The assumptions used for SSAP24 should, overall, represent a “best estimate”. However, a number of scenarios may be considered reasonable, and this and previous surveys show that in practice companies use a wide range of assumptions to determine cost.

FRS17 goes further than SSAP24 in requiring that each individual assumption should be a best estimate. We have found that best estimates still vary from company to company, particularly the estimate of the future return from equities. This is discussed in Section 6.

### **Some poor disclosures**

Some FTSE 100 companies still make inadequate disclosure under SSAP24. The lowest scores were obtained by *British Land Company, Compass, International Power* and *Man Group*.

However, the additional FRS17 disclosure information means that SSAP24 disclosure is less critical than it used to be. Moreover, for some of these companies the pension commitment is small relative to the size of the company, meaning that the pension disclosure is of limited importance.

**Balance sheet entries**

The pension cost under SSAP24 and the actual company contributions can differ considerably. Any excess of cost over contributions accumulates to form a provision in the balance sheet; any excess of contributions gives rise to a prepayment.

Large prepayments, or assets in the balance sheet, appear for *BP Amoco* (£1,235 million) and *Lloyds TSB* (£768 million). Conversely, *Unilever* (£750 million) and *British American Tobacco* (£581 million) held large provisions, or balance sheet liabilities, in respect of retirement benefits.

**Winners and losers under FRS17**

If implemented, FRS17 will affect balance sheets in different ways for different companies. *BP Amoco's* balance sheet asset under SSAP24 of over £1.2 billion would have been replaced by an FRS17 asset of almost £1.5 billion, a substantial increase in overall balance sheet value.

*ICI* disclose an asset under SSAP24 of £320 million. Under FRS17 this would have become a liability of £355m, a net decrease in balance sheet value of £675m. Whilst the numbers are not huge in the context of the pension scheme, this cannot be good news for *ICI's* balance sheet.

Next year, when many companies have produced their second disclosures under FRS17, we will also be able to analyse its impact on the profit & loss account.

**Early adoption**

FRS17 was originally brought in during 2001 to replace SSAP24 over the period to 2003. However full implementation now looks set to be delayed or even scrapped, which is discussed in Section 3.

Companies have been able, if they wish, to adopt the provisions of FRS17 in full before 2003. Only one of the FTSE 100, *WPP*, did so in 2001. (*BAA* have now done so in 2002.)

**A heavy burden**

A volatile FRS17 result can severely impact on balance sheet values and reported profits, particularly where the pension scheme is large in relation to the size of the sponsoring company. We discuss this in more detail in Section 6.

Industry responses to FRS17 have been mixed. The disclosure is clearly valuable and some believe that the FRS17 numbers are more representative of the true position than the SSAP24 numbers. However, it has been touted by some as the last straw for defined benefit pension schemes and many companies have already switched to defined contribution arrangements, although not solely on account of FRS17.

### 3. Pension accounting in turmoil

The UK accounting standard, SSAP24, was due to be replaced by FRS17, with gradual implementation of FRS17 beginning during 2001. However, as discussed below, a delay has recently been proposed by the Accounting Standards Board (“ASB”).

Internationally, pension accounting is governed by a standard known as IAS19, produced by the International Accounting Standards Board (“IASB”). However, numerous other country-specific standards exist around the world, most notably FAS87 in the United States.

#### Differences between the standards

Of the various standards, SSAP24 is the “odd one out” as all of the other major standards require assets to be taken at market value or close to market value, whereas SSAP24 allows a discounted income method to be adopted, as described in Section 5.

There are other differences between standards. FRS17 recognises “gains and losses” (defined below) in the STRGL in the year in which they arise. Under IAS19, FAS87 and SSAP24, gains and losses are generally spread over a number of years and then recognised through the profit & loss account. This results in a year on year movement that is not subject to the balance sheet volatility seen under FRS17.

(If actual experience turns out to be more favourable than assumed, for example through higher than expected investment returns, this creates a “gain”. The converse results in a “loss”.)

#### Harmonisation

From 2005, UK companies will be required to account under rules laid down by the IASB, rather than under UK standards.

However, a project is underway to review the current international standards before harmonisation in 2005. This includes a limited review of IAS19 and, perhaps ambitiously, aims to end up with just one set of standards that is applicable throughout Europe, North America and other major regions.

It is interesting to observe that the current Chairman of the IASB, Sir David Tweedie, was previously Chairman of the ASB in the UK and a key driving force behind the introduction of FRS17. He may be keen to see the principles of FRS17 implemented as the international standard but he will need to convince the other members of the IASB that immediate recognition of gains and losses in the STRGL is preferable to the spreading approach used under other standards.

**Deferral of FRS17**

In line with the calls made in our interim survey published in May 2002, the ASB have proposed an amendment to FRS17. Rather than the new standard completely replacing SSAP24 from 2003, full adoption of FRS17 is now expected to be deferred until 2005. This coincides with the imposition of the international standard in the UK, meaning FRS17 may never be adopted in full.

For the next few years, whilst this uncertainty reigns, the ASB has proposed that companies continue to account under SSAP24. Despite the announcement, disclosure of FRS17 numbers will continue to be required in the notes to the accounts.

We welcome the harmonisation of accounting standards internationally and, against that background, we certainly welcome the deferral of full implementation for FRS17. The longer period of transition will allow all commentators the opportunity to gain a better appreciation of the significance of FRS17 disclosures.

**Early adoption of FRS17**

*WPP* (in 2001) and *BAA* (in 2002) took the decision to adopt the provisions of FRS17 in full. We wonder whether they will come to regret this decision. In the current environment, companies would need to think very carefully before adopting FRS17 voluntarily in their primary accounting statements.

#### 4. The fate of the defined benefit scheme

##### What's new?

Falling equity markets, low bond yields, increasing life expectancy, FRS17...these are just some of the things that have led a large number of companies to close their defined benefit pension schemes.

Leaving aside the artificial constraints imposed by FRS17, defined benefit schemes have become intrinsically more risky and more expensive than they used to be. Legislation has progressively increased the proportion of the benefit that is guaranteed, which has increased the risks for the sponsoring company.

It is no wonder that some companies have said “enough is enough”. But we would caution against closing defined benefit schemes on account of FRS17 alone.

##### Business objectives

The question should not be simply “defined benefit (DB) or defined contribution (DC)?”. The process should begin with an analysis of the sponsoring company’s objectives, which may include targeting benefits to the employees they want to reward, redistributing the risk, or simply reducing underlying costs.

Traditional final salary DB schemes and DC schemes represent extremes of risk distribution. With a final salary DB scheme, the company bears all the risks, particularly in relation to investment returns and life expectancy, whereas with a DC scheme the employee bears these risks. Whilst one of these two extremes will be appropriate for many companies, there is also a range of “middle ground” alternatives, so-called “hybrid” schemes. Many such schemes are now appearing in FTSE 100 companies as they address the particular objectives of those organisations.

##### Cash balance

*AstraZeneca* runs a “cash balance” scheme, in which the benefit is a specified percentage of salary at retirement in lump sum form. This is used to secure payments to the employee at retirement, as both a lump sum and an annuity.

In such an arrangement, the company bears the investment risk up to the point of retirement, but all the risk passes to the employee at the point of retirement. In particular, the mortality risk (the risk that the employee will live a long time in retirement) is taken away from the company and passed to the insurer providing the annuity.

##### Career average

*Tesco* and *Safeway* both run “career average” schemes, which are defined benefit schemes but where each year’s benefit is based on the salary earned in that year rather than on salary at retirement.

Such arrangements are only modestly less risky than traditional defined benefit schemes, as the company continues to bear the mortality and investment risks. They are often suitable for an inherently mobile and/or part-time workforce.

**DB/DC combinations**

There are other ways of finding middle ground between DB and DC. For example, *Sainsbury* offers DC for younger employees and DB for older employees. Other alternatives include DB on salary up to a limit and DC above that limit (common for directors of UK companies), or a low level of DB provided by the company, with any employee contributions going to DC.

**Don't forget the old scheme**

Closing the DB scheme does not remove the problem. A closed DB scheme matures rapidly and its funding can become increasingly volatile. It may be necessary to review the investment strategy and eventually the scheme will be wound up.

**Look before you leap**

Nowadays, companies worried about the risks that their final salary schemes pose should be comforted to know that they do not have to run from one extreme to the other. There are innovative ways of structuring benefits to balance their needs with those of their employees.

## 5. Detailed analysis of SSAP24 disclosures

Although much attention is inevitably focused on FRS17, it is the SSAP24 numbers that are generally still being booked in company accounts. Adequate disclosure therefore remains essential.

### 5.1 Disclosures

We analysed and scored the disclosures of 83 companies, as listed in Appendix 1.

For this purpose, we excluded the following:

- eight FTSE 100 companies who had no evidence of significant defined benefit provision;
- one company that did not report pension costs under UK generally accepted accounting principles (*Shell*);
- *Billiton, Brambles Industries, Old Mutual* and *South African Breweries*, which are essentially overseas companies who have chosen to be quoted on the London Stock Exchange;
- *Lattice, mm0<sub>2</sub>* and *Powergen*, who did not produce a report in 2001; and
- *WPP*, as they followed the ASB's encouraged practice by fully adopting the requirements of FRS17 in their 2001 annual report. Their FRS17 disclosure provided all of the items expected.

We have analysed the disclosures in a similar way to previous years.

All companies have earned a starting score of 10 for the basic items of disclosure. We believe that there are four key additional items that have to be disclosed for a full understanding. We set these out below, with an explanation of the attaching "score".

	Disclosure required	Score
<b>Asset valuation method</b>	<p>Assets may be taken into account in two ways.</p> <p>The traditional method in the UK has been to discount future income. We refer to this as the “discounted income” method.</p> <p>The alternative is to take the assets at market value, or sometimes at a smoothed market value. We refer to such methods as “market value” methods.</p> <p>For companies using a discounted income method, we were looking for disclosure of the dividend growth assumption, as this has a very important impact on the results. Better still is disclosure of the actual value placed on the assets.</p> <p>For companies using a market value method, we were looking for a statement that the assets were indeed taken at market value, or if not, what market-related value of assets was used.</p> <p>A market value method looks quite different to a discounted income method. Where it appeared that a market value method was used, but we were unable to draw a firm conclusion, we awarded 3 rather than a full score of 5. This reflects a failure to comply with the SSAP24 requirement (in paragraph 88h) to state the actuarial method used.</p>	5 or 3
<b>Pension increases</b>	<p>The assumed rate of pension increases is necessary for a full understanding, but there is less variability of cost from this assumption. 93% of companies disclosed this item, which is comparable to last year’s survey (94%).</p>	1
<b>Split of regular cost and variation</b>	<p>The regular cost is the ongoing cost to the company of providing the benefits of the pension scheme ignoring surplus or deficit. Disclosure of this item is, therefore, very helpful and it is notable that a split is required under FRS17. 54% of companies separately included this compared with 47% who did so last year. This is a slight increase on last year, even though it remains disappointingly low.</p>	2

## Method of spreading

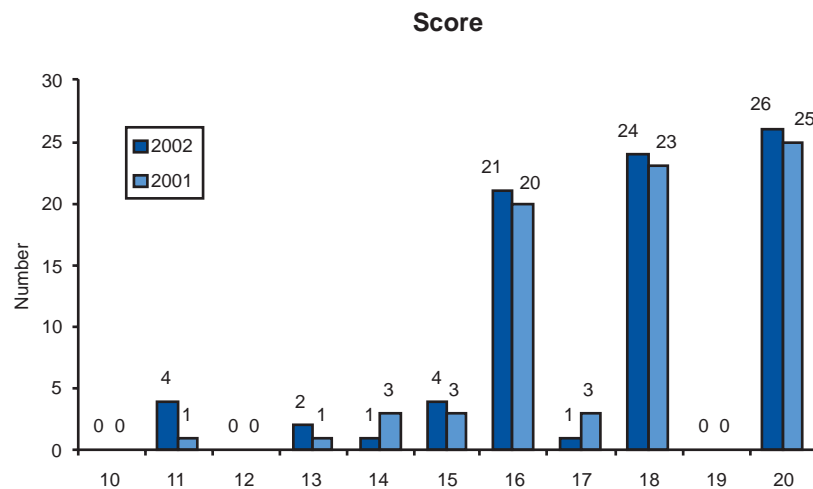
The actual pension cost will be lower or higher than the regular cost, on account of spreading the surplus or deficit. There are a number of ways this can be done, and each spreading method gives a different pattern for future pension costs.

2

45% of companies disclosed the spreading method compared to 57% last year, which is a disappointing decrease.

This gives an aggregate score from 10 to 20. A full list of each company's score is set out in Appendix 1. The spread of scores is set out below.

## Scores



The top score (20) was achieved by an impressive 26 companies this year; their details are listed in Appendix 1.

Of the companies included in last year's survey, eight improved their score this year whilst nine achieved a lower score this year. (The scores for the remainder were unchanged.)

Four companies achieved a score of only 11 this year. These are: *British Land Company*, *Compass*, *International Power* and *Man Group*.

Whilst these disclosures were disappointing, there are perhaps mitigating circumstances. We note that the pension schemes of *Compass* and *International Power* are very small relative to the size of the sponsoring company (details in Appendix 3). Furthermore, *British Land Company* and *Man Group* have now produced clear and informative FRS17 disclosures as at 31st March 2002.

**Celltech**

*Celltech*, the only company to score 11 last year, improved their disclosure considerably to score the maximum 20 this year. Whether this was a direct response to our survey or not, we were struck by the marked improvement.

**Impact on profits**

Pension cost as a proportion of pre-tax profit can be very high for those companies declaring a low level of profit; relatively small changes in terms of the pension scheme can then severely impact on profitability. In some cases pension costs can be very low, or even an addition to profits; for example *Allied Domecq* showed a pension credit (addition to profit) of over 5% of total profits.

**Standards slipping under SSAP24**

The average score this year was slightly lower than last year. This is possibly due to the fact that attention has perhaps inevitably been focused on FRS17 this year and is also partly attributable to the new entrants to the FTSE 100 providing, on average, less full disclosure than the “old hands”.

For example, *Daily Mail*, who scored 20 in last year’s survey, slipped to 18 this year because they omitted one key sentence breaking down the expense components - perhaps in order to create space for their comprehensive FRS17 disclosure.

However, others provided expansive notes. For example, *BAT* dedicated no fewer than four pages of their accounts to pensions.

While SSAP24 continues to form the basis of the primary statements we would expect to see at least the same level of attention paid to the SSAP24 disclosures as in previous years.

## 5.2 Actuarial assumptions

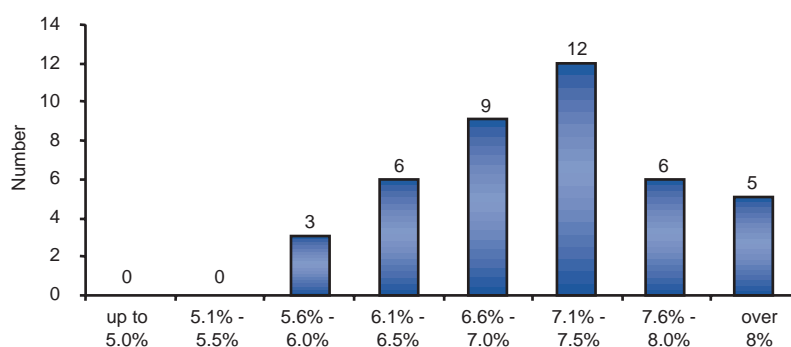
SSAP24 does not specify what assumptions should be disclosed referring only to “a brief description of the main actuarial assumptions”. Wide variations exist in the assumptions adopted.

### Investment return

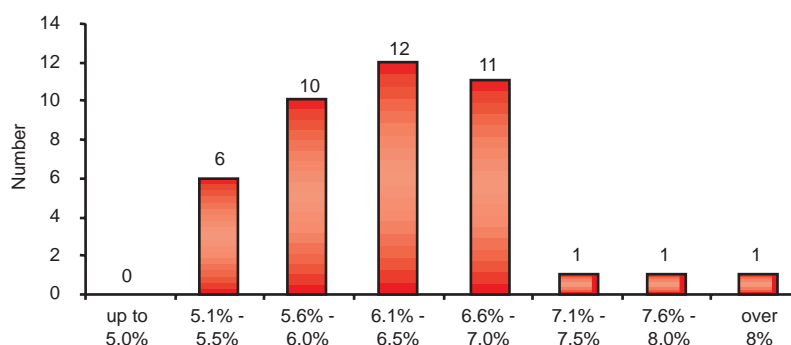
The level of investment return assumed depends on whether a discounted income or market value method is employed. We have therefore separated the two types of valuation in our analysis. Under discounted income methods assets have tended to be taken into account at less than their market value, but a higher investment return is assumed.

The range of investment returns assumed is shown in the charts below. Where companies have assumed a different rate of investment return before and after retirement, we have taken the pre-retirement assumption.

**Investment returns -  
companies using a discounted income method**



**Investment returns -  
companies using a market value method**



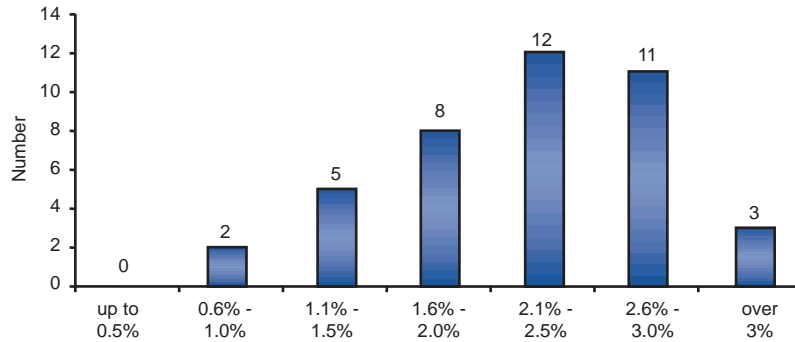
A clear decrease, from the discounted income method to the market value method, can be seen from these graphs. This increases the disclosed pension cost. However, the shift is not wholly due to differences in the two methods, but partly due to the market value methods being used, on average, more recently.

## Investment return over salary growth

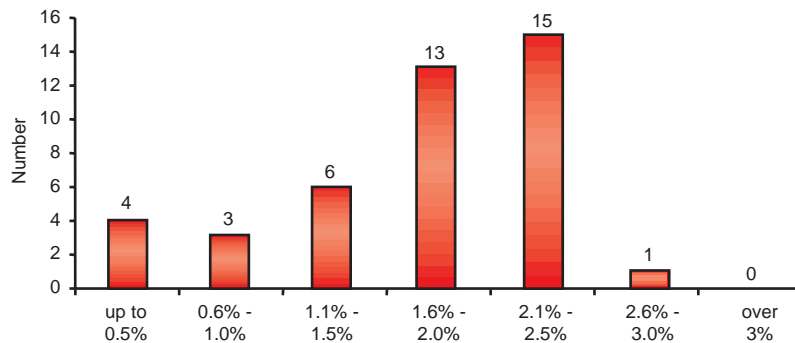
The rate of salary growth assumed has a significant effect on the eventual pension cost. The smaller the “gap” between the assumed rates of investment return and salary growth, the more conservative the assumptions.

The difference between the investment return and assumed salary growth could be analysed for 83 companies. The difference varied from less than 1% pa to over 3% pa.

**Investment returns over salary growth - companies using a discounted income method**



**Investment returns over salary growth - companies using a market value method**

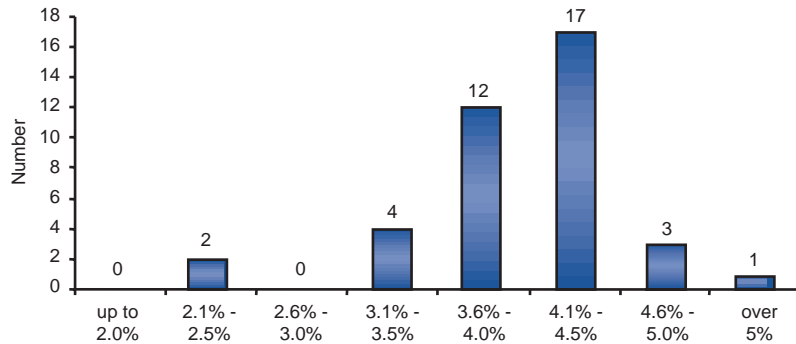


One can clearly see that the average difference under the market value methods is less than under the discounted income methods. This results in a higher disclosed pension cost under the market value methods.

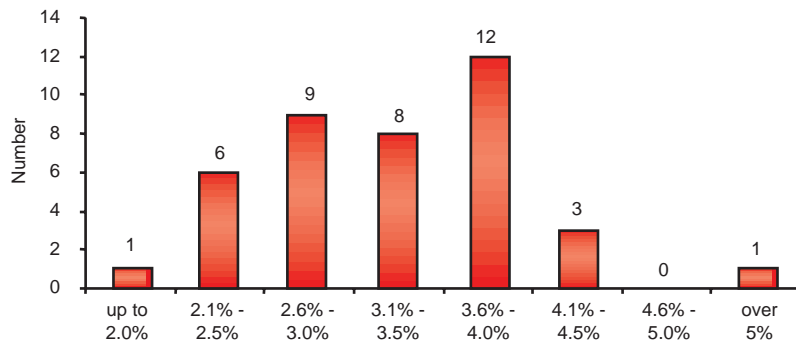
**Investment return over pension increase**

79 companies disclosed sufficient information to enable the difference between the assumed rates of post-retirement investment return and pension increase to be determined.

**Investment returns over pension increases - companies using a discounted income method**



**Investment returns over pension increases - companies using a market value method**



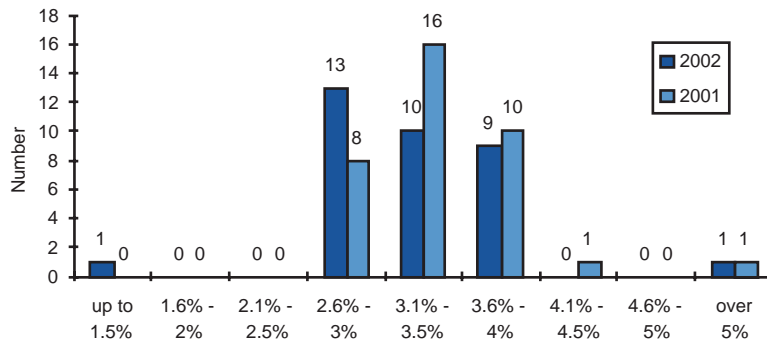
Again one can clearly see that the average difference under the market value methods is less than under the discounted income methods. This results in a higher disclosed pension cost under the market value methods.

**Assumptions used to value assets**

Under a discounted income method, the value of the assets is highly sensitive to the difference between the investment return and the dividend growth rate.

34 companies using the discounted income method gave sufficient information for us to determine the difference between the assumed rates of investment return and dividend growth.

**Investment returns over dividend growth**



It is clear that the dividend growth assumption has generally increased (and hence the gap has reduced) to reflect the current economic environment.

**Sainsbury**

*Sainsbury* assumed dividend growth 2½% pa in excess of inflation and only 1½% pa below the assumed investment return. This is outside the normal range adopted by other FTSE 100 companies. On the face of it, they are placing around twice the value on equities as a company using a typical dividend growth assumption of 3%-3½% pa below the assumed investment return. Whether this is in fact the case is not explained in the accounts.

## 6. Detailed analysis of FRS17 disclosures

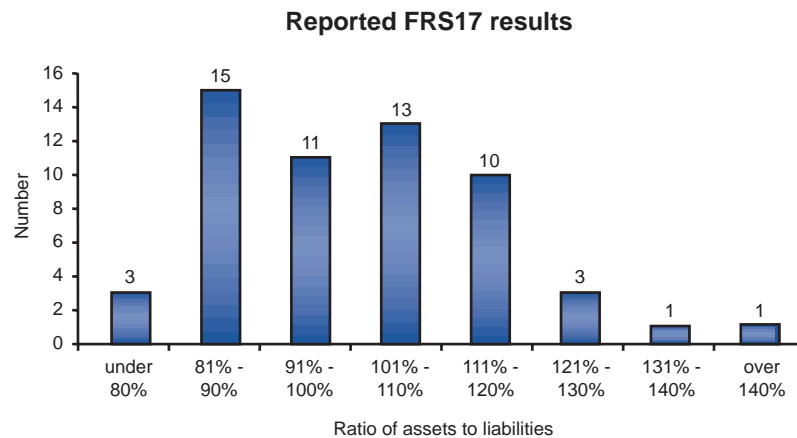
The transitional requirements of FRS17 came into force on 22nd June 2001. Only 57 companies reporting in 2001 have disclosed FRS17 information. Many companies offer post-retirement healthcare provision, which we have excluded from our analysis where possible. As with our SSAP24 analysis, overseas pension arrangements have been included.

### 6.1 FRS17 results and key assumptions

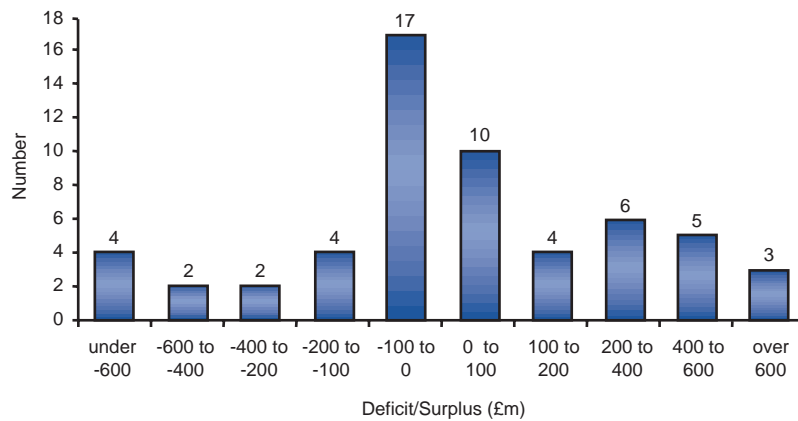
#### FRS17 results

FRS17 takes a snapshot of the surplus or deficit at the company's year-end and, once adopted, this appears directly on the balance sheet. Of the companies analysed broadly half show a surplus and half show a deficit. However, as the vast majority of these companies have not yet adopted FRS17 in full, their balance sheets are as yet unaffected by the standard.

A full list of the disclosed surpluses and deficits is set out in Appendix 2. The two charts below show the range of results, expressed both as a ratio of assets to liabilities and in absolute terms.



### Reported FRS17 results



Ratios of assets to liabilities in excess of 120% are very much the exception rather than the norm. With knowledge of what has happened in the markets so far this year, we currently expect a gloomier picture for companies reporting in 2002.

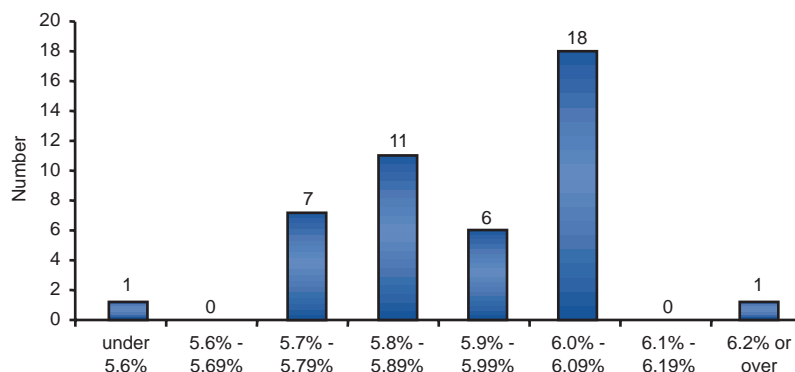
### Discount rate

The discount rate under FRS17 is the annual rate at which the projected future liabilities are discounted back to the present date. If available, FRS17 requires the use of a discount rate equal to the yield on a AA-rated bond of equivalent term and currency to the liabilities. However, due to the very long term nature of pension liabilities, it is frequently the case that a suitable yield cannot be derived directly from the market. This means that an appropriate “proxy” for the AA-rated bond yield must be derived.

We have found considerable variation in the discount rates adopted. A movement of as little as  $\frac{1}{4}\%$  in the discount rate could easily change the value of the liabilities by as much as 5%. This could be enough to turn a disclosed deficit into a surplus, and vice-versa.

The chart below shows the discount rates used by companies reporting in December 2001.

### Discount rates used in December 2001



Of those reporting in December, the highest and lowest discount rates were used by *P&O Princess Cruises* (6.25% pa) and *Reed International* (5.5% pa).

## Compass

*Compass* reported at 30th September 2001 and revealed one of the lowest FRS17 ratios in our survey (with assets covering just 74% of liabilities). Yet they used a discount rate of only 5.5% pa while other companies reporting at the same date used a discount rate of 6% pa or more.

The story has another twist, however, as *Compass*' pension commitments are small relative to the company (this is shown in Appendix 3). This illustrates the importance of viewing all of the disclosure items in conjunction with the size of the scheme and company, in order to put them into perspective - rather than assuming that the final surplus or deficit is the whole story.

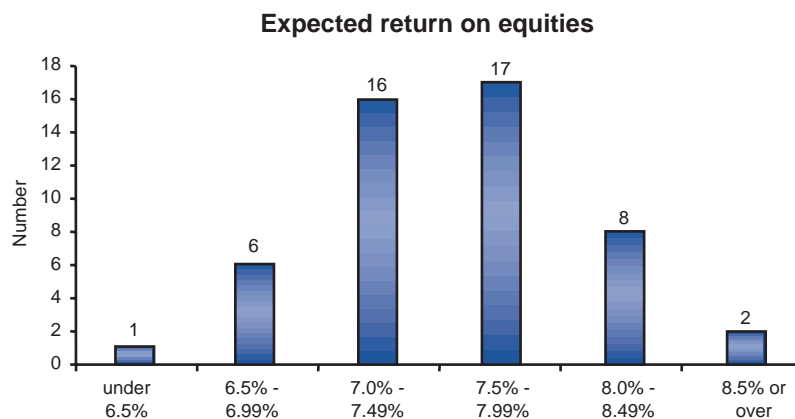
Details of the discount rates used (in the UK where the company operates pension schemes in more than one country) are set out in Appendix 2.

## Expected return on equities

Under FRS17, the expected investment return on the assets held is an entry in the financing line of the profit & loss account. The more optimistic (ie higher) the assumed return, the smaller the overall charge to profits.

The accounts are expected to show the directors' best estimate of the long-term return on each asset class held, the most subjective of which is the expected return on equities. Unsurprisingly, there is a wide variation in the assumed long-term return from equities, from 6.5% pa to 9% pa, although the general consensus seems to be an assumption of 7% pa to 8% pa.

Details of the expected return on equities (in the UK where the company operates pension schemes in more than one country) are set out in Appendix 2.



**Lack of disclosure**

Under FRS17 there appears to be nothing to gain from being anything other than at the optimistic end of a best estimate range, regarding the assumed return on equities. A higher assumed return directly increases disclosed profits. If the assets fail to match expectations, profits are not affected and the loss washes through the STRGL.

If FRS17 is fully implemented, it will become necessary to disclose the expected return on the assets held by the scheme at each balance sheet date for the forthcoming year.

We consider it best practice to have disclosed the expected return in the initial FRS17 disclosure and most companies have done so. However, the following companies did not: *AstraZeneca, Celltech, CGNU, Enterprise Oil, P&O Princess Cruises* and *Prudential*. *Standard Chartered* disclosed an aggregate expected return, which will need to be broken down according to the various asset types held for next year's disclosure.

**6.2 FRS17 and balance sheet risk**

**What is risk?**

Some companies' balance sheets are more exposed than others' to the volatility of FRS17.

Currently, there are only two ways of reducing the volatility effect of FRS17 on the balance sheet:

- by investing a significant proportion of the pension scheme assets in high grade corporate debt, which would "match" the FRS17 liability so that the assets and liabilities would move broadly in line with each other; or
- by reducing the company's exposure to defined benefit pension provision.

**Boots**

*Boots* notably took the step of investing all their pension scheme assets in bonds. One might think that *Boots* effectively "locked in" their FRS17 surplus with this investment strategy, but they maintain that the move was not made for accounting reasons and it is certainly not the case that their FRS17 position is fully protected.

For *Boots*, FRS17 overstates the true value of the pension scheme surplus. According to their recently published 2002 FRS17 disclosure, *Boots* expect to achieve an investment return of just 5.4% pa from their pension scheme assets, whereas their liabilities have, quite correctly, been discounted under FRS17 at 6.1% pa. This higher discount rate places a lower value on the liabilities and hence gives a flattering FRS17 position.

This demonstrates that an FRS17 surplus can not be regarded as a true surplus and that the full disclosure is fundamental to putting the surplus figure into context.

If this investment strategy continues, *Boots'* assets will fail to keep pace with the FRS17 liability and the surplus will reduce, unless, of course, they pay contributions into the scheme in excess of the operating cost disclosed in their accounts.

For the majority of companies with pension schemes that remain invested largely in equities, the converse logic applies. The extra return that they expect to receive in the long-term should, if the assumptions under FRS17 are borne out, improve the ratio of assets to liabilities by around 1% pa on average. In other words, an FRS17 deficit of 10% would be expected to be eliminated within around 10 years if the FRS17 assumptions are borne out in practice. Whilst this looks like a long time, it should be compared to the average point of future payments for a typical pension scheme, which can be 20 years or more.

We conclude that FRS17 disclosures need very careful consideration as the headline surplus or deficit can be very misleading.

**Increased cost**

Many of today's defined benefit pension arrangements have evolved because the sponsoring employer, quite justifiably, felt that the short-term volatility of equities was irrelevant where the liabilities become due a long time into the future. If these companies had restricted themselves to investment in bonds from the outset, many would never have set up defined benefit schemes with the current level of benefits, as such schemes would have been deemed simply too expensive.

**Measuring the risk**

Significant balance sheet risks from FRS17 occur where:

- the pension scheme is large relative to the size of the business; or
- the pension scheme is heavily invested in equities.

In Appendix 3 we list the size of each company's pension schemes relative to the company's net asset value. The higher this ratio, the greater the effect of a volatile FRS17 position on the company's balance sheet.

**ICI**

*ICI* have a very large pension scheme and disclosed negative Group shareholder funds. Their pension scheme is in deficit. However, they have significantly reduced the scheme's exposure to equities, which should limit their downwards exposure to FRS17.

**Rentokil Initial**

*Rentokil Initial* have a very large pension scheme and disclosed negative Group shareholder funds. Their scheme was in surplus at 31st December 2001. However, they have invested nearly 80% of the pension scheme assets in equities, making that surplus very fragile.

**Rolls Royce**

*Rolls Royce* disclose a deficit of £580m, over 25% of the net assets of the company. Furthermore, the pension scheme remains over two-thirds invested in equities.

**BG, P&O**

At the other end of the scale *BG (British Gas)* and *P&O Princess Cruises* both have seemingly worryingly low ratios of assets to liabilities (both 83%). However, their pension schemes are, relative to reported net asset value, very small.

## Appendix 1 - Detailed SSAP24 disclosure listing

This table shows the disclosures made by the companies surveyed and the corresponding score as explained in Section 5.

Where sufficient information was given to show the actuarial value used for assets, for example, if an unsmoothed market value is used, this is counted as being the same as disclosing the dividend growth rate on the traditional discounted income model.

Where the assumptions appear to represent a market value method but have not been stated as such the company has been awarded 3 out of 5 points for the asset valuation, shown as YES\* in the Asset valuation column below.

Company	Asset valuation	Pension Incs	Spread Method	Split of cost	Total
3i	YES*	YES	YES	YES	18
Abbey National	YES*	YES	YES	YES	18
Alliance & Leicester	YES	YES	YES	YES	20
Allied Domecq	YES	YES	NO	NO	16
Amersham	YES	YES	YES	YES	20
Anglo American	YES*	YES	NO	NO	14
Associated British Foods	YES	YES	NO	NO	16
AstraZeneca	YES	YES	YES	NO	18
BAA	YES	YES	YES	YES	20
BAE Systems	YES	YES	YES	NO	18
Barclays	YES	YES	YES	YES	20
BAT	YES	YES	YES	NO	18
BG	YES	YES	NO	YES	18
BOC	YES	YES	YES	YES	20
Boots	YES	YES	NO	NO	16
BP Amoco	YES	YES	YES	YES	20
British Airways	YES	YES	NO	NO	16
British Land Company	NO	YES	NO	NO	11
BT	YES	YES	YES	NO	18
Cable & Wireless	YES	YES	YES	YES	20
Cadbury Schweppes	YES	YES	YES	NO	18

<b>Company</b>	<b>Asset valuation</b>	<b>Pension Incs</b>	<b>Spread Method</b>	<b>Split of cost</b>	<b>Total</b>
Capita Group	NO	YES	YES	NO	13
Celltech	YES	YES	YES	YES	20
Centrica	YES	YES	YES	YES	20
CGNU	YES	YES	NO	NO	16
Compass	NO	YES	NO	NO	11
Daily Mail	YES	YES	YES	NO	18
Diageo	YES	YES	YES	NO	18
Dixons	YES	YES	YES	YES	20
Electrocomponents	YES	YES	NO	NO	16
EMI	YES	YES	NO	NO	16
Enterprise Oil	YES	YES	NO	YES	18
Friends Provident	YES	YES	YES	NO	18
Gallaher Group	YES	YES	YES	YES	20
GlaxoSmithKline	YES	YES	YES	YES	20
Granada Media	YES	YES	NO	NO	16
GUS	YES	YES	NO	NO	16
Hanson	YES	YES	YES	NO	18
Hays	YES	YES	YES	YES	20
HBOS	YES*	YES	YES	YES	18
Hilton	YES	YES	YES	YES	20
HSBC	YES	YES	NO	NO	16
ICI	YES*	NO	YES	YES	17
Imperial Tobacco	YES	YES	NO	NO	16
Innogy Holdings	YES	YES	NO	NO	16
International Power	NO	YES	NO	NO	11
Invensys	YES	YES	YES	YES	20
Kingfisher	YES	YES	NO	NO	16

<b>Company</b>	<b>Asset valuation</b>	<b>Pension Incs</b>	<b>Spread Method</b>	<b>Split of cost</b>	<b>Total</b>
Land Securities	YES	NO	NO	NO	15
Legal & General	YES	YES	YES	YES	20
Lloyds TSB	YES	YES	YES	NO	18
Man Group	NO	YES	NO	NO	11
Marks & Spencer	YES	YES	NO	YES	18
Morrison (Wm) Supermarkets	YES	NO	NO	NO	15
National Grid	YES	YES	NO	YES	18
Next	YES	YES	YES	YES	20
Northern Rock	YES	YES	NO	NO	16
P&O Princess Cruises	YES	YES	NO	NO	16
Pearson	YES	YES	NO	YES	18
Prudential	YES	YES	YES	YES	20
Reckitt Benckiser	YES	YES	YES	YES	20
Reed International	YES*	YES	YES	YES	18
Rentokil Initial	YES	YES	NO	NO	16
Rio Tinto	YES	YES	YES	NO	18
Rolls Royce	YES	YES	YES	NO	18
Royal & Sun Alliance	YES	YES	YES	YES	20
Royal Bank of Scotland	YES	YES	NO	YES	18
Safeway	YES	YES	YES	YES	20
Sainsbury	YES	YES	NO	YES	18
Schroders	YES	YES	YES	YES	20
Scottish & Newcastle	YES	NO	NO	NO	15
Scottish & Southern Energy	YES	YES	NO	NO	16
Scottish Power	YES	YES	YES	YES	20
Severn Trent	YES	YES	YES	NO	18
Six Continents	YES*	YES	NO	YES	16

<b>Company</b>	<b>Asset valuation</b>	<b>Pension Incs</b>	<b>Spread Method</b>	<b>Split of cost</b>	<b>Total</b>
Smith & Nephew	NO	YES	YES	NO	13
Smiths Industries	YES	YES	NO	NO	16
Standard Chartered	YES	YES	YES	YES	20
Tesco	YES	YES	NO	NO	16
Unilever	YES	YES	YES	YES	20
United Utilities	YES	YES	NO	NO	16
Vodafone	YES	NO	NO	NO	15
Wolseley	YES	YES	YES	YES	20

The 83 companies listed above were analysed in depth. Those not analysed were: *Amvescap*, *ARM Holdings*, *BSkyB*, *Canary Wharf Group*, *Logica*, *Reuters*, *Sage* and *Shire Pharmaceuticals* (no evidence of significant defined benefit provision); *Shell* (do not report under UK generally accepted accounting principles), *Billiton*, *Brambles Industries Ltd*, *Old Mutual* and *South African Breweries* (wholly overseas); *WPP* (fully adopted FRS17 in 2001); *Lattice*, *mm0<sub>2</sub>* and *Powergen* (no annual report produced in 2001).

## Appendix 2 - Detailed FRS17 disclosure listing

This table shows the key disclosures made by the companies who reported FRS17 figures in their 2001 accounts. Figures relate to the worldwide position of each company, not just the UK disclosure. "ND" means figures were not disclosed.

Company (listed by year-end)	Market value of assets £m	FRS17 surplus/ (deficit) £m	Discount rate % pa	Expected return on equities % pa
<b>March</b>				
BAA	1,719	548	5.80	7.00
<b>June</b>				
Diageo	5,614	979	6.30	7.70
Hays	236	2	6.27	7.25
<b>July</b>				
Smiths Industries	2,659	319	6.00	8.00
Wolseley	383	(61)	6.00	7.00
<b>August</b>				
Allied Domecq	2,196	(48)	6.10	8.00
<b>September</b>				
Associated British Foods	1,731	365	6.00	7.25
BOC	1,751	146	6.10	8.50
Compass	282	(98)	5.50	6.50
Daily Mail	1,131	30	6.00	7.50
Granada Media	970	(86)	6.00	7.94
Imperial Tobacco	2,361	344	6.00	7.50
Six Continents	1,098	(9)	6.10	7.50

<b>Company (listed by year-end)</b>	<b>Market value of assets £m</b>	<b>FRS17 surplus/ (deficit) £m</b>	<b>Discount rate % pa</b>	<b>Expected return on equities % pa</b>
<b>December</b>				
Abbey National	2,286	(87)	5.75	7.00
Alliance & Leicester	710	(59)	5.90	7.00
Amersham	276	(104)	5.75	8.00
Anglo American	1,373	(41)	5.90	7.10
AstraZeneca	2,681	(662)	5.80	ND
BAE Systems	9,645	(704)	6.00	7.50
Barclays	12,587	406	5.75	7.75
BAT	3,892	(582)	5.80	6.90
BG	199	(42)	5.70	7.70
BP Amoco	15,476	1,446	6.00	7.50
Cadbury Schweppes	1,730	122	6.00	7.00
Capita Group	153	(26)	5.80	7.50
Celltech	56	(12)	5.90	ND
Centrica	2,193	(333)	5.80	8.00
CGNU	5,656	334	5.90	ND
Enterprise Oil	99	(12)	5.80	ND
Friends Provident	701	189	6.00	8.50
Gallaher Group	856	46	5.80	7.30
GlaxoSmithKline	5,564	(714)	6.00	8.50
Hanson	1,641	209	5.80	8.40
HBOS	3,196	2	6.00	7.75
Hilton	268	(40)	6.00	8.00
HSBC	5,979	(837)	5.90	7.50
ICI	7,579	(355)	6.00	7.80
International Power	75	11	5.80	7.40

<b>Company (listed by year-end)</b>	<b>Market value of assets £m</b>	<b>FRS17 surplus/ (deficit) £m</b>	<b>Discount rate % pa</b>	<b>Expected return on equities % pa</b>
<b>December (continued)</b>				
Legal & General	874	73	5.80	8.00
Lloyds TSB	11,126	508	6.00	8.00
Northern Rock	137	(29)	5.75	7.80
Old Mutual	226	24	6.00	7.50
P&O Princess Cruises	83	(17)	6.25	ND
Pearson	1,155	(107)	6.00	7.50
Prudential	4,362	585	5.75	ND
Reckitt Benckiser	704	74	6.00	8.00
Reed International	2,069	197	5.50	7.20
Rentokil Initial	608	19	5.90	7.90
Rio Tinto	2,353	276	6.00	8.50
Rolls Royce	4,710	(580)	6.00	8.40
Royal & Sun Alliance	4,220	(195)	5.70	7.50
Royal Bank of Scotland	13,627	492	6.00	8.40
Schroders	363	65	5.80	8.40
Smith & Nephew	264	(30)	6.00	9.00
Standard Chartered	874	(32)	6.00	ND
Unilever	10,069	694	6.00	9.00
WPP	323	(135)	5.80	7.50

### Appendix 3 - FRS17 risk measures

We list below the companies that disclosed FRS17 numbers in 2001, in decreasing order of pension scheme size relative to the net asset value of the company.

A large pension scheme coupled with a low ratio of assets to liabilities represents a significant issue for the company concerned. However, these figures should not be viewed in isolation. The final column shows the percentage of the assets of the pension scheme that are invested in equities. A high percentage in this column coupled with a large pension scheme means that the company is particularly exposed to a fall in the equity market. For such companies, FRS17 represents a significant risk even if the pension scheme is currently in surplus.

<b>Company</b>	<b>Size of scheme relative to size of company <sup>1</sup></b>	<b>FRS17 ratio <sup>2</sup></b>	<b>Percentage of assets in equities</b>
	<b>%</b>	<b>%</b>	<b>%</b>
ICI	n/a <sup>3</sup>	96%	31%
Rentokil Initial	n/a <sup>3</sup>	103%	79%
Gallaher Group	n/a <sup>3</sup>	106%	64%
Imperial Tobacco	n/a <sup>3</sup>	117%	56%
Allied Domecq	486%	98%	64%
Daily Mail	354%	103%	69%
Smiths Industries	303%	114%	44%
Rolls Royce	256%	89%	68%
Unilever	209%	107%	64%
Centrica	164%	87%	80%
BAE Systems	155%	93%	68%
Prudential	110%	115%	76%
Lloyds TSB	103%	105%	70%
Diageo	97%	121%	87%
Royal & Sun Alliance	93%	96%	73%

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<sup>1</sup> Size of scheme is taken as the greater of the assets and the liabilities. Size of company is taken to be the net asset value.

<sup>2</sup> The ratio of the market value of assets to the liabilities disclosed under FRS17.

<sup>3</sup> Group net assets disclosed as negative at the year-end.

<b>Company</b>	<b>Size of fund relative to size of company %</b>	<b>FRS17 ratio %</b>	<b>Percentage of assets in equities %</b>
BAT	88%	87%	59%
Barclays	76%	103%	70%
GlaxoSmithKline	75%	89%	87%
Smith & Nephew	73%	90%	74%
BOC	71%	109%	79%
Reed International	71%	111%	63%
Capita Group	63%	85%	75%
Hanson	60%	115%	68%
Associated British Foods	59%	127%	68%
Amersham	58%	73%	72%
Reckitt Benckiser	55%	112%	58%
Cadbury Schweppes	54%	108%	68%
Granada Media	51%	92%	100%
AstraZeneca	49%	80%	43%
Hays	49%	101%	81%
Royal Bank of Scotland	48%	104%	63%
CGNU	48%	106%	70%
Rio Tinto	48%	113%	71%
Alliance & Leicester	44%	92%	74%
HSBC	40%	88%	77%
BAA	36%	147%	83%
Pearson	34%	92%	60%
Schroders	33%	122%	77%
Legal & General	32%	109%	55%
Friends Provident	31%	137%	83%
BP Amoco	30%	110%	72%

<b>Company</b>	<b>Size of fund relative to size of company %</b>	<b>FRS17 ratio %</b>	<b>Percentage of assets in equities %</b>
Wolseley	30%	86%	50%
Abbey National	27%	96%	79%
HBOS	23%	100%	85%
Six Continents	20%	99%	64%
Standard Chartered	18%	97%	27%
Anglo American	15%	97%	74%
Compass	14%	74%	79%
WPP	13%	71%	47%
Northern Rock	12%	83%	69%
Hilton	11%	87%	82%
Celltech	11%	82%	96%
Enterprise Oil	9%	89%	76%
Old Mutual	7%	112%	41%
BG	7%	83%	84%
P&O Princess Cruises	6%	83%	28%
International Power	4%	117%	54%



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