

## FRS102/IAS19 Glossary and FAQs

The purpose of this note is to provide LGPS Fund employers and their advisers with some further explanatory details about the reports we produce in accordance with Financial Reporting Standard 102 (FRS102) and International Accounting Standard 19 (IAS19).

It is divided into a glossary of terms followed by some frequently asked questions.

A topical briefing note discussing assumptions and an indication of the likely trend in results is also issued after each of the main accounting dates. In contrast, this briefing note describes the fundamentals of the accounting standards and is only expected to be updated occasionally (e.g. when the standards change). Please get in touch if you would like a copy of any of these notes.

If you have any questions please get in touch with the Fund in the first instance.

### Background

Sponsors of defined benefit pension schemes are required to account for the cost of providing retirement benefits and reserve for any outstanding liabilities associated with the schemes they sponsor. They are also required to make certain disclosures about these schemes in the notes to their accounts.

FRS102 and IAS19 are accounting standards that set out the accounting treatment for retirement benefits. For UK listed companies and local authorities IAS19 applies; for other UK entities FRS102 applies. Companies with overseas parents may need to make disclosures under other standards.

A key feature of both standards is the requirement for liabilities to be valued with respect to yields on "high quality" corporate bonds.

The actual contribution rates required by employers for each Fund are calculated every three years following a triennial actuarial valuation. The last valuation of the English and Welsh funds was at 31 March 2013, with revised contribution rates coming into force from 1 April 2014. The Scottish funds completed valuations as at 31 March 2014 with revised contribution rates coming into force from 1 April 2015.

These contribution rates are calculated using assumptions agreed with the Fund set with reference to expected future investment returns of the Fund unlike the accounting standard which value the liabilities using solely the yields on corporate bonds.

Therefore, the contribution rates paid by employers are not affected by the accounting results.

## Glossary of terms

### Actuarial gains & losses

This item reflects the extent to which the movements of the assets and liabilities over the accounting year have not been exactly as assumed at the previous accounting date, and also the effect on the liabilities of changes to the assumptions used to value them.

The components of the actuarial loss on assets are:

- the difference between the actual investment return on the assets over the year, and the **interest on assets**, plus
- an experience item, if applicable.

The components of the actuarial loss on liabilities are:

- the effect of the change in assumptions used to value the liabilities compared to the previous year, plus
- an experience item, if applicable.

There is a requirement to split the change of assumptions into those of a financial nature (discount rate, assumed future inflation growth etc.) and those of a demographic nature (future mortality rates etc.).

For more details on experience items, please see the "Gains and Losses" section of the FAQs.

### Administration expenses

Both accounting standards require the administration expenses to be recognised when the administration services are provided and to be reported as a separate item in the Profit and Loss (P&L) statement.

### Contributions by employer including unfunded

This is all of the contributions paid by the employer to the Fund including the normal contributions for active members, contributions towards the deficit and any early retirement strain contributions. If **unfunded benefits** (usually pensions in payment) are paid through the Fund and are to be included in the accounting report, then payments in respect of **unfunded liabilities** are included here as well.

For more information on the inclusion of **unfunded benefits**, please see the "Do I need to include unfunded benefits on my balance sheet?" section of the FAQs.

### Current service cost

The **current service cost** represents the cost to the employer of the benefits earned by active members during the accounting year. This is added to the liabilities and is not the same figure as the employer contributions paid to meet these 'new' benefits. It is calculated using assumptions at the start of the accounting year which means that it is not a fixed percentage of payroll and it is expected to vary from year to year as assumptions change.

Under both standards this is a component of the **Service cost** in the P&L.

### Curtailment

These will typically be the FRS102/IAS19 equivalent of early retirement costs. The actual strain payments to the Fund are calculated by the administering authority using a different set of assumptions and so the calculation of this amount under FRS102/IAS19 is unlikely to be the same as the strain payment cash amounts.

Under both standards the loss on these is a component of the **Service cost** in the P&L.

## Discount rate

Pensions and lump sums will be paid at some point in the future and so a rate known as the **discount rate** is used to express these expected future payments as a single current value.

It is analogous to a rate of interest; to illustrate this, if we put £100 into a savings account today, it is expected to grow with interest every year to become a higher amount in the future. Similarly, if we are aiming to have £100 at a future date then we only need deposit a smaller amount now which will accumulate with interest to give £100 later.

A higher **discount rate** means that the future payments have a smaller value now i.e. a lower pension liability.

The accounting standards prescribe that the **discount rate** should be based on market yields at the reporting date of a 'high-quality corporate bond' of equivalent currency and **term** to the scheme liabilities.

## Duration

Please see definition of **term** below.

## Demographic assumptions

These are the assumptions used to generally provide estimates of the likelihood of benefits and contributions being paid and for how long. This consists of all the non-financial assumptions used to value the liabilities including the mortality assumptions (i.e. how long members are likely to live for), the rates of members retiring early and the rate at which members exchange pension for cash at retirement.

Demographic assumptions are generally consistent with those adopted for the most recent triennial valuation.

## Interest cost

Over the accounting year the existing pension benefits come closer to payment than they were at the start, and so the value of the liabilities increases as a year's worth of interest is added on. This forms part of the **net interest on defined liability** (in the P&L)

## Interest on assets

The expected return on assets has been replaced with an interest on assets item which is calculated with reference to the **discount rate**. It is therefore based solely on the expected returns on corporate bonds. This forms part of the **net interest on defined liability** (in the P&L)

## Net interest on defined liability

The accounting standards assume that assets increase in line with the **discount rate**. This is combined with the **interest cost** on liabilities to form the net interest on the defined liability which is a component of the P&L.

## Past service cost

Additional benefits granted during the accounting year give rise to a **past service cost**, for example, an employer decision to award additional service to a retiring employee.

Under both standards this is a component of the **Service cost** in the P&L.

## Present value of defined benefit obligations

This is also referred to as the past service liabilities. This is the value of the past service liabilities, calculated using service to the accounting date and allows for several assumptions such as future increases to salaries, future mortality rates, future inflation rates etc. The key assumption used to calculate these liabilities is the **discount rate**.

## Re-measurements

Re-measurements are recognised in Other Comprehensive Income and is effectively the total of the actuarial gains and losses from the changes in the assets and liabilities over the accounting period. This will include the investment return on the assets in excess of interest, change in assumptions (financial and demographic) as well as any experience adjustments. More detail about this is in the FAQ section.

## Service cost

Service cost is a component of the P&L and includes **current service cost**, **past service cost** and any actuarial gains or losses on **settlements** and **curtailments**.

## Settlement

A **settlement** will generally occur where there is a bulk transfer of members in to or out of the Fund or an employer's share of the Fund. The **settlement** loss or gain reflects the difference between transferred asset share, and the value of the transferred liabilities when calculated on an FRS102/IAS19 basis. The value will be different due to the different assumptions used to put a value on the bulk transfer and the assumptions used to put a value on the FRS102/IAS19 figures.

Under both standards this is a component of the **Service cost** in the P&L.

## Term

When we talk about the **term** of the liabilities we mean the average time to payment of benefits. This is used interchangeably with the **duration** of the liabilities.

## Unfunded benefits

**Unfunded benefits** are pensions arising from additional service awarded on a discretionary basis e.g. Compensatory Added Years (CAY) pensions. Such benefits are usually charged to the employer as they are paid. Other **unfunded benefits** include gratuities and enhanced teacher's pensions which are recharged to the employer, and pensions in respect of some other public sector pension schemes.

This is in contrast to funded pensions, which are paid for out of the assets of the Fund, and which the employer has responsibility for funding by paying contributions to the Fund.

## Frequently asked questions (FAQs)

### Balance sheet

#### How are my assets calculated?

The assets shown are an estimate of the employer's notional share of the total Fund assets at the accounting date. A full assessment of each employer's asset share is made at each triennial valuation. For interim FRS102/IAS19 reporting the approach is to take the asset share at the start of the accounting year and roll this forward to allow for the employer's own cashflows to and from the Fund during the year and actual (or estimated) Fund returns.

Thus, the employer's asset share is not a fixed percentage of the Fund and is expected to vary over time.

The assets will change from year to year and increase as more benefits are accrued within the Fund (and contributions are paid in to the Fund in respect of these benefits) and reduce as benefits are paid out of the Fund such as lump sums and pensions. The assets will of course also increase or reduce over the year depending on the investment returns received on the Fund over the year.

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#### What are the liabilities and how is their value calculated?

The liabilities are the promised benefit payments (e.g. pensions, lump sums) due in the future from the Fund to its members. The value of the liabilities is calculated using a set of assumptions including how these payments will increase over time both before and after retirement, how long they will be paid out for (i.e. how long each member is likely to live for) and the **discount rate** to apply to them to give a current value.

They will change from year to year and increase as more benefits are accrued within the Fund and reduce as benefits are paid out of the Fund. The liabilities may also increase or decrease as the assumptions used to calculate their value change. For example, if the **discount rate** assumption decreases, the liabilities will increase. Therefore, even if your assets have performed well, if the liabilities increase at a rate faster than the assets increase, then the deficit in the Fund will increase.

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#### Do I need to include unfunded benefits on my balance sheet?

**Unfunded benefits** may be paid through the Fund and immediately recharged to the employer so these pension payments are regarded for the purposes of FRS102/IAS19 as pension contributions.

FRS102 and IAS19 both state that all retirement benefits should be accounted for when the member earns the benefit and not when it is paid by an employer. Therefore when a member retires and is awarded **unfunded benefits** the value of all future payments must be taken into account at the point of retirement. However, **unfunded benefits** may be allowed for elsewhere in an employer's accounts and so care must be taken to ensure that there is no double counting these liabilities.

When asked to allow for these benefits we are provided with information about the unfunded pensioners being paid through the Fund and we will value these benefits in addition.

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## Assumptions

### What is the difference between assumptions for an ongoing funding valuation and an accounting valuation?

Contributions payable by employers are derived using the same assumptions as the ongoing funding valuation. As well as setting contributions, the purpose of the ongoing funding valuation (also referred to as the triennial valuation) is to review the financial position of the Fund. An accounting valuation is prepared to meet statutory disclosure requirements and is included in the employer's annual accounts.

These assumptions can be significantly different for reasons explained below.

The assumptions adopted for an ongoing funding valuation are set by the Fund Actuary following discussion with the administering authority and in line with the LGPS Regulations. Broadly, they are set based on the long-term expected cost of providing LGPS benefits and take account of the investment strategy of the Fund and the **expected return** on each asset class that the Fund invests in.

In contrast, FRS102 and IAS19 are fairly prescriptive accounting standards which aim to allow employers' pension obligations to be compared with each other.

The main area where funding valuations for our Funds and accounting valuations differ is in the derivation of the **discount rate**.

For ongoing valuations, the **discount rate** adopted is based on the expected investment return of the assets actually held by the Fund. For FRS102/IAS19, the **discount rate** is required to be determined with reference to the market yield on 'high quality' corporate bonds and with consideration of the **duration** of the employer's liabilities. Current market conditions are such that corporate bond yields are low compared to the ongoing funding assumptions and so in general, we would expect that employers' costs and liabilities under FRS102 / IAS19 to be higher than those calculated in an ongoing funding valuation. However, it is important to note that the accounting position has no bearing on the amounts that the employers actually pay into the Fund, this being determined with reference to the ongoing funding position.

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### Why is the inflation assumption different to current inflation levels?

The current level of inflation is a measure of how prices have increased in the recent past. However, in order to project cashflows to and from the Fund over the future lifetime of the Fund, we are interested in what inflation will do in the future and therefore we have to make an assumption about expected future levels of inflation over the long term. We do this by using information published by the Bank of England.

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### How much scope is there for 'tweaking' the assumptions?

One of the objectives of FRS102 and IAS19 is to ensure that organisations all account for pension costs on a consistent market-related basis so there is not a huge amount of scope to deviate away from typical market assumptions.

One key area in which the employer can exercise more control is the assumption about future levels of pay increases. There is no market indicator of this particular assumption but history tells us that in the longer term pay increases do tend to exceed price inflation – typically by 1-3% per annum.

We do provide a recommended set of assumptions but the employer is ultimately responsible for the assumptions that are adopted.

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## Pension costs

### Why is the current service cost different from the contributions paid?

Contributions are required from the employer to meet the cost of the benefits being earned by current employees, and to pay off any past service deficiency. Minimum contributions are certified when a new employer joins the Fund and then again at each triennial valuation. These certified contributions are calculated using assumptions made at each valuation and reflect, among other things, the return expected to be earned by the assets actually held by the Fund.

The **current service cost** in FRS102/IAS19 only includes the cost of benefits being earned by current employees and does not include the cost of paying off any past service deficit. The assumptions used for FRS102/IAS19 are usually different to those used for the triennial valuation. In particular, the **discount rate** is prescribed by FRS102/IAS19 and is unlikely to reflect the Fund's actual asset allocation. This means the **current service cost** calculated for FRS102/IAS19 is likely to be different to the cost covered by the certified minimum contributions.

In comparison, the employee contributions should be the same under the triennial valuation and the accounting valuation as these are set as a fixed rate of payroll.

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### What if the reported contributions paid are different to the actual contributions paid?

The discrepancy may be because cashflows for less than the full twelve months were provided in order to enable us to produce figures in the timescales required. This discrepancy could potentially affect almost every figure in the disclosures. We can revise the disclosure to take account of the actual contributions paid but we recommend that you agree with your auditor that this is necessary on the grounds of materiality. Generally, we would only expect the auditor to require this where the difference is relatively large or is because of significant strain on fund contributions being paid.

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## Gains and losses

### What is an experience gain or loss?

The first accounting report prepared following a triennial valuation includes an experience item. Accounting reports are prepared each year using a number of estimates and approximations in the roll-forward process on both the assets and the liabilities. This experience adjustment is essentially a correction of the estimates made in the previous accounting reports leading up to the triennial valuation.

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### What does actual less expected return on Fund assets mean?

This figure looks at how the assets at the start of the accounting period have changed before allowing for the experience adjustment. After taking off the expected return on assets figure (or interest on assets figure) you are left with the actual less expected return on Fund assets. This will generally be equal to the actuarial loss or gain on fund assets in a non-valuation year.

### Why is there an experience gain or loss on the assets?

To determine the employer asset share for an accounting report we are provided with cashflows e.g. contributions received and benefits paid and a total Fund value. These cashflows may only be for part of the accounting year, and the total Fund value may be at a date earlier than the accounting date. This total Fund value will not be a fully audited number and is unlikely to be exactly accurate. We pro rata the cashflows if necessary to get full year numbers, and roll forward the assets with market returns to get an estimate of the asset value as at the accounting date.

However, at a triennial valuation we do get full cashflow data for each intervaluation year and actual audited Fund asset values. We then determine each employer's asset share accurately at the triennial valuation date and the experience item emerges as the difference between the three years' worth of estimated rolled-forward assets and the accurate figure. At the triennial valuation we may also adjust employer assets if necessary to take into account any transfers or outsourcings that may not have been resolved in time to be included in the relevant accounting years.

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### Why is there an experience gain or loss on the liabilities?

To determine the value of the employer liabilities for an accounting report we roll forward the value of the liability calculated for the most recent valuation assuming that the experience of the members has been in line with the assumptions set out in the valuation. For example, at each valuation we make an assumption about the future mortality of the members and the rate at which their salaries increase and in the roll-forward process we continue to assume that these mortality assumptions are borne out in practice i.e. members die when they were assumed to and salaries increase at the rate they were assumed to.

At each triennial valuation we recalculate the liabilities for each employer using up to date membership data and assumptions. An experience item emerges as the difference between the actual experience of the members of the Fund, and the experience that had been assumed for them in the previous accounting reports. For example, if members die earlier than assumed or the employer increases salaries at a rate lower than assumed this will result in an **actuarial gain** as the liabilities will have reduced. On the other hand, if the pensions are increased at a higher rate than assumed, this will result in an actuarial loss.

Therefore, it is highly unlikely that your experience item would be zero following the completion of a triennial valuation.

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### What is the change in assumptions?

This shows the impact on the value of the liabilities of any changes in the financial and **demographic assumptions** since the previous accounting date. The financial assumptions are updated every year to allow for changes in market conditions. **Demographic assumptions** are generally updated once every three years during the triennial actuarial valuations of the Fund although some changes may be allowed for annually if it is considered material or if requested.