KPMG

cutting through complexity

CIPFA Pensions Network – Technical Update

Accounting and Regulatory Developments

February 2014

Agenda
Accounting developments

- IFRS 9 Financial Instruments
- Changes to the Pensions SORP
- LG Code developments
- The Pensions Regulator

Project Overview

- IFRS 9 will replace IAS 39 but the effective date has not yet been finalised by the IASB
- The IASB began this project in November 2008 and structured it in three phases
  - Phase 1 – Classification and measurement of financial assets and financial liabilities
  - Phase 2 – Impairment
  - Phase 3 – Hedge accounting
- This presentation will include a brief overview of Phases 1 and 2

IFRS 9 Financial instruments
Status

- IFRS 9 *Financial Instruments* issued in 2009
- Amended in 2010
- Exposure draft issued in November 2012 on limited amendments to the classification and measurement requirements of IFRS 9 (the C&M ED)
- IASB plans to issue a final standard in the second quarter of 2014
- Who knows when the standard will be adopted by the EU

Measurement of financial assets

- There are two primary measurement categories for financial assets under IFRS 9
  - Amortised cost
  - Fair value through profit and loss (FVTFL)
- Proposals in C&M ED introduce a third mandatory measurement category (FVOCI) – designed to integrate proposals with project on insurance contracts

Measurement of financial assets

- A financial asset is measured at amortised cost if both the following conditions are met:
  - The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
  - The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest.
- A financial asset shall be measured at fair value through other comprehensive income (FVOCI) if both of the following conditions are met:
  - The asset is held in a business model in which assets are managed both in order to collect contractual cash flows **and for sale.**
  - The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding
- Remaining assets are measured at fair value through profit or loss (FVTPL)

Embedded derivatives

- Host contract is a financial asset within the scope of IFRS 9
  - Embedded derivatives are not separated
  - Hybrid financial instrument is assessed as a whole for classification under IFRS 9
- Host contract is not a financial asset within the scope of IFRS 9 (a financial liability or non-financial host contract)
  - contracts are assessed to determine whether the embedded derivative is required to be separated from the host using the same guidance as in IAS 39

Reclassification

- Classification is determined on initial recognition
- Reclassification of financial assets between amortised cost and FVTPI is made only on a change in an entity’s business model that is significant to its operations
  - This should be rare
  - IFRS 7 sets out disclosure requirements
- Reclassification into and out of FVOCI will also be covered by the disclosure and presentation requirements of IFRS 7
- Judgements made by management in classifying and reclassifying financial assets will be added to IAS 1 as examples of the significant judgements that need to be disclosed in the accounts

Measurement of financial assets

- IFRS 9 provides guidance on the limited circumstances in which the cost of unquoted equity investments may be an appropriate approximation of fair value
- The circumstances will not apply to pension funds
- Pension fund investments will continue to be measured at fair value (the IFRS 9 equivalent of FVTPL)
- Fair value will continue to mean market value for marketable securities (current bid price)

Impairment of financial assets

- In March 2013 the IASB issued an Impairment ED
- ‘Incurred loss model’ in IAS 39 delays the recognition of credit losses until a credit loss event occurs
- ED proposes an ‘expected credit loss’ model
- Applies to financial assets held at amortised cost and at FVOCI
- It will not apply to financial assets measured at fair value in the accounts of pension funds as expected credit losses will already be factored into the market value of the assets at the balance sheet date.

Impairment of financial assets

- The proposals in the ED will provide information about changes in the credit quality of financial instruments. In particular, the main proposals require an entity to distinguish between:
  - financial instruments that have not deteriorated significantly in credit quality since initial recognition or that have low credit risk (for example, that are 'investment grade') at the reporting date - for these items, 12-month expected credit losses are recognised; and
  - (b) financial instruments that have deteriorated significantly in credit quality since initial recognition (unless they have low credit risk at the reporting date) - for these items, lifetime expected credit losses are recognised.
- ED proposes significant additional disclosures about credit risk
- ASB plans to issue a final standard in the second quarter of 2014

Changes to the Pensions SORP

Investment disclosures

Investment disclosures

FRS 102 requirements

FRS 102 requirements

- Assets at end of period suitably classified
- Information that enables users to evaluate significance of financial instruments for its financial position and performance
- Disaggregation of the net assets by class of financial instrument. Class = grouping of financial instruments. Takes into account the characteristics of those financial instruments

Audited Accounts Regulations disclosure requirements

Equities

Bonds

- Fixed interest public sector
- Fixed interest other
- Index linked

Property

Pooled investment vehicles

- Unit trusts property
- Unit trusts other
- Managed funds property
- Managed funds other

Company operating fund registered in UK/not registered in UK

Analyse all between:

- Quoted/unquoted
- UK/overseas

PRAG liaising with DWP to see if regulations can be amended

SORP recommendations

Net asset statement

Class =

Equities

Bonds

Property

Pooled investment vehicles

Derivatives

AVC investments

Notes to accounts

Analysis of pooled investment vehicles:

Equities

Bonds

Hedge funds

Private equity

Infrastructure

Impact on LG Code

- The breakdown of investment assets in the Net Assets Statement is currently based on the Pensions SORP/Audited Accounts Regulations
- Any changes to the Pensions SORP are likely to find their way into the LG Code
- Revised SORP will be issued later in 2014
- LG Code may change from 2015/16

Changes to the Pensions SORP

Fair value determination

FRS 102 valuation hierarchy

Category A	Quoted price for identical asset in active market, normally bid price
Category B	Recent transaction for identical asset (adjusted if appropriate)
Category C	Valuation technique based on arms length exchange motivated by normal business transaction

Note disclosure required by FRS 102

Note disclosure required by FRS 102				
	Category			
£000	A	B	C	Total
Equities	x	-	-	xx
Bonds	x	x	x	xx
Pooled investment vehicles	-	x	x	xx
Property	-	-	x	xx
Derivatives	x	-	x	-
Total	xx	xx	xx	xx

Current disclosure under the LG Code is at the level of financial assets and financial liabilities with financial assets broken down into those valued at FVTPL and loans and receivables held at amortised cost.

Fair value determination
Category A

FRS 102 definition:

Quoted price in an active market... Quoted prices are readily available and those prices represent actual and regularly occurring market transaction on an arms length basis.

Typical category A investments

- Listed securities – equities/bonds
- Pooled investment vehicles priced and traded daily

Fair value determination
Category B

FRS 102 definition:

Price of a recent transaction for an identical asset... As long as there has not been a significant change in economic circumstances or significant lapse of time since the transaction took place. Adjust if not good estimate of fair value.

Typical category B investments

- Quoted securities with infrequent trades e.g. bonds
- Weekly/monthly priced pooled investment arrangements – property funds hedge funds

Fair value determination
Category A/B examples

Segregated positions

Consider 31 March 2013/5 April 2013 year ends

	Friday **29 March**	Saturday **30 March**	Sunday **31 March**	Monday **1 April**	Tuesday **2 April**	Wednesday **3 April**	Thursday **4 April**	Friday **5 April**
31 March Quoted Securities	**Price at close**		**Reporting date** **Category B**					
5 April Quoted Securities								**Price at close** **Reporting date** **Category A**

SORP to reference category A to ‘Business Day’.

Fair value determination
Category C

FRS 102 definition:

Estimate of value using a valuation technique... To estimate what the transaction price would be... In an arms length exchange motivated by normal business considerations.

Typical category C investments

- Bonds valued using broker quotes/evaluated prices
- OTC derivatives
- Property
- PIV’s – Private equity/infrastructure/hedge funds
- Insurance policies
- SPV’s
- Longevity swaps

Comparison with IFRS/other UK reporting

IFRS 13	FRS 102/Pension DRAFT SORP	FRS 102/IMA DRAFT SORP
Level 1 ■ Quoted prices	**Category A** ■ Quoted prices	**Category A** ■ Quoted prices
Level 2 Observable inputs other than quoted prices ■ Property ■ OTC derivatives ■ Unquoted bonds	**Category B** ■ Recent quoted prices	**Category B** ■ Recent quoted prices
	Category C ■ Valuation technique – Property – OTC derivatives – Bonds	**Category C(i)** ■ Valuation technique – observable inputs – Property – OTC derivatives – Bonds
Level 3 ■ Unobservable inputs ■ Private equity	– Private equity	**Category C(ii)** ■ Valuation technique – unobservable inputs ■ Private equity

LG Code Developments

Key developments

- Minor changes to section of LG code dealing with LGPS accounting in 2013/14
- Revisions to IAS 19 are implemented in 2013/14 and covered in a separate session
- IFRS 13 *Fair Value Measurement* will be relevant to pension funds accounting under IAS 26
- Sets rules for measuring fair value wherever a standard refers to it
- Implementation of IFRS 13 has been delayed whilst the Treasury works out the implications for the valuation of certain classes of property assets
- Impact on measurement of pension fund investments is unlikely to be earth-shaking

The Pensions Regulator

Impact of Regulation

The Pensions Regulator

- has a defined set of statutory objectives
- has wide powers to investigate schemes and take action where necessary
- takes a proactive, risk-focused approach to regulation
- provides practical support for the regulated community
- will be regulating the LGPS and other government schemes from 1 April 2015

The Pensions Regulator
Powers

- The powers of TPR fall into three broad categories:
  - Investigating schemes: how it gathers information to identify and monitor risks
  - Putting things right: what it can do where problems have been identified
  - Acting against avoidance: how it ensures that employers do not avoid their pension obligations
- TPR has already reviewed the major public sector schemes it will be regulating and has concluded that:
  - the LGPS is generally well run
  - The administration of the unfunded Police and Fire Fighters Schemes could be improved

Risk assessment

- When assessing a scheme's level of risk, TPR consider two factors:
  - How likely is it that an event will occur which will affect the security of members' benefits?
  - What would be the impact of the event, given the nature, size and status of the scheme and the employer?
- LGPS is likely to be low risk and the degree of regulation will reflect this

The Pensions Regulator
Providing support

- TPR has a range of powers to tackle problems in pension schemes, but they intend to use these sparingly
- TPR looks to:
  - encourage high standards in running schemes;
  - identify, anticipate and prevent problems; and
  - concentrate on achieving successful outcomes.

The Pensions Regulator
Codes of Practice

- TPR has produced codes of practice to give practical guidelines on how to comply with legal requirements.
- The codes set out the standards of conduct and practice expected of those involved in running and providing pension schemes.
- The standards reflect how a well-run pension scheme would choose to meet the relevant requirements
- Codes will be developed for the LGPS

Code of practice on internal control

- This code sets out the regulator's expectations of how occupational pension schemes should satisfy the legal requirement to have adequate internal controls in place.
- The ultimate responsibility to establish and operate internal controls rests with the trustees.
- The code provides a high level, risk based approach which trustees may wish to follow when assessing the adequacy of their internal controls environment.
- A risk based approach enables trustees to focus on the key risks requiring adequate internal controls.

Thank you

Presentation by Greg McIntosh

Director , KPMG LLP

Directorate of Professional Practice

cutting through complexity

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.