



# A practical user guide to the 2015 Pensions SORP





# Preface

## Background

The Financial Reporting Council has issued a suite of new UK financial reporting standards ('new' UK GAAP) to replace all FRSs, SSAPs and UITFs ('old' UK GAAP). Two of these standards have a key impact on most UK pension schemes:

- FRS 100 Application of Financial Reporting Requirements; and
- FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland.

FRS 100 applies to financial statements that are intended to give a true and fair view of the assets, liabilities, financial position and profit or loss for a period, and thus applies to pension scheme financial statements which are prepared in accordance with either the Audited Accounts Regulations or other requirements that require the preparation of pension scheme accounts that show a true and fair view.

FRS 102 is the main replacement for 'old' UK GAAP. Based on the IFRS for Small and Medium sized entities (IFRS for SMEs), it has been amended significantly from that standard to widen the scope, comply with UK company law and reintroduce a number of options available under full IFRSs and/or existing UK GAAP.

These changes to UK GAAP result in a single, shorter, more cohesive standard that is more comparable with full IFRSs.

Pension schemes are within the scope of FRS 102 and Section 34 *Specialised Activities* contains a section which deals specifically with the requirements of pension scheme accounting.

The main objective of FRS 100 is to enable users of accounts to receive high-quality understandable financial reporting, proportionate to the size and complexity of the entity and users' information needs.

FRS 100 allows for pension scheme financial statements to be prepared either in accordance with FRS 102 or International Financial Reporting Standards as adopted by the EU (IFRS).

- The revised statement of recommended practice ("SORP") has been published for pension schemes who prepare financial statements under FRS 102.
- International Accounting Standard 26 – Accounting and Reporting by Retirement Benefit Plans and other EU adopted IFRS' are appropriate if a pension scheme applies IFRS. In this scenario the SORP does not apply since SORPs are not recognised under IFRS.

The new accounting framework recognises statements of recommended practice and FRS 100 states that the purpose of SORPs is to:

**'Recommend particular accounting treatments and disclosures with the aim of narrowing areas of difference and variety between comparable entities. Compliance with a SORP that has been generally accepted by an industry or sector leads to enhanced comparability between the financial statements of entities in that industry or sector. Comparability is further enhanced if users are made aware of the extent to which an entity complies with a SORP, and the reasons for any departures. The effect of a departure from a SORP need not be quantified, except in those rare cases where such quantification is necessary for the entity's financial statements to give a true and fair view.'** (FRS 100:7)

## Effective date

The recommendations of the SORP are applicable for all scheme years commencing on or after 1 January 2015 but early adoption is permitted and in these cases the accounts must disclose that the SORP has been adopted early.

# Contents

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Executive summary	2
Fair value hierarchy	4
Investment risk disclosures	7
Annuities	9
Other matters	10
Future changes	15
Contacts	16

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## **Practical user guide**

This user guide has been prepared to primarily highlight the differences between the revised 2015 SORP and the previous SORP (May 2007). It therefore presumes a certain knowledge of the user and unless indicated within this guide, the current treatment under the previous SORP (May 2007) is still relevant under the new recommendations. We have chosen to include some areas in this guide where the revised SORP provides further guidance, as well as including notes in some places to add further commentary.

# Executive summary

The exercise of transitioning to the revised SORP should not be underestimated.

The most fundamental changes to the revised SORP are the implementation of a fair value hierarchy for investments and the introduction of disclosure requirements for credit and market risks that a scheme is exposed to.

In the majority of cases, these requirements will require pension scheme accountants to enhance their knowledge of investment pricing and strategy and require some practical considerations at the planning stage, perhaps far in excess of current practice.

There is also a key change to accounting policies for annuities held in the name of trustees. The previous SORP allowed annuities to be valued at £nil on the Statement of Net Assets whereas the revised SORP explains that these are valued at the amount of the related obligation in order to comply with FRS 102.

Obligations in the form of actuarial liabilities are not to be included in the accounts but dealt with in a separate report alongside the accounts. Whilst this is consistent with the previous SORP it is an important principle which was considered at the consultation stage. Pensions Research Accountants Group (“PRAG”) have considered that the actuarial valuation and scheme’s audited accounts serve two distinct purposes and therefore a pension scheme’s Statement of Net Assets will continue to exclude these.

In our opinion the revised SORP remains a user friendly document. We view the increased length of the SORP to be a positive development as there is now much more guidance available to trustees and scheme management.

Within the main body of this document we have provided some of the key detail from within the SORP and background to assist users in their preparation of these new disclosures. We have also included practical guidance throughout this document to enable users to think about what this means for their scheme and we strongly recommend this is done well in advance of the typical timetable.

### Fair value hierarchy

The fair value hierarchy and investment risk disclosures will move pension scheme accounts forward and align them more with the disclosures many financial institutions have been providing for a long time.

FRS 102 requires consideration of three categories of fair value; (a) to (c). However the SORP suggests that category (c) may be sub-divided into two parts and recommends the disclosure is given for all investments shown on the Statement of Net Assets.

The fair value hierarchy in FRS 102 and the SORP is not consistent with the Level 1,2 and 3 hierarchy used in International Accounting Standards and prescribed by IFRS 13 *Fair Value Measurement*.

Certain new disclosure requirements such as the fair value hierarchy and credit and market risks will require significant scheme specific information and obtaining this information, particularly in the first year, is likely to be challenging for a number of schemes.

The removal of the option to value significant annuity contracts at £nil will require many schemes to change the basis they use for valuing these contracts. The identification of such contracts and subsequent valuation will need careful planning well ahead of typical accounts production timetables.

Where practical we recommend that schemes prepare these new disclosures in draft as part of their final audit cycle under the existing SORP (Revised May 2007). This will allow the preparer of the accounts to establish the source of this information, consolidate it if necessary and ensure it is prepared on a consistent basis. Naturally, trustees may terminate contracts with investment managers and custodians from one year to the next and the early provision of sufficient information will enable comparatives to be more readily available.

### Fair value hierarchy

IFRS	Level 1	Level 2		Level 3
	Quoted daily price	Valuation technique with observable inputs (other than quoted prices)		Non-observable inputs
SORP	Category a	Category b	Category c(i)	Category c(ii)
	Quoted daily price	Recent price	Valuation technique Observable inputs	Valuation technique Non-observable
Examples	Equities	Weekly and monthly priced PIVs	Investment property OTC derivatives Bonds	Private equity Insurance policies SPVs
	Exchange traded derivatives Daily priced and traded PIVs			

Early engagement of the following advisors is recommended:

- custodians;
- investment managers;
- investment consultant;
- actuary;
- scheme accountant; and
- auditors

Additional time for consultation and review of the accounts in the typical audit timetable will be needed in many cases.

Our experience of the adoption of the fair value hierarchy by the local government pension scheme sector for the year ended 31 March 2012 showed that those that engaged early on generating these disclosures experienced a lot smoother process than those that engaged with this issue during the final audit visit. In either case the preparation of these disclosures required significant time input from management as well as some financial resource to obtain specialist input from scheme advisers.

### Investment risk disclosures

New disclosures of the nature and extent of credit and market risks arising from the scheme's financial instruments are required. Exposure to such risks and the policies in place for managing them will need tailoring to each scheme's circumstances.

The increased level of tailoring will mean that the accounts are much more focussed on each specific scheme and hopefully much more engaging to the reader. However this is likely to require significant input from trustees and scheme management.

We are recommending a holistic approach to these disclosures meaning that the strength of the employer covenant and the scheme's funding position are clearly linked in such disclosures as these will drive the appetite for risk the scheme has.

### Investment commentary

The revised SORP recommends that all the material in the investment commentary should focus on the circumstances and requirements of the scheme itself, with commentary on general economic and market conditions restricted to what is necessary for an understanding of the scheme's own situation.

This should therefore prevent the unnecessary "boilerplate" general economic review seen in many annual reports.

### Annuities

The revised SORP requires annuities held in the name of trustees to be valued at the present value of the related obligation and removes the option to value these assets at £nil. The related obligation will depend on the basis for valuation for the scheme's liabilities. In valuing these liabilities the trustees must therefore use a reasonable basis and apply this consistently year on year.

### Other matters

Since the publication of the previous SORP the pensions industry has evolved at a rapid pace, introducing auto-enrolment and numerous investment products/strategies. Accounting guidance has also evolved and whilst the SORP does not make any fundamental changes to the areas below, it does provide helpful commentary for schemes to consider and ensure they are making the appropriate disclosures.

- Special Purpose Vehicles
- Longevity swaps
- Repurchase Agreements ("repos") and Reverse Repurchase Agreements
- Common Investment Funds
- Multiple Sections
- Related Parties
- Employer Related Investments
- Tax
- Auto-enrolment
- Subsidiaries, Joint Ventures and Associates
- PPF Assessment
- Transitional provisions

FRS 102 states that comparative information in respect of the preceding period for all amounts presented in the current period's financial statements should be disclosed. The SORP illustrations reflect these detailed comparatives in the notes to the accounts and show a single comparative in the primary financial statements, making a suitable presentation more achievable. Consideration should therefore be given for sectionalised or hybrid schemes where this currently is not the case.

The SORP does state that comparative information is not required for items included in the investment reconciliation table.

# Fair value hierarchy

One of the most significant new disclosure requirements is the introduction of the fair value hierarchy. This will provide further transparency to a scheme's investment portfolio and will in some cases require significant thought.

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

For all financial instruments held at fair value in the Statement of Net Assets, a scheme is required to disclose for each class of financial instrument, an analysis of the source used to determine fair value.

A fair value hierarchy seeks to increase consistency and comparability in fair value measurements and disclosures.

FRS 102 requires the use of the following hierarchy to estimate the fair value of investments:

**Category (a)** – The best evidence of fair value is a quoted price for an identical asset in an active market. The quoted price is usually the current bid price and therefore a daily price. If a daily price (on a normal business day) is not available for a particular investment at the reporting date then this would normally be considered as Category (b) or (c) below. Actively traded exchange traded securities, such as equities and certain derivatives will typically fall into this category, where official prices are available from the relevant securities exchange at the reporting date.

The fair value classification should be consistent from one year to the next and will not be affected if the scheme year end falls on a non-trading day for example.

An active market is defined by a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

**Category (b)** – When quoted prices are unavailable, the price of a recent transaction for an identical asset provides evidence of fair value as long as there has not been a significant change in economic circumstances or a significant lapse of time since the transaction took place. This type of investment would normally be recently priced.

Exchange traded securities which are relatively illiquid would be included in this category. The SORP comments that judgement will be required when considering the use of prices for assets which are other than at the reporting date.

Certain bonds are likely to fall into this category where they are judged to be traded on a relevant exchange but are relatively (to category (a)) illiquid, often because of the comparatively small issues of these securities.

The term 'recent' is not defined by the SORP, and is a matter of judgement.

**Category (c)** – If the market for the asset is not active and recent transactions of an identical asset on their own are not a good estimate of fair value, an entity estimates the fair value by using a valuation technique. There are two sub categories which the SORP indicates trustees may wish to distinguish between:

- (i) The valuation technique uses primarily observable market data; and
- (ii) The valuation technique uses generally non-observable market data.

Examples of these assets include:  
Category c(i)

- Over the counter derivatives;
- Some bonds; and
- Some relatively illiquid traded pooled investment vehicles.

Category c(ii)

- private equity investments as, by their nature, publically quoted prices are unavailable and there is not an active market from which to obtain transaction prices; and
- Special Purpose Vehicles as the assets are typically bespoke to the scheme and are valued on the basis of expected cash flows.



Note that FRS 102 does not specifically require the split between c(i) and c(ii) but the SORP states that trustees may wish to use this approach. We believe this will aid transparency and will be helpful for readers of the accounts to get a better understanding of the pension scheme assets.

Private equity, infrastructure and other relatively illiquid pooled investment arrangements are normally reported at the net asset value (NAV) of the fund. The NAV should be determined by the manager of the vehicle by applying fair value principles to the underlying investments of the arrangement. If for example the trustees have decided to sell the pooled arrangement there may be circumstances where the NAV is not an appropriate measure of fair value.

Depending on the nature of the vehicle and the market in which it is sold there may be a premium or discount to the NAV reported by the pooled manager.

If the trustees have committed to dispose of the pooled vehicle, consideration should be given to adjusting the NAV to reflect the level of discount or premium to NAV at the reporting date.

Properties may be included on the basis either of an annual valuation by an internal or external valuer or, if the proportion of property assets within total investments justifies a less frequent valuation, on a rolling basis over one to three years.

In the case of properties in the course of development, redevelopment or refurbishment more frequent valuations may be necessary.

Where the valuation of investment properties is not at the reporting date, for example where the rolling valuation approach described above is adopted, consideration should be given to the need for a fair value adjustment to the reporting date using available market information such as property indices.

With-profit insurance policies should be reported at an estimate of their fair value. This will normally be the on-going value of the policy based on the cumulative reversionary bonuses declared and the current terminal bonus. If there is a commitment to redeem the policy then surrender value should be used. Under FRS 102, which requires fair value to be determined on an 'exit' value rather than an 'entry value' the use of an actuarial value or premium value is not appropriate.



#### Typical disclosure of the FV hierarchy

31 Dec 2015					
Defined benefit section	Category (a) £000	Category (b) £000	Category c(i) £000	Category c(ii) £000	Total £000
Equities	35,000	–	–	–	35,000
Bonds	–	500	60,000	–	60,500
Property	–	–	5,000	5,000	10,000
Pooled investment vehicles	8,000	10,000	200	100	18,300
Derivatives	5,000	–	8,000	–	13,000
Repurchase agreements	–	–	(2,000)	–	(2,000)
Insurance policies	–	–	–	10,000	10,000
AVC investments	–	–	–	100	100
Cash	50	–	–	–	50
Other investment balances	1	–	–	–	1
	<b>48,051</b>	<b>10,500</b>	<b>71,200</b>	<b>15,200</b>	<b>144,951</b>
<b>Defined contribution section</b>					
Pooled investment vehicles	10,000	100	50	–	10,150
	<b>58,051</b>	<b>10,600</b>	<b>71,250</b>	<b>15,200</b>	<b>155,101</b>

It should be noted that full comparatives are required for this disclosure.

The SORP recommends that the disclosure above is made for all investment assets and liabilities held on the Statement of Net Assets rather than for financial instruments only. The disclosure should therefore clearly reconcile back to the Statement of Net Assets.

Comparative information is also required and in order to provide additional clarity to the readers of the accounts, preparers of these disclosures may find it helpful to state the percentages held within each category at the scheme year end.

It is likely that the preparation of these disclosures will require significant input from a scheme's investment managers and custodians, therefore trustees should engage with their advisors early to ensure that their current investment mandates allow for the provision of such information. Important matters to consider when collating the above information are:

- in the normal course of a scheme's operations it will terminate certain investment and custodian mandates from one year to the next so provision to provide such information should be considered standard practice;
- a scheme will need to ensure that a consistent approach for categorising investments has been taken from one investment manager to the next, particular care for those items of a more judgemental nature is required; and
- a scheme may wish to do a full internal audit or review of these disclosures as part of its governance arrangements to ensure completeness and accuracy of data provided to it.



# Investment risk disclosures

## Investment risk disclosures

The SORP requires pension schemes to disclose information that enables users of financial statements to evaluate the nature and extent of credit risk and market risk arising from financial instruments to which the scheme is exposed.

Trustees may wish to cross refer the Trustees' Report to the financial statements to avoid duplication of the disclosures, given the presence of an investment commentary (see below).

FRS 102 defines credit risk as: the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

FRS 102 defines market risk as: the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk:

- Interest rate risk – the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
- Currency risk – the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
- Other price risk – the risk that the fair value of future cash flows of a financial instrument 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 financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.

For each type of credit and market risk arising from financial instruments, the SORP requires the following disclosures.

- a) the exposures to risk and how they arise;
- b) the scheme's objectives, policies and processes for managing the risk and the methods used to measure the risk; and
- c) any changes in the above from the previous period.

FRS 102 requires these risk disclosures for financial instruments\* only, which therefore exclude other investments such as investment properties. The SORP however goes further than FRS 102 and recommends that these risk disclosures are applied to all investments reported at fair value in the Statement of Net Assets so increasing the disclosures for all investment assets.

These disclosures are required for both defined benefit and defined contribution scheme investment assets (including AVC assets), subject to materiality.

The notes to the financial statements should explain how the risks arise in the context of the scheme's investment strategy.

The SORP comments that putting these risks into the context of the scheme's Statement of Investment Principles will be useful.

We recommend that wider risks are taken into account when making such disclosures. For example in a:

- Defined benefit scheme, investment strategy will be set after taking into account the strength of the employer covenant and actuarial liabilities.
- Defined contribution scheme, investment strategy will be determined by a member's risk appetite given future drawdown or annuity levels and contributions.

It is key that these disclosures are prepared and reviewed by someone who is involved in managing the investment strategy. The preparer may find it helpful to use the Statement of Investment Principles and Investment Policy Implementation Document as a starting point when preparing these disclosures. When assessing the risks of Pooled Investment Vehicles fund fact sheets are also a useful resource.

It will be helpful to the reader of the accounts to link the investment risk disclosures with the derivative disclosures as this will show how the trustees are addressing these risks.

In relation to credit risk a scheme should disclose:

- A description of collateral held as security and of other credit enhancements, and the extent to which these mitigate credit risk.
- If derivatives are held to mitigate credit risk relating to other financial instruments it would normally be appropriate to include this information with the disclosures required for derivatives.

\*FRS 102 defines a financial instrument as a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

- The amount by which any related credit derivatives or similar instruments mitigate the maximum exposure to credit risk.
- Information about the credit quality of financial assets that are neither past due nor impaired.

This requires the disclosure of the credit quality of bond portfolios and other financial assets subject to credit risk. The SORP recommends as a minimum that pension schemes disclose investment grade, non-investment grade and unrated financial assets.

There is no industry standard definition of investment and non-investment grade. Therefore trustees should agree with the provider of credit quality information the basis of this classification and apply it consistently across investments from one year to the next.

FRS 102 requires financial institutions to prepare a sensitivity analysis of market risks an entity's profit and loss and equity is exposed to. Whilst pension schemes are included in FRS 102's definition of financial institutions they are exempt from these disclosure requirements and therefore schemes will not have to produce such a sensitivity analysis.

Commentary should be made to outline and explain the trustees' policies on investments and the strategy for achieving the policies. This may be particularly useful to the readers of the financial statements where there is:

- a delegated credit fund/fiduciary managed fund;
- the presence of derivatives including liability driven investments;
- a special purpose vehicle/pension funding partnership structure; and/or
- a complex investment strategy.

As detailed in the May 2007 SORP, the investment commentary should also review investment performance against that background and compare the investment return with any benchmark adopted. The SORP provides the following background:

The revised SORP recommends that all the material in the investment commentary should focus on the circumstances and requirements of the scheme itself, with commentary on general economic and market conditions restricted to what is necessary for an understanding of the scheme's own situation. This should therefore prevent the unnecessary general economic review seen in many annual reports.

Scheme's should ensure that all of their disclosures are written:

- in clear and plain English;
- without jargon;
- acronyms are defined and if needed explained; and
- with the knowledge of members and other readers of the accounts in mind.

Where a pension scheme invests in a pooled investment vehicle it obtains direct exposure to the credit and market risks arising from the pooled investment vehicle and indirect exposure to the credit and market risks arising from the underlying investments of the pooled investment vehicle.

Where a pension scheme is the sole investor in a pooled arrangement, for example, liability driven investment funds typically set up as a Qualifying Investment Fund (QIF), the SORP recommends the following is disclosed:

- a summary of the assets and liabilities of the pooled arrangement at the reporting date; and
- an explanation that the scheme is the sole investor in the pooled arrangement.

The investment risk disclosures should be made using the look through approach for these type of arrangements.

The SORP recommends as a minimum that pension schemes disclose investment grade, non-investment grade and unrated financial assets.

# Annuities

The main change to accounting policies for pension schemes arising from the revised SORP relates to the requirement to value annuity policies at the amount of the related obligation.

FRS 102 requires annuities, defined as an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under the scheme, to be fair valued. The fair value of the asset is deemed to be the present value of the related obligation. The opportunity to value these policies at £nil under the previous SORP has therefore been removed in the revised SORP.

The present value of the related obligation will depend on the basis of the valuation of the scheme liabilities. A pension scheme has several bases for determining actuarial liabilities, for example scheme funding or buy-out. The SORP recommends that the basis adopted by the trustees for pension scheme financial statements reflects the circumstances and purpose of the annuity arrangements. For example, if the intention is to hold the annuities in the scheme for the long term then the scheme funding valuation basis would seem most appropriate. If the annuity has been purchased with a view to moving to a buy-out then the trustees may consider the buy-out basis more appropriate.

The basis adopted should be disclosed in the financial statements. If the basis adopted is not consistent with the scheme funding valuation this should be noted in the financial statements so the scheme actuary can consider any adjustments necessary to the scheme's reported net assets for the purposes of the scheme funding valuation.

The SORP permits the use of roll-forward techniques when valuing annuity contracts. Trustees may find it practical to value the contracts in conjunction with the triennial valuation of the scheme and engage the actuary to roll forward these valuations in the years without a formal valuation.

Trustees may also find it helpful to liaise with the employer when assessing the value of annuity contracts as the employer will also be required to fair value them for their accounting purposes.

When performing the scheme valuation the actuary can either consider the value of the annuity contracts or exclude these assets (and the corresponding liabilities) from the valuation.

Trustees should assess the significance and materiality of the related obligation of such annuity contracts and have early discussions with their auditor before deciding on how to estimate these liabilities.

When assessing materiality trustees should consider the size and number of annuity contracts. It is also important to consider the maturity of the contracts as their fair value will generally reduce throughout their life time.

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The main change to accounting policies for pension schemes arising from the revised SORP relates to the requirement to value annuity policies at the amount of the related obligation.



# Other matters

## Special Purpose Vehicles (SPVs)

In recent years we have seen an increasing number of SPV arrangements and so we welcome additional guidance in this area. These arrangements are where the employer contributes business assets to the scheme using a ring-fenced structure. The pension scheme will then receive future cash flows from the SPV. There are a variety of different structures available ranging from regular fixed amounts to the more complex structures where cash flows vary depending on, for example, the funding position of the scheme or the financial performance of the employer.

Due to their highly bespoke nature SPVs are usually highly illiquid and are typically not transferrable. The SORP recommends that if an SPV is highly illiquid this is disclosed in the scheme financial statements.

The fair value will be based on the present value of expected future cash flows. As such where cash flows are variable the valuation method will use stochastic modelling techniques.

The discount rate used will depend on a number of factors, for example the security of the arrangement; the credit worthiness of the employer and related collateral in the arrangement; the illiquidity of the arrangement and the current yield on any market-traded securities which have features similar to the SPV.

When modelling the value of an SPV the SORP recommends consideration of the following aspects (where relevant):

- future assumed investment returns;
- the trustees' future investment strategy;
- the employer's approach to funding future deficit contributions;
- determination of the future actuarial valuation discount rate;
- development of the scheme's actuarial liabilities; and
- conditional criteria that may switch off cash flow from the SPV, for example, funding triggers.

Consideration of the above should be from the perspective of a third party willing buyer or seller at arms-length rather than from the trustee perspective.

This is an important consideration as this may require assessment of factors that may not seem relevant to the trustees for example; if by clearing the deficit the employer reduces the future cash flows from the SPV then a third party purchaser would lose out and so this would affect the price they would be willing to pay for the SPV. Whilst this risk would not impact the trustees adversely they will need to include it in their fair value assessment.

## Longevity swaps

In respect of longevity swaps, the SORP provides the following guidance:

There are typically two types of swap: bespoke swaps and index-swaps. Bespoke longevity swaps provide a hedge against the longevity of actual members of the pension scheme whereas index based swaps move in line with general developments in longevity.

Longevity swaps may be classified as derivatives where they use market based longevity information to determine cash flows. If they use scheme specific longevity information they are technically not regarded as derivatives for accounting purposes and are reported under 'other investments'. This does not alter the approach to valuing the arrangements.

The fair value of the longevity swap should be based on the expected future cash flows arising under the swap discounted using market interest rates. The cash flows are discounted using market-based interest rates, taking into account credit risk and liquidity premium appropriate for the circumstances. Projected variable cash flows also need to take into account current market views of longevity.

The valuation of longevity swaps is particularly complex and schemes should consider using specialists to value such investments.

### Repurchase agreements (“repos”) and reverse repurchase agreements

A repurchase agreement normally takes the form of an agreement to sell a security with the simultaneous agreement to repurchase it at a fixed future price.

When a pension scheme enters into a repo, the scheme retains substantially all the risks and rewards of the ownership of the securities. It therefore continues recognising and valuing the securities that are transferred and disclosing them in the notes to the scheme financial statements.

The cash which is received as a result of the agreement is recognised as an asset and the obligation to transfer the assets back is recognised as a liability. The interest on such agreements is either rolled up into the liability or paid as cash flows from the scheme, where cash flows are paid then the expense should be recognised within the investment income note.

When a pension scheme enters a reverse repo, the scheme does not have the economic benefits and therefore does not recognise the assets received in its financial statements. The scheme does however recognise the cash transferred to the counterparty as a receivable in the financial statements.

In both cases collateral arrangements are disclosed.

Whilst transitioning to the revised SORP, schemes should consider their current disclosures and refreshing the whole of their financial statements.

### Common Investment Funds (CIFs)

A CIF’s financial statements are required to show a true and fair view under UK GAAP and are therefore to be prepared in accordance with FRS 102.

The CIF will value its investments at fair value in accordance with the guidance above and disclose the fair value hierarchy.

In many cases it is envisaged that by including a CIF’s financial statements within a scheme’s annual report the new disclosure requirements will be less onerous.

The scheme’s financial statements can cross refer to the fair value hierarchy and investment risk disclosures and need not include risk and fair value disclosures in its financial statements.

Further, if the scheme financial statements include equivalent details of the CIF’s portfolio then it should also include the risk and fair value disclosures.

### Concentration of investments

The SORP excludes pooled investment vehicles as well as gilts from the concentration of investments note.

Whilst the concentration of investments note is not required by FRS 102, it is an important aspect of risk management. The revised SORP therefore recommends the disclosure of any individual investment that represents more than 5% of the net assets of the scheme. The SORP states that you should only ‘look through’ pooled investment vehicles to determine the holding of underlying securities if the trustee controls the investment mandate of the pooled investment vehicle.



### Multiple sections

The revised SORP is consistent with the previous version in its approach to hybrid schemes, whereby a columnar approach is recommended if both sections are material. It does provide a little more clarity in the case of multiple benefit sections by stating that if a scheme has multiple defined benefit sections or defined contribution sections it is not necessary to report these sections separately.

In some cases however, sections will be ring fenced defined benefit sections which meet the requirements set out in paragraph 1, Schedule 2, of the Occupational Pension Scheme Funding Regulations 2005, (contributions payable in respect of an employer are allocated to that employer's section and a specific part or proportion of the assets of the scheme is attributable to each section and cannot be used for the purpose of any other section). That paragraph applies the requirement to obtain audited financial statements for the purpose of the scheme funding valuation to each section as if it were a separate scheme. Therefore trustees should consider the most appropriate approach to meeting this requirement.

### Related parties

Whilst the accounting standard for related party transactions has not vastly changed, the SORP does provide further updated guidance than was set out in the previous SORP and in particular refers to the concept of 'close families'.

#### Trustee-related parties

Trustee-related parties include:

- a) Trustees and their *close families*;
- b) key management (that is the directors) of a corporate trustee and their *close families*;
- c) entities controlled by, and associates and joint ventures of, the scheme itself;
- d) companies and businesses controlled by the trustees or their *close families*;
- e) companies and businesses controlled by the key management of a corporate trustee, or their *close families*; and
- f) other pension schemes that have a majority of trustees in common with the scheme.

### Employer related investments

Where practical the percentage of employer related investment at a scheme's year-end should be disclosed.

The SORP considers that where this is impractical, the trustees should make a reasonable estimation of the percentage of employer related investment, if any, and disclose whether it is above or below the statutory restriction of 5%.

Where it is estimated to be above 5% the trustees should consider the disclosures required in relation to the steps to be taken to bring the level below the statutory restriction.

The Disclosure of Information Regulations provide an alternative disclosure option for schemes with members from different employers:

- list the largest 100 investments by value held by the scheme at the year-end stating what percentage of the resources of the scheme each investment represents;
- identify which of the investments listed above are employer related investment; and
- if more than 5% of the resources of the scheme are invested in employer related investments in relation to any one employer, disclose the employer related investments, the name of the employer, the steps the scheme has taken or proposes to take to reduce the percentage to 5% or less and the time when proposed steps will be taken.

This applies to direct investments and investments made through pooled investment vehicles.

Any contributions that remain outstanding after the due date as set out in the schedule of contributions do constitute an employer related investment. They are however exempt from counting towards the statutory restrictions for employer related investment but should be included in the disclosures.

As mentioned already, a scheme should take the opportunity to revisit the whole of its financial reporting obligations and in particular its financial statement disclosures and ensure the needs of users are taken into consideration.



## Tax

In order to comply with FRS 102, the SORP recommends the notes to the financial statements disclose the tax status of the scheme so as to explain the scheme is exempt from taxation except for certain withholding taxes.

Tax on investment income should be accounted for in accordance with FRS 102 and the terms “withholding tax” and “tax credit”.

Schemes may pay amounts to HMRC on behalf of members where lifetime or annual allowances are exceeded. The revised SORP recommends that the tax payment on behalf of the member is shown separately in the notes to the financial statements.

## Auto-enrolment

The SORP provides guidance on the accounting for auto-enrolment, particularly over the treatment of the opt out period.

If contributions are received by the scheme (and then subsequently refunded) then these should be accounted for as a contribution received and corresponding refund. However where the contributions are withheld by the employer and not paid to the scheme the accounts do not need to reflect the contributions or refund.

There is no prescribed method for treatment of the opt out period in the member reconciliation. Members can therefore be shown as joining the scheme either at the beginning or end of the opt out period. The notes to the member reconciliation should clearly set out the approach taken.

Whilst this treatment simplifies the accounting there are cut-off implications as schemes will need to accrue for contributions expected, but not yet received at year end. In addition trustees should review the wording of their schedule of contributions to ensure that the employer withholding contributions does not lead to contributions being received after the due dates.

## Subsidiaries, Joint Ventures and Associates

For schemes that hold subsidiary undertakings, not preparing consolidated accounts does not necessarily imply that the aggregated position of the scheme when accounting for the subsidiaries at fair value will be significantly different; where subsidiaries are themselves an investment vehicle, the consolidated value would be aligned to the fair value of the investments held by the subsidiary. Therefore the direct impact on the scheme asset value is unlikely to be materially different, which ensures that there is no significant impact on scheme assets when assessing any funding deficit levels.



### Schemes in PPF

For Schemes in the Pension Protection Fund ("PPF") assessment period, it is unlikely that the preparation on a cessation basis will result in changes to carrying values of the scheme assets, since assets are invested and valued at market value as required by the SORP. Therefore for the majority of schemes, the only change in the basis of preparation will be to disclose this fact.

For Schemes in the PPF assessment period, the trustees should consider the requirements to continue to have statutory accounts audited. It may be appropriate to change the accounting year end of the scheme to the relevant accounts date, such that the Relevant Accounts become dual purpose. This would need to be assessed on a scheme by scheme basis.

Where a scheme sectionalisation is required, there is no requirement to present the annual scheme accounts in a sectionalised format, therefore depending on the complexity of the sectionalisation, the accounts can be prepared for the scheme as a whole. The trustees, however, are responsible for maintaining underlying records where sectionalised scheme assets are required to be maintained, including the method of allocation of income and expenses between the relevant sections. A bridge of the sectionalisation movements needs to be maintained between the Relevant Accounts and any future annual accounting date, however this does not need to be reported in the statutory financial statements.

### Transitional provisions

Transition from reporting under previous UK GAAP to FRS 102 is required to be carried out in accordance with the requirements of Section 35 of FRS 102. These requirements require the first set of financial statements that are prepared in accordance with FRS 102 to be prepared on the basis that FRS 102 always applied to the current and previous accounting periods. There is therefore no need to account for changes in asset recognition or valuation as a prior year adjustment.

The revised SORP has not changed the content of scheme financial statements and states that they should contain:

- a) a statement of changes in net assets available for benefits (which can also be called a Fund Account);
- b) a statement of net assets (available for benefits);
- c) notes, comprising a summary of significant accounting policies and other explanatory information; and
- d) such additional information as is necessary to show a true and fair view of the financial transactions of the scheme for the scheme year and of the amounts and disposition of its net assets at the end of the scheme year. In particular, material unusual or non-routine transactions or balances should be given sufficient prominence on the face of the primary statements to draw readers attention to.

The SORP recommends that the transition disclosures required by FRS 102 are satisfied by disclosing reconciliations between amounts previously disclosed under UK GAAP and now under FRS 102 for:

- the scheme net assets at the transition date;
- the scheme net assets at the end of the comparative period; and
- and the net increase/decrease in the fund during the comparative period.

The transition date is the opening date of the comparative period.

# Future changes

Further developments post publication of this document will impact on the financial reporting of pension schemes.

## **Audited Accounts Regulations**

The current regulations require disclosure of:

- Fixed interest securities between UK and overseas and public sector and corporate;
- Equities between UK and overseas and quoted and unquoted; and
- Pooled investment vehicles between managed funds and unit trusts and property and other.

In Autumn 2015 the Audited Accounts Regulations are due to be revised. The revised SORP has been prepared assuming that these disclosure requirements will be removed as they are now somewhat outdated. If however the changes to legislation are not consistent with the revised SORP then further disclosures will be required.

## **DWP (Department for Work and Pensions) consultation**

At the time of publication of the SORP the DWP is consulting on increased governance and on charges and transaction costs within DC schemes. It is expected that this consultation will result in new requirements in Spring 2015.

DWP is intending for a Chair Statement to be included in the Annual Report which should be subject to the same level of scrutiny as the rest of the annual report.

Trustees and managers of occupational schemes are likely to have new duties to ensure that default investment arrangements are designed in members' interests and kept under regular review, that core financial transactions are processed promptly and accurately and that they assess the value of transaction costs and charges borne by scheme members.

## **Investment Association/PRAG Joint Working Party**

PRAG and the Investment Association (formerly the IMA) have set up a joint working party to consider the information requirements arising from the revised SORP.

We will prepare additional guidance documents covering future changes and have included a pocket at the back of this document to store them.



**In order for you to maintain your pension scheme accounting records together we have added a pocket on the back cover of this document so that future supplementary Deloitte publications can be added.**



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