Appendix 2

HYMANS ROBERTSON

# Accounting Assumptions

## Take control early, it's your call!

From listening to LGPS employers, we understand the importance of the pension figures disclosed in your accounts. The figures disclosed can have a material impact on your ability to carry out your normal business function.

The pension figures, in both the balance sheet and revenue account, are heavily dependent on the choice of assumptions. Crucially, as directors of the organisation, it is your responsibility to set assumptions that reflect the characteristics of your organisation.

## Your options

### 1 Enhanced Service

For employers who wish to take control of the figures disclosed in their pension accounts, using the enhanced service would allow your organisation to:

- Receive provisional FRS102 / IAS19 figures in advance of the reporting date, giving an early indication of how your assets and obligations have developed and can also help inform the assumption setting exercise. Further, for Scottish employers in 2018, provisional figures would also capture the 'step-change' from the 2017 actuarial funding valuations. This 'step-change' experience item could have a significant positive or negative impact on your accounting balance sheet.
- Provide an employer specific assumptions paper covering the assumptions key to your organisation, what changes to assumptions could be made, and the impact on your accounting disclosures. This would be based on information you provide about future expected pay growth and recruitment plans.
- Arrange a face-to-face meeting (or a call) with an Actuary to discuss the accounting assumptions further and how these impact on your organisation's accounting figures. Engaging directly with the Actuary preparing your FRS102 / IAS19 report is typically more cost-effective than seeking third party advice.

### 2 Basic Service

For employers who are happy to adopt the default assumptions, appropriate for an average LGPS employer with your liability profile, we will prepare the standard accounting report for the standard fee.

If you would like to know more about our enhanced service, please click here
or speak to either Craig Alexander on 0141 566 7843 or Kameel Kapitan on 0141 566 7880.

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# Briefing note

Local Government FRS102 / IAS19 February 2018

> "You choose assumptions appropriate for your organisation"

As the actuary to the LGPS fund in which you participate, we provide a set of default accounting assumptions for a 'typical LGPS employer' which can be amended to be more appropriate for your organisation.

The accounting assumptions adopted are ultimately the responsibility of your organisation's directors (or equivalent) based on actuarial advice.

We therefore strongly recommend that you consider the suitability of the default assumptions to your specific organisation. It is up to you to determine how to proceed with the choice of assumptions given the relative importance of the LGPS accounting figures to your organisation's own circumstances.

The value placed on the liabilities for accounting purposes (the defined benefit obligation) is heavily dependent on the assumptions adopted. The assumptions you choose to adopt will drive:

1. your **accounting balance sheet at the year-end date**; and
2. your **profit and loss cost for the year following the year-end date.**

For example, adopting a lower salary increase assumption than our default assumption may better reflect your own organisation's forecasts. This change would lower the value placed on the defined benefit obligation (and improve the accounting balance sheet position).

If you wish to take control of your accounting disclosures, please get in touch with us as soon as possible.

The remainder of this briefing note sets out the rationale behind the setting of our default principal accounting assumptions. The approach to our default assumption setting applies to all accounting disclosures (unless otherwise stated). We have discussed this approach with the National Audit Office, Audit Scotland and Wales Audit Office who have not raised any concerns.

## Discount Rate

Both FRS102 and IAS19 state that the discount rate used to place a value on the liabilities should be determined by reference to market yields on high quality corporate bonds at the reporting date. In addition, the currency and term of the high quality corporate bonds used to set the discount rate should be consistent with the currency and term of the liabilities.

### Corporate bond yield curve

Government bond yield curves are updated and available on a daily basis from the Bank of England. It is therefore relatively easy to identify a spot yield on Government bonds at any duration and at any date. Unfortunately, a similarly accessible corporate bond yield curve is not so readily available.

We have adopted an approach to setting the discount rate whereby a “Hymans Robertson” corporate bond yield curve is constructed based on the constituents of the iBoxx AA corporate bond index.

#### Weighted average duration

The discount rate should reflect the ‘term’ of the benefit obligation. We have interpreted ‘term’ to be the weighted average duration of the benefit obligation. This is broadly defined as ‘*the weighted average time until payment of all expected future discounted cashflows, determined based on membership and the financial and demographic assumptions at a particular time’*. The shorter the duration, the more ‘mature’ the employer.

With increased divergence of LGPS employers, the weighted average durations of individual employers can be materially different. It is therefore not appropriate for all employers to adopt the same financial assumptions for accounting purposes. Our default assumption approach sets out 3 separate discount rates (and corresponding RPI/CPI inflation assumptions) for employers who fall into each duration category below:

| Weighted average duration at most recent actuarial valuation | Duration category |
|---|---|
| Less than 17 years | Short |
| Between 17 and 23 years | Medium |
| More than 23 years | Long |

## Retail Prices Inflation (RPI)

This assumption is typically derived from yields available on fixed interest and index linked government bonds, and should be consistent with the derivation of the discount rate.

We use a market implied inflation curve over a range of maturities. Cashflow weighted single RPI rates are derived from the market implied inflation curve that recognise the weighted average duration of each corresponding duration category defined above.

## Pension Increases (CPI)

The pension increase assumption is set in line with our default Consumer Prices Index (CPI) assumption. As a market in CPI linked bonds does not exist, we need to estimate the long term gap between RPI and CPI in order to derive a CPI assumption for accounting purposes.

Our default assumed RPI-CPI gap will be 1.0% p.a. (unchanged from the 2017 accounting exercise).

### Salary growth

Our default assumption for salary growth is set relative to the derived RPI/CPI assumption at the reporting date using the same methodology as the most recent actuarial funding valuation for the LGPS fund(s) in which you participate. Further details on the salary growth assumption can be found in the latest actuarial valuation reports available on each LGPS fund's website.

### Longevity assumptions

Our default longevity assumptions for the 2018 accounting exercise are in line with those adopted by your LGPS fund(s) for the most recent funding actuarial valuation.

### Other demographic assumptions

These include assumptions for commutation, withdrawal, ill-health early retirements, proportions of deaths leaving a dependant, etc.  We gathered data on recent experience of LGPS funds in order to set appropriate demographic assumptions for the most recent actuarial valuation.  Our default approach will be to use the same demographic assumptions for accounting purposes as at the most recent funding actuarial valuation. Collectively, these demographic assumptions are intended to be best estimate.

### Indicative default assumptions (based on market conditions as at 31 January 2018)

The following table shows our default financial assumptions at 31 January 2018, based on the above methodology.  Our default assumptions used for the 31 March 2017 exercise are also shown for comparison purposes.

Please note that bond yields can be particularly volatile and it is the observed bond yields at the actual year-end date that will be used to set our default assumptions. Therefore, the actual default assumptions could be significantly different from the indicative assumptions which are based on ***market conditions as at 31 January 2018***.

| Duration category | 31 March 2017 | | 31 January 2018 | |
|---|---|---|---|---|
| | Discount rate | RPI (CPI) | Discount rate | RPI (CPI) |
| Short | 2.5% | 3.4% (2.4%) | 2.6% | 3.5% (2.5%) |
| Medium | 2.6% | 3.4% (2.4%) | 2.7% | 3.5% (2.5%) |
| Long | 2.7% | 3.4% (2.4%) | 2.7% | 3.4% (2.4%) |