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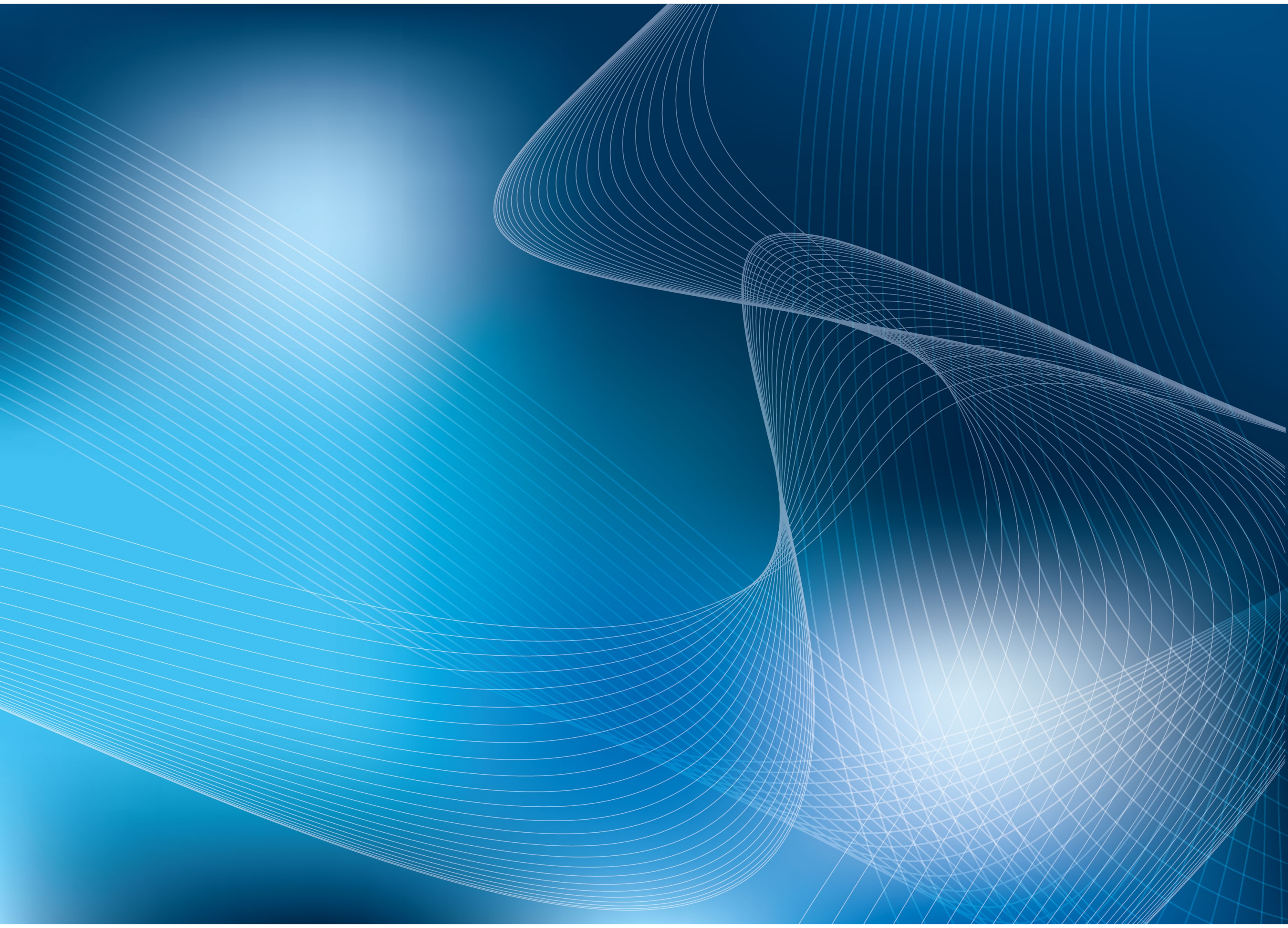
Guide to Pensions Accounting in the Local Government Pension Scheme



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PensionsWatch
ACTUARIAL CONTROL SYSTEMS

Introduction

The purpose of this document is to provide a general overview of how and why employers account for their pensions obligations in the Local Government Pension Scheme. It is not a detailed technical document, its purpose is to provide those who are new to the subject with a basic introduction to some of the key concepts

Please note the disclaimer that applies to this document. This can be accessed by following the link under “Site Info” on the homepage of our website at **www.pensionswatch.com**.

Why do employers need to account for pensions?

In the private sector, the requirement for a company to account for its pensions obligations in a highly transparent manner has become increasingly important. Legislative change, increasingly longevity and falling investment returns have exposed the significant financial risks associated with maintaining a defined benefit pension scheme. Thus shareholders and potential investors need a clear and unambiguous method of measuring pensions exposure.

With the advent of outsourcing in the public sector, there are now many private sector organisations that participate in the LGPS. Thus, the requirement for greater transparency naturally carries over to LGPS pensions as well.

The case for public bodies accounting for their pensions obligations might not be obvious to many. However, whilst there are no shareholders, the public are stakeholders and so the inclusion of a consistent measure of pensions obligation provides a much more complete picture of the true nature of our public finances.

But not all employers who participate in the Local Government Pension Scheme need to account for pensions. Some employers may be exempt, for example, if the employer's pension liabilities are not material in the context of the overall accounts. Employers that require a definitive answer to this question should consult their auditor.

How are LGPS pensions accounted for?

In preparing their annual financial statements, most UK employers follow a particular set of accounting standards. Larger bodies such as councils and listed companies follow International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB), smaller admission bodies are more likely to follow UK Generally Accepted Accounting Principles (UKGAAP) issued by the UK Accounting Standards Board.

The relevant UK pensions accounting standard is FRS17 (Financial Reporting Standard 17) and the relevant international standard is IAS19 (International Accounting Standard 19).

Over the years significant progress has been made in harmonising FRS17 and IAS19 and very few differences now remain insofar as they relate to the LGPS.

There are also a number of interpretation documents issued by the various accounting bodies that provide additional guidance. Public sector bodies in the UK generally follow a version of IFRS prepared by the Chartered Institute of Public Finance and Accountancy (CIPFA) and the Local Authority (Scotland) Accounts Advisory Committee (LASAAC) known as the “Code of Practice on Local Authority Accounting in the United Kingdom” (“the Code”).

Private sector and public sector accounting

At the time of its introduction, one of the most controversial aspects of FRS17 was that the surplus or deficit in the pensions scheme (i.e. the difference between the pension assets and liabilities) should be shown on the employer's balance sheet.

Given that private sector pension schemes are trust-based and hence the assets are legally separate from those of the employer, this might at first seem a strange concept. However, the subsequent strengthening of the law regarding defined benefit pension schemes (the Pensions Act of 1995) meant that employers were no longer able to “walk away” from their pensions obligations, thus the accounting treatment was consistent with the new legal position.

Similar principles have also been adopted for employers obligations in the LGPS. However, due to the long term and statutory participation of many public sector bodies in the LGPS, the accounting impacts as set out in the IFRS may be “reversed out”. This is then replaced by a the ongoing cost of contributions and other pension payments made in the relevant accounting period.

However, this accounting treatment does not apply to all employers in the LGPS, and does not negate the need to disclose the balance sheet and pension costs in accordance with the relevant accounting standard.

Assumptions

The other notable feature of FRS17 was the requirement for assets and liabilities to be valued with reference to current market conditions. In other words a market value of assets was required and liabilities were to be evaluated using market rates of interest ("discount rates") in the relevant actuarial calculations.

At the time, this represented a significant change. Actuaries had previously been used to using "smoothed" values of assets and liabilities in both funding and accounting calculations. These changes have generally led to more volatile accounting figures, and higher net deficits (or lower net assets) and pension costs being disclosed.

The new accounting standards were also notable for the extent to which they appeared to prescribe the assumptions to be used.

In practice, the new standards do permit a degree of flexibility, however, the requirement to have regard to AA-rated corporate bond yields (FRS17) and the yields on high quality corporate bonds (IAS19) in the selection of the discount rate (the interest rate used to value pension liabilities) has significantly narrowed the typical ranges in assumptions.

The role of the employer

Both FRS17 and IAS19 make it clear that responsibility for the choice of assumptions lies with the directors or their equivalent.

To fulfil this role, the directors should take actuarial advice and then consider whether the proposed assumptions are suitable given the employer's particular circumstances.

The role of the actuary

In the vast majority of cases actuaries are used to prepare FRS17 and IAS19 disclosures. However, the legal requirement to use actuaries is actually very limited. The only requirement to use an actuary is found in FRS17 which says that assumptions should be set upon the advice of an actuary.

Thus, in theory at least, no actuary is required at all in the preparation of IAS19 based disclosures and the advice provided under FRS17 need only be limited to assumptions. However, auditors will need to gain comfort that the figures have been calculated correctly (subject to materiality).

In practice, an actuary can add much more value than simply advising on assumptions or preparing the calculations. Actuaries can help employers choose the most suitable set of assumptions for their particular situation and can help defend the use of such assumptions if challenged by the employer's auditor.

Each month our actuaries provide a baseline set of assumptions and make them available on our website. Our assumptions are generally expected to be close to the median position when compared with other UK reporting entities. However, there may be circumstances where an employer does not wish to use these. There may also be special circumstances specific to the employer which would not be reflected in the baseline recommended assumptions, particularly regarding pay increases.

PensionsWatch actuaries are available to help employers who wish to explore more bespoke assumptions. In addition the NeXtStep platform may be used to help illustrate the impact of changes on the overall financial position that would be disclosed.

The role of the auditor

The auditor is responsible for checking that the figures have been calculated correctly and that the financial and demographic assumptions used by the employer are reasonable. Where the assumptions do not fall within the auditor's expected range, or there has been a change in the methodology used to generate the assumptions that has not been justified to their satisfaction, they may challenge the assumptions and seek further information.

Auditors sometimes send audit checklists to the actuary that has prepared the disclosure. These usually contain a series of standard questions. Our actuaries have seen many examples of the these questionnaires over the years and so have prepared a standard response which can be downloaded directly from the home page of our website **www.pensionswatch.com**.

How are calculations carried out in practice?

The vast majority of pensions accounting figures in both the private and public sector are generated by updating the results of the most recent funding valuation.

Data from the fund's valuation is obtained and then fed into a calculation system that carries out a process popularly known as a "roll forward".

A roll-forward takes a known financial position at a fixed point in time using a known set of assumptions and then adjusts this position to take account of:

- Different financial assumptions between those used in the valuation and those required for accounting purposes;
- New benefits earned and benefits paid;
- The payment of contributions and investment returns achieved on the assets attributed to the employer;
- The passage of time on the discounted value of the liabilities (i.e. allowing for the effects of compound interest).

Roll-forwards are generally reliable procedures that enable reasonably accurate financial positions to be established quickly with fairly minimal data, avoiding the large costs and delays associated with “full” member-by-member calculations.

If there have been any “special events” in the reporting period, such as a redundancy programme or the creation or change of benefits, then adjustments should be made to reflect these events.

Further information is set out in our Calculation Methodology paper in the “Client Area” of the PensionsWatch website (see **www.pensionswatch.com**).

Questions?

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