Pensions accounting under FRS 102

July 2018

TRAC DEVELOPMENT GROUP

Supporting and understanding financial sustainability

Pensions are by nature technical, and can be complex to understand. It is therefore necessary to consider the detail, in order to understand how the accounting approaches differ for different schemes. The schemes used by universities are not all treated the same way in the Transparent Approach to Costing (TRAC).

The purpose of this briefing note is to provide TRAC practitioners and members of higher education (HE) providers' internal TRAC oversight groups with background information and understanding on the accounting treatment of the different pension schemes that are used by universities in the UK.

1. Types of pension scheme benefits in the UK

In the UK, pension benefits provided by employers to employees are generally what are referred to as 'defined benefit' or 'defined contribution'. These terms refer to the form of the benefits an employee will receive at retirement.

Defined benefit pensions are determined based on a defined formula – often expressed as a rate of build up for each year of service, and linked to an employee's salary at retirement or over the life of their pension scheme membership. Both the employer and employee contribute towards benefits building up each year. If a deficit emerges between the accumulated funds in the pension scheme and the obligation to provide future benefits to members, additional contributions are required to make good the shortfall.

In a defined contribution scheme, it is the level of contributions that are defined, rather than the level of benefits that an employee will receive at retirement. An employer's obligations in respect of a defined contribution scheme are limited to the contribution rates due over a period, and no future deficit can emerge.

2. University pension schemes

The pension schemes typically used by universities to provide pension benefits to employees are:

- Defined contribution pension schemes:
  - In recent years a number of institutions have set up defined contribution schemes for groups of their staff in order to satisfy automatic enrolment duties and to provide access to retirement savings for individuals who may not have been eligible to join one of the HE sector's defined benefit pension schemes.
- Defined benefit pension schemes:
  - The **Universities Superannuation Scheme (USS)** is predominantly used for provision of pensions for academic staff employed at pre-1992 universities.
  - The **Superannuation Arrangements of the University of London (SAUL)** is used by a significant number of institutions, mostly linked to the University of London, for provision of pensions to staff.

- The **Teachers' Pension Scheme (TPS)** tends to be used by post-1992 universities in England and Wales for the provision of pensions for academic staff. A similar scheme – the **Scottish Teachers' Superannuation Scheme** – operates in Scotland.
- Pensions for academic staff and non-academic staff can also be provided through the **Local Government Pension Scheme (LGPS)**, most commonly used in post-1992 universities.
- A number of universities with medical staff participate in the **National Health Service Pension Scheme (NHSPS)**
- Some universities have also set up their own defined benefit pension schemes to provide benefits to employees. These are used by the individual university, and are not sector-wide schemes used by multiple universities.

3. FRS 102 Pensions accounting reporting obligations for universities

Universities are required to follow Financial Reporting Standard (FRS) 102 and the 'Statement of recommended practice: Accounting for further and higher education' (SORP), in preparing their financial statements. FRS 102 and the SORP require institutions to recognise an estimate of their pension obligations in their financial statements. This will be the costs incurred over the period in the income statement (for both defined benefit and defined contribution schemes) and a pension liability on the balance sheet for a defined benefit pension scheme.

The inclusion of a pension liability is to reflect an estimate of the obligations that the employer has to its pension scheme members as at the financial reporting period end. This estimate is usually prepared by an independent actuary, using a set of appropriate actuarial assumptions about demographic and financial variables.

In practice, the estimate of those obligations carried out for accounting purposes and disclosed in the financial statements has no direct relevance to the contributions that an employer is making, or will be required to make in the future, nor to its ultimate obligation to a defined benefit pension scheme.

Cash contributions and an employer's ultimate obligations are usually determined as part of a scheme's actuarial valuation, which is carried out every three years by the scheme's actuary. This is a completely separate process with a different purpose to the estimate for (annual) accounting.

3.1 Defined contribution pensions accounting

Defined contribution pensions accounting applies to employers providing defined contribution pensions to employees (but these schemes are not currently commonly in place in the HE sector).

This approach requires an employer to account for the cost of the contributions it has paid towards pensions over the period. An employer's liability is limited to the contribution rates it has agreed to pay over the period, and no future balance sheet deficit can build up. There is therefore no requirement for a net asset or liability to be disclosed in the employer's financial statements.

3.2 Defined benefit pensions accounting

Defined benefit pensions accounting applies to employers providing defined benefit pensions to employees.

This approach requires disclosure of the difference between the pension scheme assets and liabilities (known as the net pension asset or net pension liability), and the change in the balance over the reporting period. The cost of benefits built up, and any interest costs and administration expenses incurred over the period, must also be disclosed in the statement of comprehensive income.

Universities providing benefits through the LGPS or their own university defined benefit pension schemes are required to use defined benefit accounting when disclosing pension obligations in respect of these schemes in their financial statements.

3.3 Defined benefit pensions accounting: multi-employer exemption

Under certain circumstances employers participating in multi-employer schemes are able to apply the multi-employer exemption when disclosing their defined benefit pension's obligations in their financial statements. This exemption may apply where it is deemed that insufficient information is available to enable an employer providing defined benefit pensions within a multi-employer scheme to account on a defined benefit basis – for example where an employer cannot identify its share of underlying assets and liabilities.

Under the FRS 102 accounting standard, **USS, SAUL and TPS are each treated as 'multi-employer pension schemes' and so employers participating in these schemes apply the multi-employer exemption when disclosing pension obligations in respect of these schemes.**

Employers are not able to apply the exemption in respect of LGPS or university 'own schemes'.

3.3.1 Defined benefit pensions accounting: multi-employer exemption – USS and SAUL

USS and SAUL are funded pension schemes with contributions due in respect of any deficit arising. Contributions paid over the period in respect of benefits built up over the period, plus any contributions agreed to be paid in respect of a deficit revealed at the last actuarial valuation, will therefore need to be disclosed.

Employers report the present value of future contributions that they have signed up to at the reporting date on the balance sheet. This decreases over time as those contributions are paid, but can step up or down after a new agreement is made by the employer to pay contributions (e.g. following the triennial valuation of the scheme). Contributions paid over the period must also be disclosed in the statement of comprehensive income.

3.3.2 Defined benefit pensions accounting: multi-employer exemption – TPS

The TPS is an unfunded arrangement backed by the Government.

An employer providing benefits through the TPS will pay contributions in respect of benefits earnt by members to date, but typically there is no legal or constructive obligation to pay anything further in respect of current or prior service. This means that only contributions paid over the period in respect of benefits built up over the period need to be disclosed in staff costs in the Statement of Comprehensive Income. No provision is needed on the balance sheet.

This arrangement also applies to the NHSPS.

4 Key factors that impact pensions disclosures

4.1 Defined benefit standard approach (applicable for LGPS and university 'own' defined benefit schemes)

Under defined benefit pensions accounting, universities are required to report the following items, calculated by an actuary, using the approach specified in FRS 102:

- Net pension asset or liability (on the balance sheet) – the difference between the pension scheme assets and liabilities at the reporting date.
- Income and expenditure (reported in the Statement of Comprehensive Income) – comprised of the cost of benefits earned over the period, interest accrued on the net pension asset/deficit over the period, administration expenses incurred, and the impact of any special events over the period.
- Other comprehensive income – experience in relation to changes in the assumptions used to calculate the pension liabilities, scheme experience, and in relation to asset performance over the period.

The valuation of the liabilities is driven by several assumptions, most importantly the rate at which future pension scheme cash flows are discounted (the discount rate), which is set by the actuary with reference to corporate bond yields at the reporting date. The three components listed above are therefore very sensitive to change in corporate bond yields, and also to inflation – both of which are factors over which an employer has no control. As a result of this, it is common for employers reporting defined benefit pensions obligations on a defined benefit basis to experience volatile balance sheets, income and expenditure, and other comprehensive income charges from year to year.

The balance sheet position is also affected by the asset valuation at the reporting date – so any adverse or volatile movements close to the end of the reporting period can result in an increased deficit at the reporting date.

4.2 Multi-employer exemption approach (applicable for USS, SAUL and TPS)

Under the multi-employer exemption for defined benefit pensions accounting, employers are required to report the following items, determined using the approach set out in the FRS 102 standard:

- Net pension asset or liability (on the balance sheet) – the present value of agreed future deficit contributions at the reporting date

- Income and expenditure (reported in the Statement of Comprehensive Income) – the cash cost of benefits earned over the period, interest accrued on the pension liability over the period, any gain or loss arising from the change in discount rate over the period, administration expenses incurred over the year, and the impact of any changes to future contribution requirements.

- Other comprehensive income – not applicable.

Under this approach, there is no assessment of the (individual) employer's underlying assets and liabilities as there is for the standard defined benefit accounting approach. The balance sheet liability

is equal to the present value of agreed future deficit contributions. (This will be nil for TPS and NHSPS as they are unfunded schemes.)

Deficit contributions to be paid by the employer are calculated by the actuary at each valuation, based on the funding basis for that valuation. There may therefore be significant changes in the balance sheet liability every three years, following each actuarial valuation when a new schedule of contribution comes into effect. In the years between actuarial valuations, the balance sheet liability reduces for deficit contributions that have been paid since the last valuation.

Contribution rates are agreed following each actuarial valuation, and are generally fixed for a number of years. This means that institutions generally have reasonable foresight over expected costs, and therefore this element of income and expenditure charges, for three-yearly periods.

As noted above, interest on the balance sheet liability is calculated by the actuary using the discount rate set by reference to corporate bond yields. This component can therefore be volatile from year to year. The value of the deficit contributions is updated each period to reflect the discount rate at the reporting date and so this value is also sensitive to corporate bond yields.

5 Guidance for TRAC practitioners

There are several pension schemes used by university employers, and these schemes are not all treated the same way in TRAC. It is therefore important that the implications for TRAC of membership of different schemes are understood by TRAC practitioners and members of TRAC oversight groups. The key differences are set out below:

- ***USS and SAUL:*** The TRAC guidance requires that costs or credits attributable to the agreement of a deficit recovery plan for certain multi-employer defined benefit pension schemes, including USS and SAUL, are adjusted for in calculating TRAC full economic costs. This is to address a concern about the potential distorting effect of large charges (and potential credits) caused by triennial reassessment of multi-employer pension scheme recovery plans. This is addressed by replacing the financial accounting charges with the annual cash contributions (which include deficit contributions) to the pension scheme in question.
- ***Other defined benefit schemes including LGPS and university own:*** Employer contributions and interest charges relating to LGPS and university own defined benefit pension schemes (where it is possible for individual employers to identify their share of assets and liabilities and where there is no periodic recovery plan) should be included in staff costs and interest payable (if a cost), and interest receivable (if a credit).
- ***Defined contribution pension plans:*** Employer contributions to defined contribution pension plans (including certain institutions' own pension schemes) should be included in staff costs.
- ***TPS:*** Employer contributions to the TPS, Scottish Teachers' Superannuation Scheme and NHSPS should be included in staff costs. These unfunded multi-employer schemes are treated as defined contribution schemes for accounting purposes.

6 Sources of reference and assistance

There are further materials in the TRAC guidance which can be used to provide assistance on this subject[1].

The TRAC Support Unit is also a source of reference and assistance and can be reached on 0115 935 3400, trachelpdesk@kpmg.co.uk.

[1] See for example TRAC Guidance (v2.3), July 2018, paragraph 3.1.5.3a.