The asset ceiling: accounting for surpluses in the LGPS

This note provides information on how the asset ceiling applies when the accounting position shows a surplus.

Please note that this briefing provides an overview of general considerations and should not be taken as a recommendation for a particular course of action – please seek advice specific to your own particular circumstances.

For professional use only

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Surpluses, IFRIC14 and the asset ceiling

As interest rates have increased over recent periods, improvements in funding levels on the accounting basis may mean LGPS employers find themselves with an accounting surplus at the next balance sheet date.

While this is generally good news, it is not simply a case of recognising the full surplus – accounting standards only allow an asset to be recognised to the extent that the employer can gain economic benefit from that surplus.

Economic benefit can be gained in two ways – either via a refund, or via a reduction in future contributions. **This limit to the net asset is known as the "asset ceiling".**

It is a complex area of pensions accounting. IFRS (IAS19 and IFRIC14) are quite detailed, but UK GAAP (FRS102) is less definitive. This note raises some of the key issues that employers should consider.

Refund of surplus

Under IFRIC14, an employer's right to a refund must be *unconditional* and not depend on *uncertain future events not wholly within its control*. This is a high barrier. It will almost certainly not be met by Scheduled Bodies due to their ongoing participating in the LGPS. For other employers who may have an entitlement to an exit credit on cessation, their right to a refund can be subjective and may require legal interpretation of relevant documentation.

Under FRS102, the situation is less definitive. The right to a refund requires employers being *able to recover the surplus . . . through refunds from the plan*. This is potentially a lower barrier than IFRS.

The right to a refund, at the level required by each accounting standard, is subjective. It is for each employer to consider whether they wish to claim a right to a refund when recognising a surplus and set accounting policy accordingly. Our starting assumption is that employers will not have a right to a refund and cannot recognise an acccounting surplus via this route.

Reduction in future contributions

If an employer was able to pay primary contributions at a lower rate than the accounting service cost, this would be considered a reduction in contributions. The employer is gaining economic benefit from providing remuneration to staff in the form of pension accrual while paying less than the value of that accrual. In this way, economic benefit is obtained "in kind" even if an actual refund is not possible.

If the employer could cease primary contributions entirely, the value of the reduction in contributions would be the actuarial present value of the future service cost, for as long as employees would be expected to consider accruing benefits. For an employer expected to continue in the LGPS, admitting new employees, the period is indefinite. For an employer expected to cease at some point in the future, and/or no longer admitting new employees into the LGPS, a shorter period is appropriate.

For a scheduled body, our assumption is that accrual will continue indefinitely and we will use an actuarial function called a perpetuity when valuing future service. For employers expected to cease accrual at some point, we will use an annuity over an appropriate period.

The minimum funding requirement

In practice, an employer cannot cease contributions at the accounting date due to current and potential future funding commitments. Such contribution commitments are referred to in IFRIC14 as a *minimum funding requirement*.

In the LGPS, employers are bound by the current rates and adjustments certificate, and in the longer term by the ongoing expectation that contributions will be required under the regulations into the future. While there is an element of judgement on whether LGPS funding commitments constitute a *minimum funding requirement,* and hence a matter of accounting policy for the employer, there's a growing consensus among auditors that a *minimum funding requirement* does exist in the LGPS.

The economic benefit from a reduction in contributions therefore becomes the present value of the future service cost *minus* the present value of estimated primary contributions. The asset ceiling is set to this value. When carrying out this calculation, it is common practice to assume that primary contributions will continue into the future beyond the period of the rates and adjustments certificate, for the same period as used to value the future service cost.

One small detail is that for employers with a negative secondary rate, these can be deducted from the primary rate for the period over which they are expected to be in force.

Under FRS102, the *minimum funding requirement* is an IFRIC14 concept, so does not automatically apply. Employers therefore have more discretion on whether to value the economic benefit from a reduction in contributions as the gross service cost, or to deduct primary contributions as would be the case under IFRS.

It is for each employer to set accounting policy on whether a minimum funding requirement applies. Under UK GAAP, there is a genuine judgement to be made, but under IFRS it would be relatively unusual to assume one does not apply. Our starting assumption is that a minimum funding requirement applies under both IFRS and UK GAAP, and that it spans the full period of anticipated participation in the LGPS. We can consider other approaches if desired.

Additional liability from an onerous funding commitment

There is one further concept to consider. The good news for those reporting under UK GAAP is that it does not apply to FRS102, so this is purely an issue for those reporting under IFRS.

Employers with a funding deficit at the last valuation will likely be paying secondary contributions to make good the deficit over the recovery period. Under IFRS, there can therefore be a *minimum funding requirement* to make secondary contributions.

It is possible that these secondary contributions, once paid, lead to a future accounting surplus that will not be recognisable due to the asset ceiling. In such cases the requirement to make these contributions leads to an additional accounting liability.

This is referred to as an onerous funding commitment. The additional liability can either reduce the accounting net surplus or increase the net deficit to be shown on the balance sheet.

Due to the relative strength of the accounting assumptions vs the funding assumptions, it may be relatively unusual for this to apply in practice. However, we still need to carry out the calculation to determine this to be the case, since auditors will generally expect some analysis to show that there is no additional liability.

An element of judgement applies to the period over which the commitment to make secondary contributions extends. From an actuarial perspective, the remaining portion of the original deficit recovery period appears appropriate, although there are arguments for using a shorter period.

For employers reporting under IFRS, we will carry out a calculation of the potential additional liability from an onerous funding commitment. Our starting assumption is to include secondary contributions for the period they are assumed to remain in force.

This note raises some of the key issues to be considered when accounting for pension surpluses. If you need more information on any of the above topics, please contact your LGPS fund in the first instance who will liaise with Barnett Waddingham to provide you with the help and support you need.

The information is provided in our capacity as actuaries advising LGPS funds. We produce IAS19 and FRS102 and disclosures for employers participating in those funds. This note contains a broad overview of our understanding of the general considerations that apply when accounting for surpluses under the relevant standards. Each employer should consider their own particular circumstances.

BARNETT WADDINGHAM
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