

# Accounting reporting as at 31 March 2019

Employer briefing note pre-accounting date

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## Accounting reporting as at 31 March 2019

Many LGPS employers, in particular local authorities and other public sector employers, prepare accounting disclosures as at 31 March each year and these may be in accordance with the IAS19 or FRS102 standard, depending on the employer.

This note outlines some of the changes to the key financial assumptions that are used in preparing the IAS19 and FRS102 accounting numbers since the last reporting date as well as information on asset performance over the period.

This note complies with Technical Actuarial Standard 100: Principles for Technical Actuarial Work (TAS 100).

### How has the accounting position changed?

As we will not know the assumptions that will be adopted for accounting disclosures until after 31 March 2019, we have utilised the latest market statistics available. The following analysis uses market statistics as at 25 January 2019. **It is very likely that market conditions at 31 March 2019 will be different.**

As LGPS Funds are usually invested in a range of asset classes, the performance of the assets may be quite different from that of the accounting liabilities (which are linked to corporate bonds, as set out below) and so the results can be very volatile from year to year.

This note discusses our recommended assumptions for the exercise, however the responsibility for setting assumptions ultimately belongs to the employer and therefore if an employer was to request alternative assumptions then we would be happy to use these in producing our report. The assumptions in this report are therefore the standards that we intend to use unless instructed otherwise. We believe that these assumptions are likely to be appropriate for most employers but we have not consulted with each employer in setting these.

The change in the balance sheet position over the year is mainly dependent on the answers to three key questions and this report is split into these three sections:

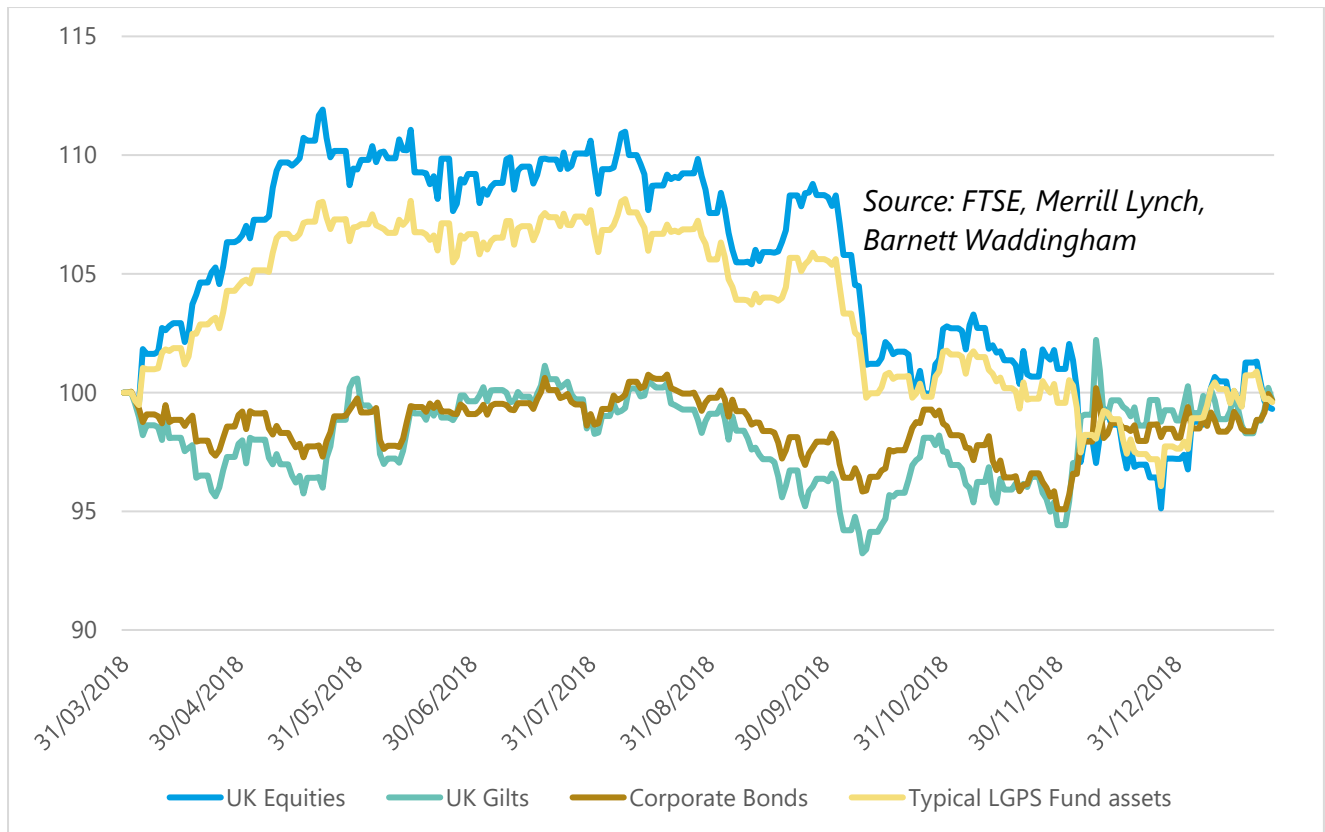
- What were asset returns for the twelve months to 31 March 2019?
- What were corporate bond yields as at 31 March 2019?
- What were market expectations of inflation as at 31 March 2019?

We appreciate that some of the terminology in this report may not be familiar and therefore we would recommend also reading our Glossary and FAQs document for a more detailed explanation on some of the jargon used here. This document has been circulated with this briefing note but please get in touch with the Fund if you would like a copy.

Please let your usual Barnett Waddingham contact know if you have any queries.

## Asset returns

The following chart plots returns from the major asset classes since 31 March 2019 alongside the return that would have been achieved by a Fund invested 75% in equities, 20% in corporate bonds and 5% in gilts.



Equity returns have been particularly volatile over the period to 25 January 2019 with the value of equities, increasing significantly during April and May before falling sharply in October and December.

Despite the value of gilts and corporate bonds also falling at some point over the period, the value of each of the three indices shown above are at similar levels, at 25 January 2019, to those at 31 March 2018.

Therefore, based on the allocation outlined above, a typical LGPS Fund might expect the value of fund assets at this date to be similar to those at the last accounting date, however, this could vary considerably depending on each Fund's investment strategy and net cashflow profile.

If Fund returns have been around this level, asset returns will have been lower than the discount rate assumed last year and this will have led to an actuarial loss on the assets, increasing the accounting deficit.

However, the overall position is also influenced by the effect of market movements on the assumptions used to place a value on the defined benefit obligation. This is discussed in the next section.

## Changes to accounting assumptions

The key financial assumptions required for determining the defined benefit obligation under either accounting standard are the discount rate, linked to corporate bond yields, and the rate of future inflation. These assumptions are discussed below.

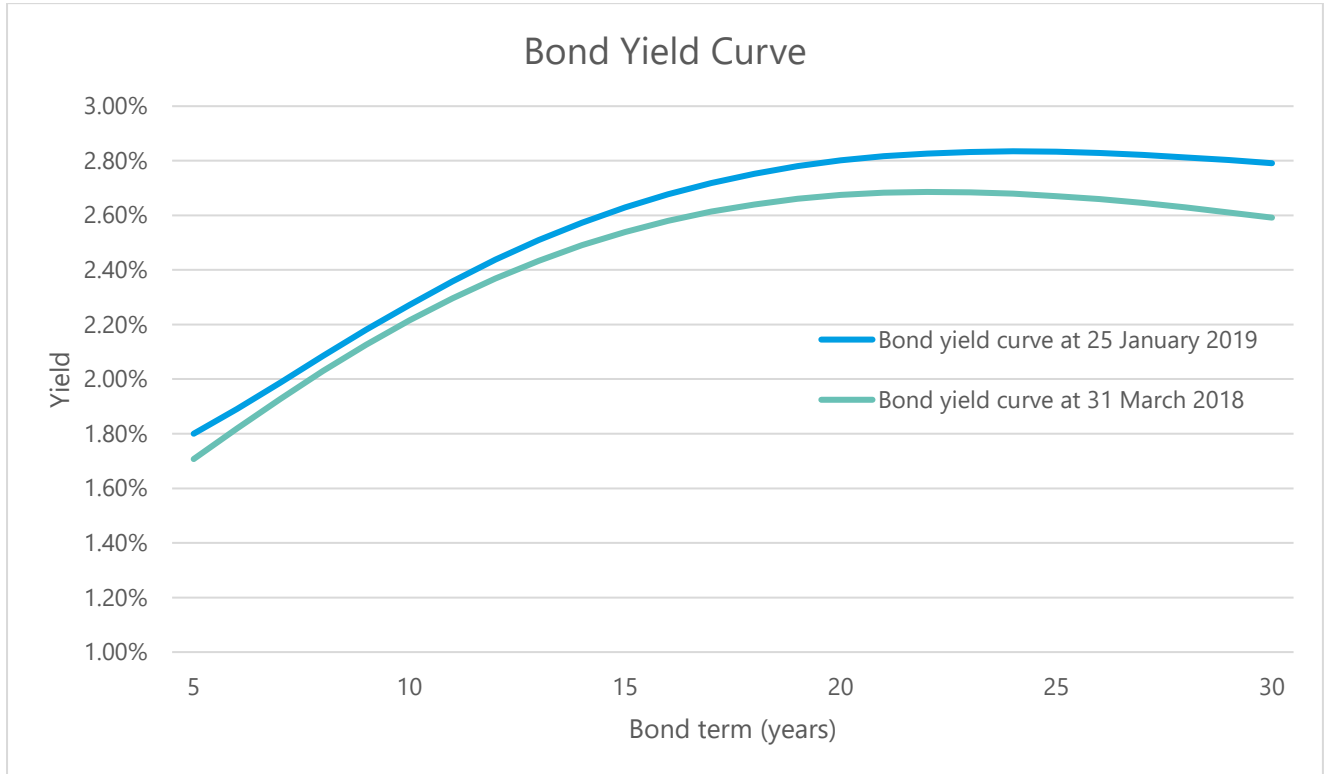
### Discount rate

Under both the FRS102 and IAS19 standards the discount rate should be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. The approach we adopted to derive the appropriate discount rate at the previous accounting date is known as the Single Equivalent Discount Rate (SEDR) methodology. We intend to adopt the same approach for assumptions used for accounting disclosures at 31 March 2019.

We use sample cashflows for employers at each duration year (from 2 to 30 years) and derive the single discount rate which results in the same liability value as that which would be determined using a full yield curve valuation (essentially each year's cashflows has a different discount rate). This discount rate is known as the SEDR. In carrying out this derivation we use the annualised Merrill Lynch AA rated corporate bond yield curve and assume the curve is flat beyond the 30 year point.

The standard assumptions set for an employer will be based on their individual duration. For example, an employer with an estimated liability duration of 13 years will adopt assumptions consistent with those derived using the 13 year cashflows.

The below graph shows the bond yield curve at the last accounting date along with the yield curve at 25 January 2019:



You will see that the bond yield at 25 January 2019 is higher than that at 31 March 2018 at all terms. As a result, the discount rate assumed would be higher at 25 January 2019 than at 31 March 2018. All else equal, this would result in a lower value being placed on the defined benefit obligation.

Sample SEDRs are set out in the table below based on market conditions at 25 January 2019:

Duration (years)	25 January 2019
10	2.50%
15	2.65%
20	2.70%
25	2.75%

Assumptions are rounded to the nearest 0.05%.

The below table sets out the estimated effect of the change in discount rate assumed based on the same sample durations:

Duration (years)	Estimated effect of change in discount rate on employer's liabilities
10	Decrease of 1%
15	Decrease of 2%
20	Decrease of 3%
25	Decrease of 4%

## Inflation expectations

Whilst the change in corporate bond yields is an important factor affecting the valuation of the liabilities, so too is the assumed level of future inflation as this determines the rate at which active members' CARE benefits and deferred and pensioner members' benefits increase.

IAS19 suggests that in assessing future levels of long-term inflation we should use assumptions that would result in a best estimate of the ultimate cost of providing benefits whilst also giving consideration to the gilt market (in line with general price levels) to give us an indication of market expectation. FRS102 simply refers to a best estimate of the financial variables used in the liability calculation.

### Retail Price Index (RPI) assumption

Similar to the SEDR approach described above we intend to adopt a Single Equivalent Inflation Rate (SEIR) approach in deriving an appropriate RPI assumption.

The SEIR adopted is such that the single assumed rate of inflation results in the same liability value (when discounted using the yield curve valuation described above) as that resulting from applying the BoE implied inflation curve. As above, the Merrill Lynch AA rated corporate bond yield curve is assumed to be flat beyond the 30 year point and the BoE implied inflation curve is assumed to be flat beyond the 40 year point.

Consistent with the SEDR approach, assumptions are rounded to the nearest 0.05% and we intend to use sample cashflows for employers at each duration year (from 2 to 30 years) in deriving the assumptions for employers.

Sample SEIRs are set out in the table below based on market conditions at 25 January 2019:

Duration (years)	25 January 2019
10	3.40%
15	3.40%
20	3.35%
25	3.30%

## Difference between RPI and CPI

Pension increases in the LGPS are expected to be based on the Consumer Prices Index (CPI) rather than RPI. As there is limited market information on CPI-linked assets, we take the implied RPI assumption outlined above and make an adjustment.

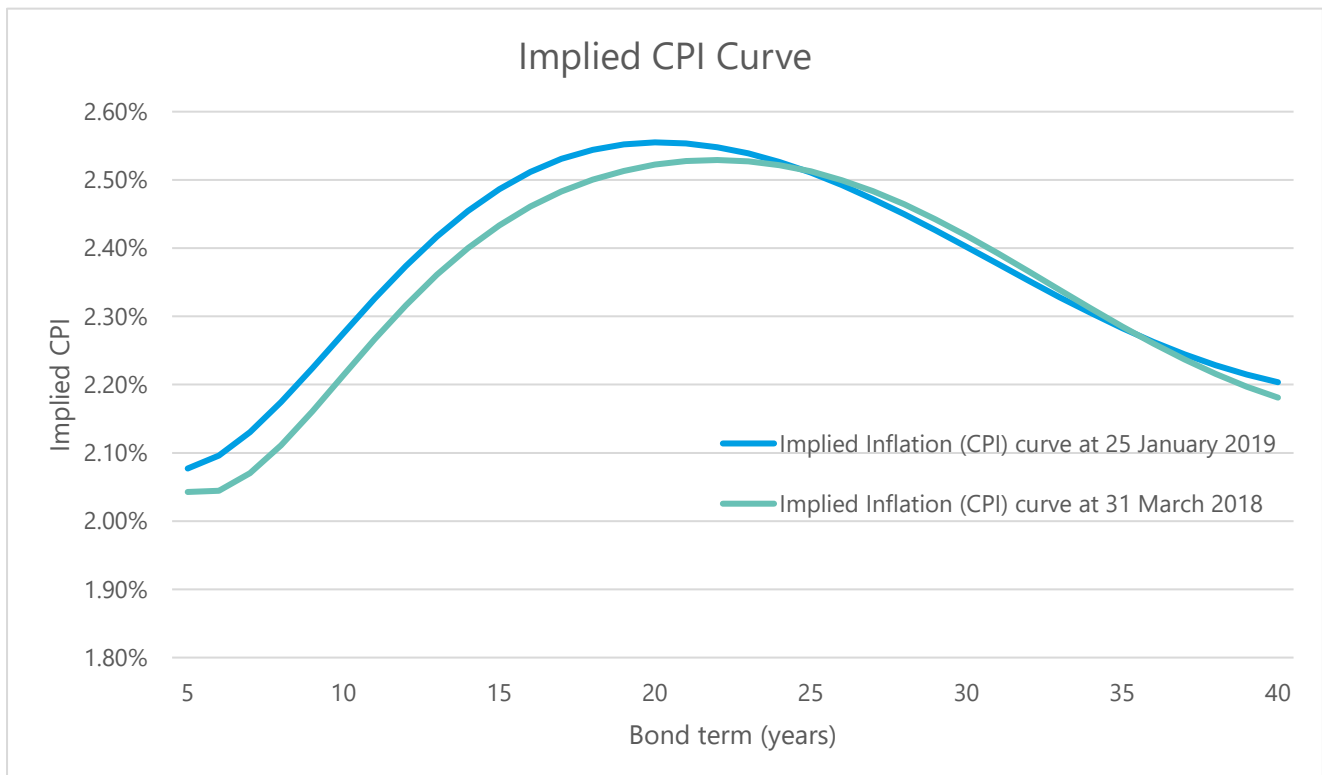
The difference between RPI and CPI can be split between the 'formula effect' and differences between the compositions of the two indices. The formula effect results from technical differences in the way the two indices are calculated so it is reasonable to assume it will be persistent, although the calculation methods will occasionally be updated. The formula effect means that RPI increases are usually expected to be higher than CPI.

The differences in composition of the two indices will mean that RPI and CPI are different for any given period but this is not necessarily biased one way or the other. For these reasons, we base our assumption for the difference between RPI and CPI on the formula effect only.

We have assumed that CPI inflation will, on average, be 1.0% lower than RPI. This is consistent with that assumed at the previous accounting date.

## Consumer Price Index (CPI) assumption

The resulting implied CPI curve at 25 January 2019 is shown below along with the implied CPI curve at the last accounting date for comparison:



As shown above, the implied CPI curve at 25 January 2019 is slightly higher than that at 31 March 2018 at earlier terms but very similar at later terms. As a result, expect the assumed level of pension increase to be slightly higher than or very similar to the previous year.



The below tables set out the assumed pension increase assumptions at sample durations, based on market conditions at 25 January 2019, as well as the estimated effects due to the change in the inflation assumption from last year's standard assumption to this year's:

Duration (years)	25 January 2019
10	2.40%
15	2.40%
20	2.35%
25	2.30%

Duration (years)	Estimated effect of change in inflation on employer's liabilities
10	No significant change
15	Increase of 1%
20	Increase of 1%
25	No significant change

Please note the CPI increase assumption at the 10 year duration is the same as at 15 year duration. This may not be the case for all durations between 10 and 15 years.

Due to the nature of SEDR and SEIR methodology, the assumptions derived are dependent on the sample cashflows used and as result different cashflows of similar liability durations may result in alternative assumptions. Therefore another actuary replicating the same approach set out above may derive different assumptions from those set out above. Reasonableness checks have been carried out on the cashflows used.

## Salary increases

Although future benefits are not linked to final salary, benefits accrued up to 31 March 2014 in England and to 31 March 2015 in Scotland will continue to be linked to the final salary of each individual member. Therefore we still need to set an appropriate long-term salary increase assumption.

For English Funds, we intend to use the salary increase assumption from the 2016 actuarial valuation. For all English Funds, this means assuming that salary increases are in line with CPI to 31 March 2020 then increases in line with CPI plus 1.5%. This is consistent with the approach adopted last year.

For Scottish Funds, we intend to use the salary increase assumption from the 2017 actuarial valuation. For all Scottish Funds, this means a single long-term salary increase assumption of CPI plus 1.0% with no short term adjustment.

This is the assumption that employers are most likely to request a specific assumption in line with their own expectations and we are happy to discuss this as required.

## Bespoke financial assumptions

As mentioned above, the responsibility for setting assumptions ultimately belongs to the employer and therefore if an employer was to request alternative assumptions then we would be happy to use these in producing our report. The approaches described above are the standard approaches we will adopt to derive financial assumptions, however, we are happy to advise individual employers on the range of assumptions they may be able to adopt.

As part of this advice we are able to provide employers with a deficit modeler which provides an indication of the impact of any changes to their accounting position.

If you would like more information on the options available to employers regarding bespoke assumptions please feel free to contact [publicsector@barnett-waddingham.co.uk](mailto:publicsector@barnett-waddingham.co.uk) or your usual Barnett Waddingham contact. However, please be aware that both requesting and receiving advice on bespoke assumptions will incur additional fees.

## Service accrued over the period

The change in employer's deficit will also be affected by the difference in the cost of benefits accrued over the period and the level of contributions paid by the employer and employees.

The service cost accrued over the year is based on the assumptions at the start of the period, i.e. at the previous accounting date. Employers' contributions may consist of contributions towards funding any deficit as well as funding the cost of benefits being accrued on an ongoing funding basis. These contributions are likely to have been calculated using different assumptions than under IAS19/FRS102 and may therefore differ from the service cost calculated for the period.

Depending on the membership profile of the employer; the cost of benefits accrued over and above the level of contributions paid may have a more significant effect on the level of deficit than the change in financial assumptions and investment performance.

## Overall expected results

### What does this all mean when we bring it all together?

The first caveat is that no employer is average and so any prediction of what might apply to an average employer will not apply to every, or possibly any employer.

The effect of the changes in the financial assumptions on an employer's liabilities are dependent on the assumptions adopted as well as the specific duration of the employer's liabilities. Typically employers with greater liability durations are more sensitive to changes in financial assumptions as benefits will be paid over a longer term. The table below describes the estimated effects for employers at liability durations of exactly 10, 15, 20 and 25 years: based on assumptions derived as at 25 January 2019:

Duration (years)	Estimated effect of change in financial assumptions rate on employer's liabilities
10	No significant change
15	Decrease of 1%
20	Decrease of 2%
25	Decrease of 4%

Based on market conditions at 25 January 2019, employers who receive reports at March would typically expect to see a small decrease in the value of the defined benefit obligation as a result of changes in assumptions. However, the value of liabilities will increase with interest accumulated over the year; offsetting any reduction in liability value from the change in assumptions.

Of course the impact on deficits will also depend on asset performance and overall funding position. As shown in the section above, based on market conditions to 25 January 2019 and the investment strategy of a 'Typical Fund', assets are expected to have increased at a rate lower than the level of interest on their deficit, thereby increasing the size of employers' deficits.

In addition, as mentioned above the change in employer's deficits will also be affected by the difference in the cost of benefits accrued over the period and the level of contributions paid by the employer and employees. For less mature employers, this may have a more significant effect on the level of deficit than the change in financial assumptions and investment performance.

## Brexit effect

### Market movements

It's difficult to predict how markets will change from now until the accounting date, to add to that unpredictability, the UK is scheduled to leave the European Union on 29 March 2019. Therefore, any market shock on or after that date is likely to affect accounting disclosures produced at 31 March 2019.

For this reason our usual caveat that 'analysis uses market statistics as at 25 January 2019 and it is likely that market conditions at 31 March 2019 will be different' applies more than ever.

### Auditor views

It should also be highlighted that auditors continue to look for greater accuracy in the roll forward approach used to calculate employers' results. This includes the approach used to determine each employer's share of fund assets at the accounting date.

Given the tight timescales for local authorities to submit their final accounts we appreciate that it is not always possible to wait until the final net asset statement at 31 March is available to begin producing accounting disclosures. As a result, we request details of the fund's assets at the most recent date available and, for the remaining period, we assume that returns are in line with relevant market indices.

Considering the expected volatility of markets around the accounting date, we expect the difference between the estimated value of fund assets and the actual final value will be placed under greater scrutiny by auditors.

In order to reduce the chance of having to revise any reports we recommend that employers engage with their auditors and the administering authority of the fund as early as possible to ensure they are comfortable with the information being used to calculate results.

## Appendix 1

### Adjustments to fees

The Fund will communicate fees to employers however we would like to make you aware that there may be additional fees if there are particular features or events for an employer which need to be taken into account.

As examples of this:

- where an employer chooses their own assumptions;
- if there are additional calculations to be carried out if a surplus is revealed;
- when there are any staff transfers/movements to allow for;
- if additional disclosures are required;
- an employer asks to receive their report by a particular deadline; or
- if auditors ask a significant number of queries following receipt of the report.

Please get in touch with the Fund for further information on fees.