Scotland's Colleges

Finance CoP

Briefing Paper

Pension Scheme Accounting Disclosures Under FRS17 – Issues and Options

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Pension Scheme Accounting Disclosures Under FRS17 – Issues and Options

As more and more colleges disclose their Local Government Pension Scheme ('LGPS') liabilities under FRS17 in their accounts and that liability assumes increasing importance for organisations this paper considers the underlying actuarial assumptions used in the calculations and what flexibility exists to change the results depending on the specific circumstances of each organisation. We've benefited from some input from Alan Collins, an actuary at Spence & Partners, who provides advisory services in this area for many LGPS participants.

So what is FRS17?

FRS17 is an accounting standard used to assess the balance sheet impact and pension costs associated with the operation of occupational pension schemes. The objective of the FRS is to ensure that: -

a) Financial statements reflect at fair value the assets and liabilities arising from an employer's retirement benefit obligations and any related funding;

b) The operating costs of providing retirement benefits to employees are recognised in the accounting period(s) in which benefits are earned by the employees, and the related finance costs and any other changes in value of the assets and liabilities are recognised in the accounting periods in which they arise; and

c) The financial statements contain adequate disclosure of the cost of providing retirement benefits and the related gains, losses, assets and liabilities.

For defined benefit arrangements (e.g. final salary pension schemes) such as LGPS, the balance sheet asset or liability for the organisation is calculated as the surplus or deficit of the scheme assessed in accordance with assumptions appropriate for FRS 17. Actuarial gains and losses are changes in actuarial deficits or surpluses that arise because:

- Events have not coincided with the actuarial assumptions made for the last valuation (experience gains and losses) or
- The actuarial assumptions have changed.

The pension cost is a combination of the cost to the organisation of providing benefits built up over the past year and an interest charge applied to the liabilities built up in the past, offset by a credit in respect of the expected return on the scheme's assets. The elements of the pension cost are again calculated in accordance with assumptions appropriate for FRS 17.

FRS17 Assumptions

The responsibility for the FRS17 assumptions adopted lies with the directors/trustees of each organisation. The agreement of the auditor is required, and the organisation should seek the advice of an actuary on the assumptions. There is a considerable degree of flexibility in setting these assumptions and the impact of small changes to the assumptions can be quite substantial (some examples are provided in the table overleaf).

In general, the assumptions proposed by each actuary to the LGPS will be based on the "average" population of the scheme and therefore may not be appropriate for the individual circumstances of each organisation. As the assumptions are the responsibility of the directors/trustees, they are entitled to request that the actuary carries out their calculations on alternative assumptions which they feel might be more appropriate.

It is important as early as possible in the process for each organisation to consider whether the assumptions proposed are appropriate and take suitable action if not. However, it is not appropriate to "cherry pick" assumptions on a year by year basis as directors/trustees need to ensure a consistent approach is used from year to year.

FRS17 requires a market-related approach, with assets being taken at their market value. Liabilities are valued using the 'discount' rate equivalent to that available on AA corporate bonds. The rate should be adjusted to make it appropriate for the maturity of the scheme's liabilities (this will depend on the proportion of pensioner and active members in the scheme). Other assumptions (e.g. pension increases, mortality) are on a best estimate basis. The expected return on asset assumption is set independently of the liability discount rate. The assumptions should be mutually compatible and lead to best estimates of the future cash flows arising from the Scheme's liabilities. The assumptions should also reflect market conditions at the reporting date.

How assumptions can change from organisation to organisation

As noted above, the impact of small changes to FRS 17 assumptions can have a significant impact of the organisation's balance sheet asset/liability and pension costs. The main assumptions driving FRS 17 disclosures are the rate at which future values are discounted to "present day" terms (the discount rate), the expected rate of future price and salary inflation and the life expectancy of members. Taking a scheme with a total liability of **£30 million**, an indication of the impact of assumption changes on the balance sheet would be as follows:-

Change	Reduction in liability
Discount rate increased 0.25% per annum*	£1.8 million
Salary inflation less 0.25% per annum (assuming 50% of members are active)	£0.5 million
Price inflation and salary inflation less 0.25% per annum	£1.8 million
Life expectancy reduced by 1 year	£0.8 million

*- liabilities are reduced by increasing the discount rate and increased by reducing the discount rate.

There would be corresponding increases in the liability if the opposite changes occur (i.e. reduced discount rate, higher salary and price inflation and higher life expectancy). Therefore, it is clear that setting assumptions can have a material outcome on the organisation's balance sheet. The impact on the pension costs are more difficult to quantify but are generally higher when liabilities are lower and assets are higher.

It is worth noting that on 8 July 2010 the Minister of State for Pensions, Steve Webb MP, made a Written Ministerial Statement to Parliament which announced the Government's intention to move to using the Consumer Price Index (CPI) as the measure of price inflation for the purposes of regulating occupational pension schemes. For LGPS schemes, this will mean that future increases to pensions in payment and revaluation of pensions in the period up to retirement for deferred pensioners will be linked to CPI rather than RPI. Given that historically, on average, CPI has been around 0.5% per annum lower than RPI, this change places a lower current value on future pension payments and so reduces the liability of organisations in respect of pension benefits. Typically, we understand this change could reduce overall pension liabilities by around 10%.

Summary

It is worth remembering that the assumptions used for FRS17 purposes are no more than assumptions - the assumptions used for the ongoing funding of each scheme will be different and give rise to different costs and liabilities and the costs and liabilities associated with a cessation valuation (the amount an organisation has to pay if it leaves a scheme) will be significantly higher.

LGPS actuaries will provide participants with a briefing note outlining the assumptions they will base the calculations on and these will be carried out on a consistent basis for all participants and will therefore in most circumstances not reflect the specific circumstances of the participating organisation and may be more conservative than the organisation might deem to reflect a best estimate approach resulting in higher liabilities and therefore disclosed deficits. Independent advice at an early stage will allow assumptions appropriate to each organisation to be set and ensure that the ultimate results need be run only once.

Glossary

Best estimate – an estimate where there is judged to be an equal probability of the eventual outcome being higher or lower.

Defined benefit pension scheme – a pension scheme where the amount of benefit payable to the member is determined by the member's service and salary.

Pension scheme liability – the value, using actuarial methods and assumptions, placed on the obligations of a pension scheme for outgoings expected to fall on the scheme after the date to which the calculations relate.

Market value of assets - The current value of a pension scheme's assets assuming they were sold in return for cash.

Balance sheet asset/liability – the pension scheme *surplus/deficit* at the end of the accounting year.

Surplus/Deficit – The *pension scheme liability* subtracted from the market value of assets, defined as a surplus if this value is positive and a deficit if this value is negative.

Discount rate – The rate of interest used to convert future outgo from the scheme into the present value of this outgo, the *pension scheme liability*. For FRS17, the discount rate is assumed to be the current rate of investment return on a high quality (AA) corporate bond appropriate for the *maturity of the scheme's liabilities*. A high discount rate leads to a low value for the *pension scheme liability* (and vice versa), all else being equal.

Maturity of the scheme's liabilities – a measure of the average time period over which the benefits of the pension scheme will be paid. This will depend on the proportion of pensioner and active members in the scheme, with more mature schemes having a greater proportion of pensioner members.

Price inflation assumption = Expected rate of future price inflation – the expected average rate of annual price inflation over the future lifetime of the scheme. High assumed price inflation leads to a high value for the *pension scheme liability* (and vice versa), all else being equal.

Salary growth assumption = Expected rate of future salary inflation - the expected average rate of annual salary inflation over the future working lifetime of active members of the scheme. High assumed salary growth leads to a high value for the *pension scheme liability* (and vice versa), all else being equal.

Mortality assumption = Expected rate of death among scheme members - generally, the higher the rate of death that is assumed, the lower the life expectancy of members is expected to be. This will place a lower value on the *pension scheme liability*, all else being equal.