

LAAP BULLETIN 89

The change from Retail Prices Index to Consumer Prices Index for pensions increases

April 2011

The Local Authority Accounting Panel issues LAAP Bulletins to assist practitioners with the application of the requirements of the Code of Practice on Local Authority Accounting, BVACOP and Prudential Code, and to provide advice on emerging or urgent accounting issues. Bulletins provide influential guidance that is intended to be best practice, but are not prescriptive and do not have the formal status of the Code, BVACOP or Prudential Code.

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Preface

1. This bulletin, and the opinions expressed therein, is solely intended to assist organisations that are subject to the CIPFA LAASAC Code of Practice on Local Authority Accounting in the UK to implement the requirements of UITF abstract 48 - *Accounting implications of the replacement of the retail prices index with the consumer prices index for retirement benefits*. The scope of this bulletin is limited to the accounting concept of a 'constructive obligation'. The commentary in this paper is limited to a consideration of the extent to which a constructive obligation to pay pension benefits based on RPI indexation may have arisen for the purposes of properly accounting for the substance of the change from RPI to CPI. No opinion is offered, intended or should be inferred as to the legal obligations of pension schemes which are set out in the relevant scheme legislation. Consideration of the legal obligations of pension schemes is outside the scope of this bulletin.

Background

2. In the UK budget statement on 22 June 2010 the Chancellor announced that with effect from 1 April 2011 public service pensions would be up-rated in line the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI).
3. The move from RPI to CPI-based pension uplift has implications for local government 2010/11 financial statements which are considered below.
4. In assessing these implications preparers should be aware that the Code 2010/11 paragraph 1.1.6 adopts the following hierarchy of standards:
 1. IFRS (IAS, IFRS, IFRIC SIC)
 2. IPSAS
 3. UK GAAP (SSAP, FRS, UITF).
5. The Code specifies the accounting requirements in section 6.4 'Post-Employment Benefits'. Neither IFRS nor IPSAS provide any specific guidance regarding the change from RPI to CPI.

UITF 48

6. In response to the proposed change in indexation arrangements the ASB has issued UITF (Urgent Issues Task Force) Abstract 48 on the implications of the changes under UK GAAP, principally as it affects the implementation of FRS 17 'Retirement Benefits'. UITF 48 identifies three key issues:
 - Whether there is a reduction in scheme liabilities
 - How the effect of any reduction should be presented
 - When the effect of any reduction should be recognised.
7. FRS 17 was generally intended to implement the requirements of IAS 19 Employee Benefits in respect of retirement benefits, and the Appendix to UITF 48 notes that entities applying IFRS may refer to UITF 48 as a source of guidance in developing an accounting policy. As mentioned above, the hierarchy of standards adopted by CIPFA/LASAAC in developing the Code includes UK GAAP where there is no international standard or interpretation. It follows that UITF 48 is relevant to local authorities, and the potential impact on the Code requirements are outlined below with reference to the UITF conclusions.

Existence of Reduction In Liabilities

8. UITF 48 paragraph 4 concludes “whether there is a reduction in Scheme liabilities depends on facts and circumstances”. This is regarded as being equally applicable to the Code requirements under IFRS and IPSAS. It should be noted that under the Code and IAS 19, liabilities can arise from constructive obligations as well as the legal terms of a pension scheme.
9. For local government this implies that consideration will need to be given to the specifics of each defined benefit scheme supported or operated by an employing authority, including:
 - Local Government Pension Scheme
 - Police Pension Scheme (new and old)
 - Fire Fighters’ Pension Scheme (new and old)
 - Teachers’ additional pension benefits.
10. Schemes accounted for as defined contribution schemes (such as the main Teachers’ Pension Scheme) are not considered to be affected since the employer’s obligation is limited to their contribution for the year.

Point of Recognition of Any Reduction in Liabilities

11. UITF 48 (paragraph 9) indicates that where it is deemed that a change in benefit has occurred:

“the past service cost should be recognised in the accounting period when any necessary consultations have been concluded or employees’ valid expectations have been changed. An entity may need to apply judgement in determining when employees’ expectations have been changed.”
12. Where it is considered that employee expectations have not been changed it should be noted that some form of additional disclosure surrounding future decisions that could significantly affect the pension liabilities would almost certainly be required under IFRS and the ‘true and fair view’ requirements.
13. UITF 48 (paragraph 10) indicates that where it is deemed that the actuarial assumptions have changed, the requirements of the standard will apply. IAS 19 (paragraph 77) states “Financial assumptions shall be based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled.” The UITF suggests that the ministerial statements to date would provide sufficient basis for such a change in actuarial assumptions.

Presentation of Any Reduction in Liabilities

14. Based on UITF 48 paragraph 5 any reduction in liabilities could potentially be recognised in the Comprehensive Income & Expenditure Statement in one of two ways:

EITHER:

in the ‘Surplus or Deficit on the Provision of Services – SDPS)’ where the reduction is regarded as a ‘change in benefit’. This presentation would present the move to a CPI basis as a reduction in earned retirement benefits (negative past service cost).

OR:

in ‘Other Comprehensive Income and Expenditure’ within ‘actuarial gains or losses on pension assets and liabilities’ where the reduction in liability is treated as

resulting from a change in assumption. This presentation would therefore suggest that the previous assumption that future benefit payments would be uplifted by RPI was incorrect.

15. It should be noted that neither presentation would be expected to impact immediately on the General Fund nor Housing Revenue Account balances in local authorities. This is because the amounts do not form part of actual contributions made in the period, which form the basis for the statutory charges made against the General Fund and HRA balances. Admitted bodies may not, however, be in the same position. Authorities should be aware that if the change is accounted for as a change in benefits, this might impact on the 'bottom line' within an authority's group accounts, where other group entities are admitted bodies within the pension fund, but are not classed as local authorities and therefore do not replace the IAS 19/FRS 17 charges with the statutory charges.
16. It is anticipated that the actuarial report for 2010/11 will reflect the appropriate presentation, and that no accounting entries beyond reflecting the actuarial report will be required.

Change in benefit or change in assumption?

17. UITF 48 (paragraphs 6 & 7) indicates that treatment as a change in benefit would occur where the obligation is to pay pension increases based on RPI. This may occur due to the explicit terms of the scheme rules (which is outside the scope of this bulletin) or where a constructive obligation has arisen. UITF (paragraph 6) states "An employer's public statement or past practice gives rise to a constructive obligation where the entity has created a valid expectation that it will pay certain employee benefits."
18. Where no obligation to base pension increases on RPI has been established the UITF concludes that the change to CPI would represent a change in actuarial assumptions.

Application of UITF in local authority context

19. UITF 48 sets out three possible ways in which an obligation or constructive obligation to pay pension increases based on RPI might arise:
 - Where the scheme rules state that indexation will be based on RPI (this scenario is outside the scope of this bulletin)
 - Where past actions might have given rise to valid expectations that pension increases would be based on RPI
 - Where past statements might have given rise to valid expectations that pension increases would be based on RPI.
20. In order to assess whether the change from RPI to CPI is treated as a change in benefits or a change in assumption (based on the second and third scenarios above), CIPFA has considered whether a constructive obligation to pay benefit increases in line with RPI has arisen. This bulletin expresses no opinion on whether the scheme rules give rise to an obligation to pay benefit increases in line with RPI (the first scenario).

Constructive obligation – past events

21. There may be an argument that, after decades of pension increase being based upon RPI, index-linking and RPI-linking may be seen as one and the same and thus create an expectation that this would continue. This not only applies to public sector

22. However RPI is only one measure of inflation and whilst it may, for a considerable period of time, have been chosen as the “preferred measure” of inflation, this implies that the use of RPI-based indexation was based on an assumption that RPI indexation was sufficient to maintain purchasing power in the face of price inflation. As with all assumptions, they are subject to change and in 2003 the government adopted CPI as the new preferred measure of inflation.
23. Therefore taken on its own it is debatable whether this expectation, however valid, is sufficiently strong to imply a constructive obligation to continue the use of RPI-based pensions increases.
24. On balance, CIPFA does not believe that past use of RPI is, in itself, conclusive evidence that a constructive obligation exists. LAAP however accepts that it would be possible to come to a different view based on the fact that pension increases based on RPI continued for a number of years after CPI became the preferred measure of inflation.

Constructive obligation – past statements

25. The strongest case as to whether a constructive obligation exists lies in the extent to which the “promise” of RPI-based indexation has been communicated by government to pension scheme administrators (and by extension by scheme administrators to pension scheme members).
26. The relationship between administrator and member is such that the member may build up expectations based on the material they are provided with. If such materials refer widely to RPI, the member therefore takes the view that RPI-based indexation can be expected. This applies not only to pensioners but also to deferred pensioners and active members.
27. The fact that the pension schemes found in local, police and fire authorities are national schemes, albeit administered locally, means that government pronouncements could create a legitimate expectation and give rise to a constructive obligation.

CIPFA INTERPRETATION

28. CIPFA has formed the view that:

where there is evidence that there has been pervasive and consistent reference to RPI-based pensions increases in scheme communications between government and scheme administrators or in general and personal communications between, scheme administrators and scheme members, taken together with expectations based on past events,

then a constructive obligation may have arisen.

29. Despite the decentralised nature of the administration of the LGPS, Police and Fire schemes, these are national schemes, and national literature for employees whilst explaining benefits would have been protected against cost of living increases may have referred to that increase being based on RPI¹.

¹ See for example the changes made to [“A Guide to the Local Government Pension Scheme for Employees in England and Wales”](#) which included references to RPI alongside the wording cost of living increase prior to the

30. In addition, guidance to employers from the government (such as the explanatory memorandum referred to above) also referred to RPI. This guidance would have been considered by the various Pension Committees, which generally include union or other staff representatives, and may have been communicated, at least indirectly, to employees, and could therefore give rise to a constructive obligation.
31. **CIPFA has therefore concluded that on balance there is sufficient cause to conclude that, across all schemes, there may be a presumption that a constructive obligation will have arisen and should therefore be accounted for as a change in benefit.**
32. Ultimately however the choice of accounting treatment is a matter for individual preparers. Authorities may, if they wish, chose to challenge the presumption that the change from RPI to CPI constitutes a change in benefit and account for the change as a change in assumption. However in order to successfully do so they will need to demonstrate that, for example, locally produced pension information is and was consistently worded in such a way as to ensure employees could not reasonably infer an expectation that future rises would be based on RPI.

Actions for authorities

33. Individual accounts preparers should take the above into consideration when forming a judgment on how the matter should be treated in their accounts.

Measurement, presentation and disclosure

34. It is likely that the actuary will have anticipated the appropriate presentation in the actuarial report for 2010/11 (refer to paragraph 16 above). However, if an authority disagrees with this presentation, it will need to liaise with their actuary to ensure that the impact of the change from RPI to CPI is consistent with the authority's view and is therefore correctly classified in the IAS 19/FRS17 reports.
35. In addition, given the one-off nature of this change, preparers should also append a suitable narrative disclosure note to the post-employment benefits assets and liabilities reconciliation. Suggested wording is given below:

- a. Where the reduction in liabilities is recognised as a past service gain**
(i.e. due to the explicit terms of the scheme (which is outside the scope of this bulletin) or where a constructive obligation is considered to exist)

"In the UK budget statement on 22 June 2010 the Chancellor announced that with effect from 1 April 2011 public service pensions would be up-rated in line with the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI).

This has the effect of reducing xxxxxxx authority's liabilities in xxxxxx Pension Fund by £xxxxxx and has been recognised as a past service gain in accordance with guidance set down in UITF Abstract 48, since the change is considered to be a change in benefit entitlement. There is no impact upon the General Fund [or Housing Revenue Account]."

- b. Where the reduction in liabilities is recognised as an actuarial gain**
(i.e. there are no explicit terms of the scheme in relation to indexation and there is no constructive obligation)

announcement in June 2010. But the disclaimer to that guide makes clear that members must rely on the regulations not the guide and the LGPS does not contain any reference to the index to be used.

"In the UK budget statement on 22 June 2010 the Chancellor announced that with effect from 1 April 2011 public service pensions would be up-rated in line with the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI).

This has the effect of reducing xxxxxxx authority's liabilities in xxxxxx Pension Fund by £xxxxxx and has been recognised as an actuarial gain in accordance with guidance set down in UITF Abstract 48 since the change is regarded as an adjustment to the actuarial assumptions previously used to estimate the liability. There is no impact upon the General Fund [or Housing Revenue Account]."