HYMANS ROBERTSON

The corporate pension viewpoint

Accounting implications of run-on and surplus sharing

Companies with defined benefit (DB) pension schemes considering a run-on strategy, and sharing any surplus generated with members, should think through the corporate accounting implications of such an agreement.

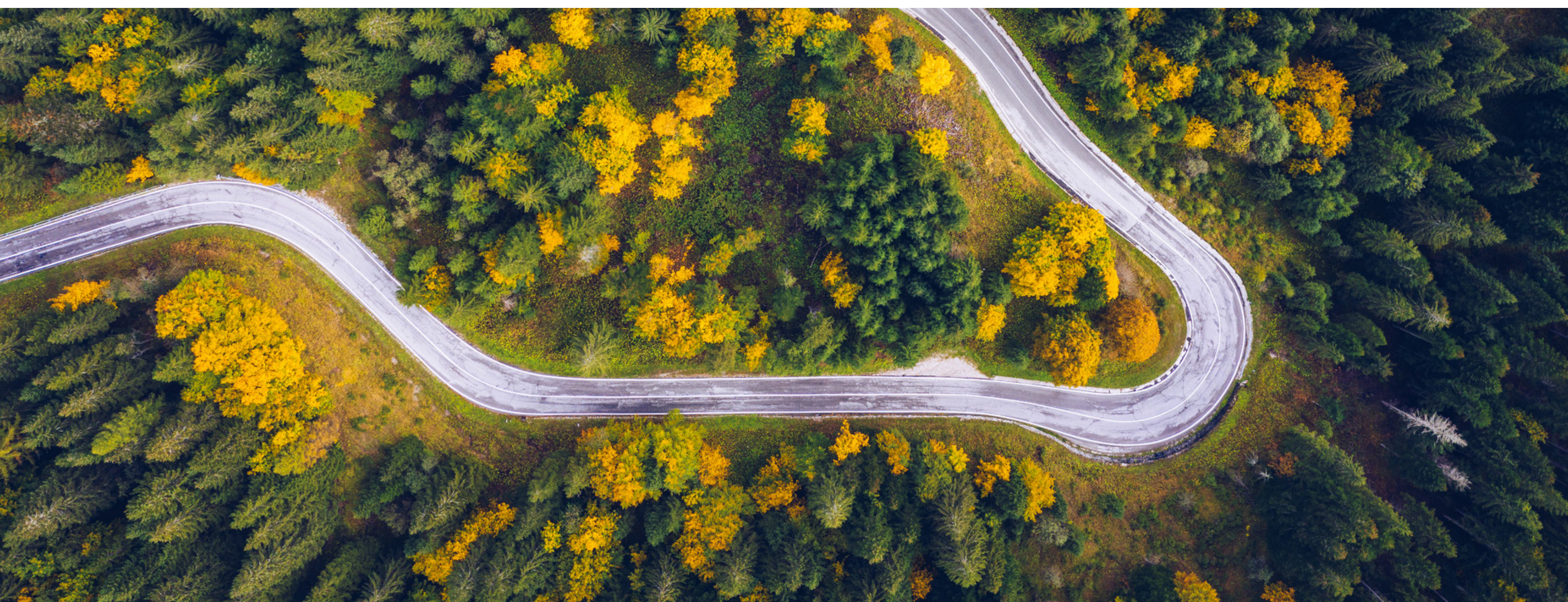
Companies are increasingly considering the range of endgame options available to their DB pension schemes, and many are considering running on instead of a buy-out strategy. The change in thinking has come as many DB schemes' funding levels have improved, and against the background of the proposed Mansion House reforms and the Department for Work and Pensions' (DWP's) consultation on surplus extraction.

Some companies are considering whether they can share with members any surplus generated from a run-on strategy. Subject to the scheme rules and balance of powers, this improvement to member outcomes may also be an objective for trustees.

Changes in government policy and regulation will affect any strategy that the sponsor and trustees agree on. But it may take some time after the election before the finer details of any new regulations and guidance emerge and can be implemented.

With a run-on strategy looking to generate and share surpluses with corporates and members, there are many details that need to be thought through, one such detail being the corporate accounting implications. Without planning in advance and if not managed appropriately, it may be that the accounting implications could be a deterrent for many corporates considering such a strategy.

There are a few potential approaches to accounting for such an agreement and care should be taken to confirm the preferred treatment when agreeing a framework.



'Normal' augmentation treatment

Our starting point is to consider what currently happens when members' benefits are augmented or improved in the normal course of events of an ongoing scheme. For example, at a time of high inflation a scheme could give discretionary pension increases above what the scheme rules require.

IAS 19 requires a company to recognise a past service cost as an expense when a plan amendment occurs. This happens when a company changes the benefits payable under an existing DB plan or there is a new constructive obligation.

One-off augmentations or improvements such as this therefore require one-off past service costs, which will impact a company's income statement or Profit & Loss account (P&L). There may be ambiguity as to whether a constructive obligation has arisen, a term which IAS19 references as 'an informal practice...where the entity has no realistic alternative but to pay employee benefits'.

Using the provision of discretionary pension increases as an example, the specifics of a pension scheme (and the views of the auditor) will dictate whether or not a constructive obligation has arisen when a potentially new discretion is introduced. If this is the case, an assumption should be made for future discretionary increases. Any underestimates or overestimates of discretionary increases that may or may not occur in the future are then treated as an Other Comprehensive Income item (OCI), rather than requiring a further P&L hit.

Applying these principles to an agreed framework

We can consider this context when looking at a future framework for sharing a surplus that may not yet exist. Let's say a run-on strategy framework is agreed to distribute a set proportion of future surplus above a certain funding level to members. For example, any surplus above a buy-out funding level of 110% is distributed equally between members and the corporate on an annual basis.

Potential questions around accounting treatments

While a number of questions arise, perhaps the most important are:

- Should the cost of member benefit improvements go through P&L each year as and when the benefit improvements are agreed? Or should the cost only go through once at the point when a constructive obligation is considered to have been created and 'reasonably estimable', with the one-off hit on P&L reflecting some best estimate of future improvements?
- Given that its value depends on factors such as uncertain future asset returns, is the constructive obligation reasonably estimable from the outset when the run-on strategy framework is first agreed? Or is it reasonably estimable only once a surplus has emerged and benefit improvements have started to be paid out? Or at some other point?

It seems incongruous for a company to have to expense a benefit that's entirely delivered by asset growth, rather than being 'paid for' by the company. Placing a reasonable estimate on this future obligation faces challenges, principally:

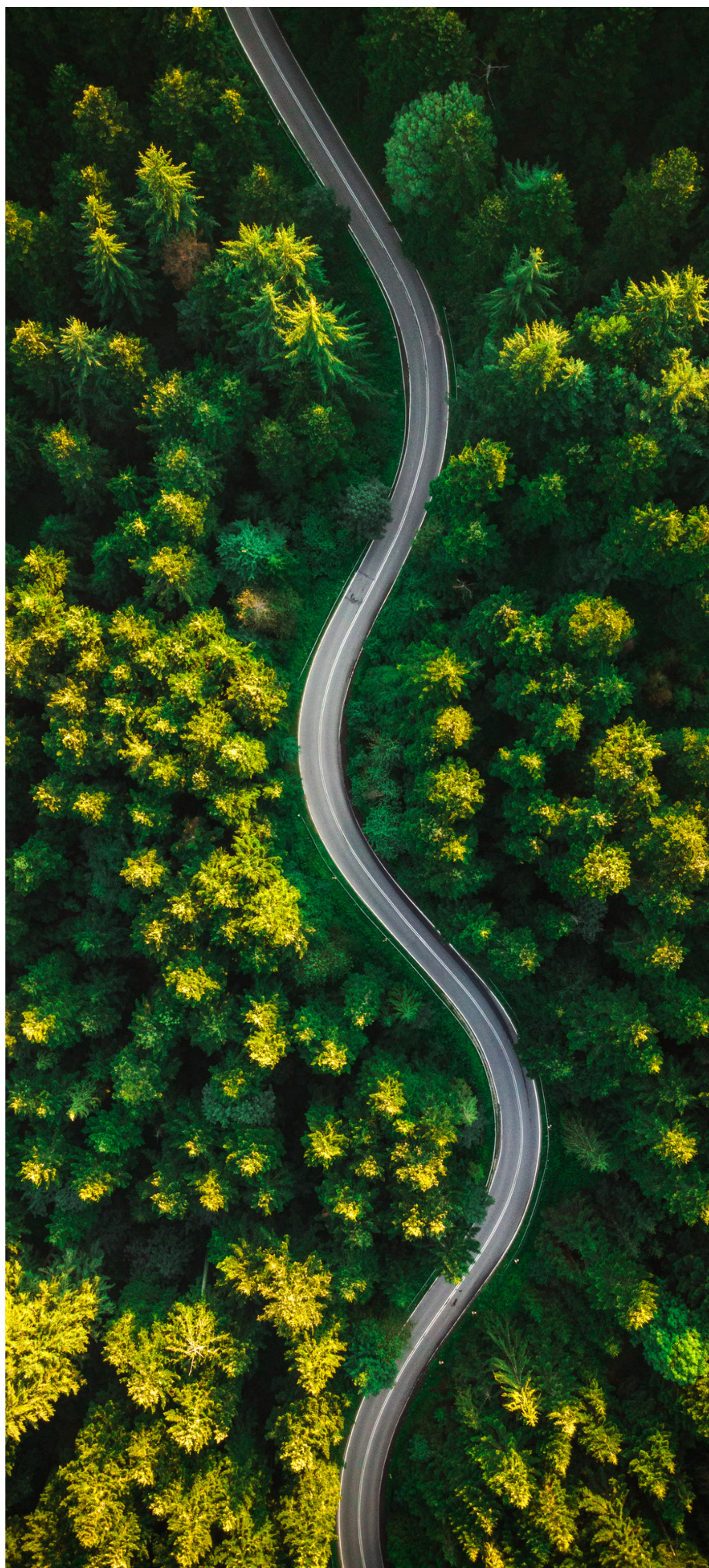
- How to project the funding surplus, allowing for uncertain future asset returns, changes to asset strategy and potential patterns of distribution to members and company?
- How long will this run-on strategy continue? Any good strategy should have a clear exit, and trustee or company objectives may change at short notice. If the strategy retains the flexibility to pivot to an insurer, then any constructive obligation would end when this happens (perhaps with a final element crystallised).

Two accounting treatments

The accounting treatment will be specific to each situation and should be agreed in advance with auditors.

Two potential accounting treatments are:

1. Allowing for the past service cost as an expense year on year when the amendment has occurred (ongoing approach)
2. Making an initial allowance, with any refinement to assumptions and actual increases coming through OCI (one-off assumption approach)



Ongoing approach

It could be argued that a run-on strategy has enough uncertainty that there's no need to introduce an assumption for future benefit improvements paid out. This argument could be strengthened by asserting that the improvements are conditional on future asset performance.

One-off assumption approach

The alternative argument is that when the framework has been agreed and is capable of being reasonably estimated, a constructive obligation is triggered. The actuarial assumption for this constructive obligation is then set and monitored.

The opening value from establishing this constructive obligation would impact P&L. However, given the uncertainty of any future improvements, the initial change could result in little or no immediate P&L impact.

Any changes to the assumption and actual benefit increases would come through OCI later, as a change in assumption or an experience item. However, at a future date, it may be that after an established practice and member expectation have been set, a constructive obligation has been created at a higher level, needing a significant change in assumption. If this change is big enough, some auditors may argue the increase would need to be treated as P&L.

Comparing the accounting treatments

Table 1 sets out accounting under each treatment using example figures. In year 1 the scheme is 110% funded on an insurance buy-out basis (the minimum threshold). The agreed run-on strategy is to distribute the surplus above the threshold equally between members (through discretionary pension increases) and the corporate on an annual basis. Asset performance in this example generates a distributable surplus in years 2, 4 and 5. The total accounting value of the surplus generated is £60m with half of this - £30m – being granted to scheme members.

Under approach 1, there is a P&L hit each year to reflect that half the surplus above 110% is awarded to members as benefit improvements annually.

Under approach 2, an assumption is made up front that no surplus will be distributed to members (in line with the arguments above), with an adjustment coming through OCI each year to reflect the actual discretionary benefits paid.

Under approach 3, cautious assumptions are used to produce an assumption that gives a one-off P&L hit in year 1; with the difference to actual discretionary benefits coming through OCI.

Table 1. Comparing accounting treatments of surplus sharing

	Accounting value of distributable surplus	1. Ongoing approach	2. One-off assumption approach (nil up-front assumption)		3. One-off assumption approach (minimal up-front assumption)	
		Past service cost for annual discretionary benefits to members	Past service cost (assumes no discretionary benefits paid)	OCI item for actual discretionary benefits to members	Past service cost (assumes £3m paid for next 4 years)	OCI item for difference to actual discretionary benefits to members
Year 1	-	-	-	-	£12m	-
Year 2	£20m	£10m	-	£10m	-	£7m
Year 3	-	-	-	-	-	-£3m
Year 4	£30m	£15m	-	£15m	-	£12m
Year 5	£10m	£5m	-	£5m	-	£2m

Documentation matters

The language used to document any run-on strategy will be key. This should balance:

- Ensuring the wording guarantees appropriate surplus to stakeholders above a certain level.
- Demonstrating there is still uncertainty around future surplus arising.
- Consideration around intergenerational fairness in any benefit improvements paid out.
- Providing clarity on timescales and flexibility of the strategy (for example if having flexibility to pivot to insurance is one of the agreed objectives).

Other considerations

- As part of the DWP's consultation on surplus extraction statutory overrides are being considered to withdraw surplus on an ongoing basis or at point of wind up. Consideration will need to be given to how this interacts with the current IFRIC14 requirements.
- Agreeing to such a strategy will also have implications on the amount of surplus that can be recognised on a company's balance sheet.
- Being in surplus will also generate a positive annual P&L income that will at least partially offset any P&L costs from discretions.
- The extent to which any value in the Company accounts influences stakeholder expectations should be considered.
- A possible outcome is that the government introduces statutory overrides to change the balance of powers for sharing surpluses with members and companies. It may be that these powers are now only exercised under a joint agreement between trustee and companies. How would this potential joint agreement change the landscape, for example, how it can be a constructive obligation if any surplus sharing is dependent on third party agreement.
- Entities reporting under US GAAP will need to consider any different treatment.
- Consideration should be given to if the accounting treatment would change for different forms of discretionary benefits.

Conclusions

With any run-on strategy there will be arguments for various accounting treatments, and this is going to be specific to the circumstances and discussions with auditors.

However it's clear that this is a complex and grey area, and for many considering whether to run-on, the preferred accounting treatment should be considered early on in the process.

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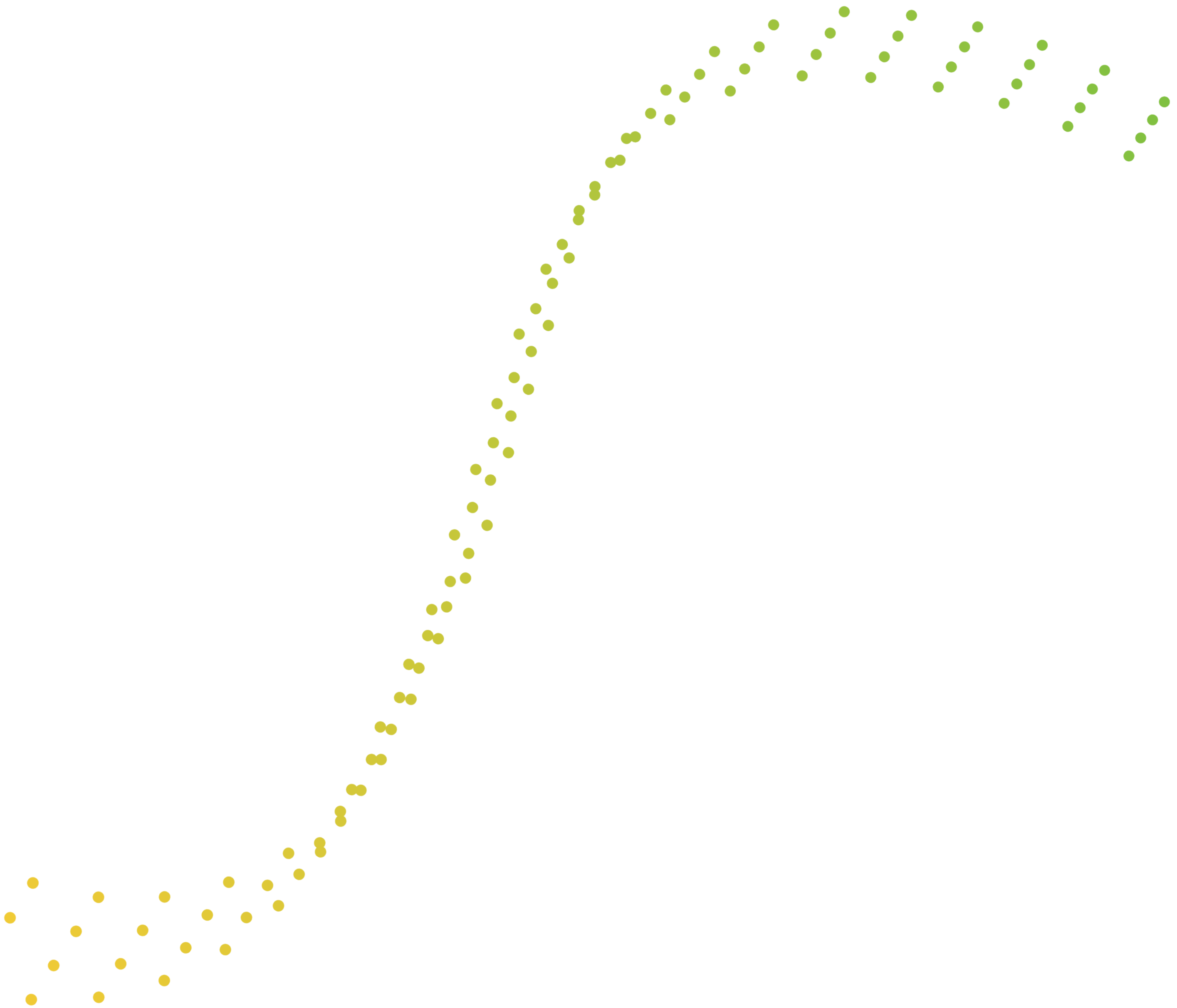

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