Pension scheme accounts: Problem areas and solutions

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Abstract This paper examines the statutory and accounting profession's requirements in Great Britain for pension scheme annual accounts. It also examines the accounting problems arising from additional voluntary contributions and their assets, the presentation of accounts with both final salary and money purchase sections, and the treatment of policies. The paper concludes with a summary of the requirements of the Occupational Pensions Regulatory Authority, Opra.

Keywords: *Pensions Act; audited accounts; Opra; scheme accounts formats*

Introduction

The Pensions Act 1995¹ has introduced a more complex regulatory regime for pension scheme accounting and auditing. Under the 1986 Disclosure Regulations,² the trustees of approved schemes and those seeking approval were, with a few exceptions, required to obtain audited accounts. The exceptions were:

- unfunded schemes
- public service pension schemes and
- schemes with fewer than two members.

Under the regulations issued under the Pensions Act, the requirements have become more complex and the exemptions have been extended.

The Pensions Act requirements for audited accounts

The regulatory requirements are now contained in several sets of regulations.

Content of the audited accounts

The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996 (the Audited Accounts Regulations)³ deal with the contents of the accounts and the reporting requirements and deal with the definition of an 'earmarked scheme' and the exemption for such schemes. Accounts must be obtained within seven months of the scheme year end and failure to comply is a criminal offence.

Requirement to obtain audited accounts

The requirement to obtain audited accounts features in several sets of regulations as well as the Pensions Act itself. The rules on scheme accounts in connection with a minimum funding valuation are contained in the Occupational Pension Schemes (Minimum Funding Requirement and

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Actuarial Valuations) Regulations 1996 (the Minimum Funding Regulations).⁴ Where a claim is made for compensation, audited accounts are also effectively required under the Occupational Pension Schemes (Pensions Compensation Provisions) Regulations 1997.⁵

The Occupational Pension Schemes (Scheme Administration) Regulations 1996⁶ set out the exemptions from the requirement to appoint an auditor (and hence the need to obtain statutory accounts) and deal with the appointment of the auditor, and the auditor's qualifications and independence. They also deal with the rights of the auditor to obtain information about the scheme.

Disclosure of the audited accounts

The requirement to provide audited accounts to the scheme members, prospective members and trade unions is contained within the Occupational Pension Schemes (Disclosure of Information) Regulations 1996 (the Disclosure Regulations).⁷ While there are no filing requirements, the Occupational Pensions Regulatory Authority (Opra) has the right to call for audited accounts.

The Pensions Act exemptions

There are several exemptions from the requirement to produce audited accounts each year, including:

- schemes with only one member
- schemes providing only death benefits
- most money purchase small self-administered schemes (SSASs) (see below)
- unfunded schemes
- public service and statutory schemes
- earmarked schemes
- funded unapproved retirement benefits schemes (FURBS).

Even though these statutory exemptions exist, the scheme's trust deed and rules may continue to require the production of audited accounts or scheme accounts, and often trustees request accounts to be prepared and audited each year.

Statutory accounts required

Statutory accounts are required for schemes not falling into the above exemptions:

- final salary schemes
- money purchase schemes
- insured schemes unless 'earmarked'
- schemes in winding up
- certain SSASs.

Earmarked schemes

Such schemes are defined as 'an occupational pension scheme under which all the benefits other than death benefits are money purchase benefits and all the benefits are secured by one or more policies of insurance or annuity contracts and such policies or contracts are specifically allocated to the provision of benefits for individual members or any other person who has a right to benefits under the scheme'. The trustees of such schemes have only to obtain an auditors' statement on contributions. However, this is subject to the same seven-month deadline as the production of audited accounts.

It is very important to obtain confirmation from the insurer that the scheme is earmarked, both to provide comfort to the trustees that they are fulfilling their statutory responsibilities and to provide suitable evidence for the scheme auditors.

SSASs

The position of SSASs is more complex.

A money purchase SSAS is exempt from appointing a scheme auditor under the legislation if:

- all the members are trustees and
- all decisions are made only by the trustees who are members of the scheme by unanimous agreement (disregarding the pensioner trustee).

However, the trust deeds of many SSASs do require an audit. In such circumstances, the Scheme Administration Regulations require the trustees to appoint their auditor as a professional adviser (with the exception of SSASs with only one member) in accordance with the prescribed procedures, even though the audit is not a statutory one. In these circumstances, the auditor has a right but not a duty to report to Opra. An ICAEW Technical Release, 97/17,⁸ goes into these requirements in some detail.

Scheme accounts formats

The Statement of Recommended Practice (SORP), 'Financial Reports of Pension Schemes', July 1996,⁹ was developed by the Pensions Research Accountants Group (PRAG). SORPs are intended to give guidance on the application of accounting standards to the accounts of particular industries and sectors. In the UK, SORPs are produced by industry bodies which are themselves approved by the Accounting Standards Board (ASB) for the purpose of the production and issue of SORPs. The pension scheme SORP applies to all accounting periods ending on or after 6th April, 1997, so all schemes should have now adopted it. There have been a few cases of non-compliance where schemes have wound up and trustees have decided that changing formats for one period only was not justifiable.

Where this has been the case, the notes to the accounts have included the reasons for the departure as required by the Audited Accounts Regulations. See Tables 3, 4, 5 and 6 for examples of formats.

Meeting deadlines

Bearing in mind the fact that a breach of the seven-month deadline for the production of the audited accounts and the preparation of the auditors' statement on contributions is a criminal offence, it is critical to ensure that they are produced within the specified time limit.

There are many reasons for failure by trustees to obtain audited accounts on a timely basis, including:

- trustees not being aware of the need to produce an annual report and accounts
- trustees not properly informed and even misinformed of the nature of the requirements in relation to their scheme
- trustees failing to instruct their auditors and administrators, expecting to have the annual report presented to them for signature without any effort or input on their part
- scheme accounts not ready for audit at the time the auditors come in to do the work
- auditors called in late
- no trustee available to sign off the report and accounts because they are all on holiday or abroad.

It is vitally important to plan the production of the accounts, with a planning meeting if possible to set deadlines for each stage, such as:

- the date by which the accounts have to be ready for audit
- the timetable for the audit

- the co-ordination of the production of the rest of the annual report and the relevant deadlines for this
- the dates of the audit committee/trustees' meeting at which the draft annual report is to be discussed and agreed
- the arrangements for the signing of the reports and accounts by the trustees and the auditors.

Liaison between all parties involved — trustees, investment managers, insurers, administrators and auditors — needs to be considered. The extent to which this takes place will clearly depend on the size and complexity of the scheme, but to ensure that the statutory deadline is met, trustees should take an active interest. This can be achieved by nominating an audit committee to oversee the process, which is the process that some schemes adopt, or by nominating a trustee to 'progress chase'.

Accounting problem areas

Additional voluntary contributions (AVCs)

Where AVCs purchase additional years of service, the related assets have always been part of the asset pool of a final salary scheme, so the comments below address money purchase AVCs. The SORP expects all money purchase assets, including those relating to AVCs, to be included in the net assets of the scheme. However, this is a new accounting policy for most schemes, and many have found compliance difficult because the figures are not readily available to them. Many trustees have relied on the insurance companies and building societies running the AVC arrangements to provide the annual statements and handle the record keeping. Many of the providers have not maintained their

records on a scheme-by-scheme basis, so that when trustees ask for the data relating to their members, the AVC provider has often been unable to provide them on a timely basis.

The statutory exemption

There is a statutory exemption, an amendment to the Audited Accounts Regulations which was introduced by the Occupational Pension Schemes (Miscellaneous Amendments) Regulations 1997 (SI 1997 No. 786),¹⁰ which states:

'Where the assets —

- (a) are invested only for the purposes of securing additional money purchase benefits derived from voluntary contributions . . . and
- (b) are specifically allocated to the provision of additional benefits for particular members or other persons in respect of particular members (or both)

a note that paragraphs (a) and (b) apply must be included in the statement [of net assets], but that entry need not include the market value or an estimate of the value of those assets.'

This means that if the scheme trustees do not include the information on the money purchase AVCs as required by the SORP, there is no statutory qualification.

Certain insurance companies have not provided the information required within the deadline. While trustees may wish to wait until the information is obtained in order to ensure compliance with the SORP, because of the statutory exemption, this is not an excuse to use for departing from the seven-month deadline.

Materiality and prior year adjustments

A change of accounting policy, such as taking AVC assets into account for the first time, requires a prior year adjustment. In practice, many schemes

have taken advantage of the statutory exemption and omitted AVCs, also using the immateriality argument, as paragraph 1.2 of the SORP states that the provisions of the SORP need not be applied to immaterial items. If the amount of AVCs is material, the auditors may qualify their audit report on the grounds of non-compliance with the SORP in relation to a material item meaning that the accounts do not show a true and fair view.

Where AVCs were included for the first time and the amounts were immaterial (and particularly where it has been difficult to establish the comparative figures for the previous year), a number of schemes have not put through a prior year adjustment, but have shown the introduction of AVC investments into the accounts as a 'reserves' movement.

Trustees with money purchase AVC arrangements (and trustees of money purchase insured schemes) are advised to write to their insurer(s) to obtain accounting information in advance of their financial year end, specifying the date to and as at which details of contributions and investments are required. If a request is made after the year end, a lengthy reconciliation process may be required as leavers since the year end are often not included in the listings and new joiners are.

Multiple benefit schemes

Schemes which have multiple benefit structures, that is, both a final salary and a money purchase section, are becoming much more common, as many employers are shifting towards money purchase pension provision, and many final salary schemes are opening up money purchase sections in their existing scheme, as an alternative to setting up a completely separate money purchase scheme.

The SORP offers a choice of

presentation in scheme accounts, the deciding factor between the two being the relative size of each section. If one section is relatively immaterial, the standard format for a final salary scheme can be used and an extra note to the accounts added to disclose that proportion of the total investments which belongs to the money purchase members. If both sections are material, then the SORP recommends a columnar format for the fund account, which shows all income, expenditure and returns on investments for both sections, with a total column, and the assets of each section separately disclosed in the net assets statement (see Tables 1 and 2).

There have been relatively few accounting problems encountered in such schemes. If the employer has a contribution holiday, his contributions are effectively paid by a transfer from the final salary to the money purchase section (though the legality of such a procedure is currently being questioned). A suggestion to cope with this is to show below returns on investments a line showing 'transfer of funds in lieu of contributions'. If the number of members in a new money purchase section is material but the amounts of money are not, it may be appropriate to split the money purchase section in the fund account rather than simply referring to the money purchase section in the notes to the accounts; this approach may be more meaningful from the members' perspective.

Insurance policies

Money purchase insurance policies

Under the 1986 Disclosure Regulations, the policies of such schemes were dealt with 'off balance sheet'; the costs of policies were treated as the expense of discharging the liability to pay benefits.

Table 1: Multiple benefits scheme

Fund Account — Illustration					
	Note	Defined benefit section £'000s	1996 Defined contribution section £'000s	Total £'000s	1995 £'000s
Contributions and Benefits					
Contributions receivable					
Transfers in					
Other income					
Benefits payable					
Other payments					
Administrative expenses					
Net additions (withdrawals) from dealing with members					
Returns on investments					
Investment income					
Change in market value of investments					
Investment management expenses					
Net returns on investments					
Net increase (decrease) in the fund during the year					
Net assets of the scheme					
At 1st January, 1996					
Transfer between Sections					
At 31st December, 1996					

The accounting treatment was to show the receipt of the contributions and matching payment to the insurance company. The accounts of money purchase insured schemes therefore showed only current assets and liabilities in the net assets statement.

The SORP states that where trustees have in effect discharged their full liability to members by purchasing matching policies, that advantage be taken of the concession in the schedule to the Audited Accounts Regulations. This states:

‘Where the assets include insurance policies which are specifically allocated to the provision of benefits for, and which provide

all the benefits payable under the scheme to, particular members or other persons in respect of particular members or both, those policies must be included in the statement and there must be a note of the existence of such policies but that entry need not include their market value or an estimate.’

The SORP gives the example of annuities purchased to cover pensions in payment. Some accountants believe that such policies include earmarked policies and that where accounts are prepared for earmarked schemes, the policies should be included at nil value; as before, the acquisition costs of such policies should be treated in the fund account as the cost of discharging the liability under the

Table 2: Multiple benefits scheme

Net Assets Statement — Illustration	Note	1996 £'000s	1995 £'000s
Defined Benefits Section			
Investments			
Fixed interest securities			
Equities			
Index-linked securities			
Managed and unitised funds			
Properties			
Cash deposits			
Other			
Current assets and liabilities			
Defined Contribution Section			
Investments			
Managed funds			
Current assets and liabilities			
Net assets of the scheme at 31st December, 1996			

scheme to the relevant members. Accounts drawn up on this basis include a note which explains the existence of such policies and their accounting treatment. (As noted above, the Audited Accounts Regulations state that the requirement to produce audited accounts does not apply to earmarked schemes so if the scheme's assets comprise an earmarked policy or policies, only the auditor's statement on contributions is required unless the deed and rules require audited accounts.)

However, not all accountants subscribe to this view and are of the opinion that the SORP recommendation applies only to annuities bought for deferred and pensioner members. There is thus a divergence of interpretation.

Final salary insurance policies

The SORP recommends that for unit-linked policies, surrender value may be the most appropriate value and for policies where there is an underlying guarantee, actuarial value may be used.

Problems are starting to arise in practice with the introduction of minimum funding valuations. The MFR Regulations require actuaries to value insurance policies at surrender value for the purposes of a minimum funding valuation, and it has become apparent that many actuaries are providing only this value to the trustees. As scheme accounts are required to be prepared on a going concern basis, the use of surrender value for policies which are not unit linked is seen by accountants and auditors as inappropriate unless the scheme is winding up. A number of auditors may qualify the pension scheme accounts if the surrender value is included, so trustees should ask for the valuation of such policies on the bases recommended in the SORP.

Understanding Opra's requirements

The seven-month deadline for audited accounts is important to Opra, and

trustees and their auditors are expected to report failures. The auditor has to report, irrespective of whether the trustees themselves have reported, as Opra Note 1 and the professional guidance in Practice Note 15 issued by the Auditing Practices Board, 'The audit of Occupational Pension Schemes in the United Kingdom', require him to do so.

Most audit firms prefer to write separate letters to Opra rather than joint ones, so that the auditors' views are put to Opra independently.

In the Opra bulletin of November 1998, John Hayes stated that during the first year of the Pensions Act, Opra was prepared to take a lenient and pragmatic approach, with a priority of achieving compliance rather than to sanction as a matter of course.

However, trustees who are late a second time without reasonable excuse should not expect the same lenience.

He also included some advice for auditors and asked that their reports to Opra 'should include the reason for the delay in producing the audited accounts, together with copies of any correspondence with the trustees which

indicate that they believe they have a reasonable excuse. We will also need the details about the pension scheme which we ask for in our standard scheme information form.'

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References

- 1 The Pensions Act 1995.
- 2 The Occupational Pensions Schemes (Disclosure of Information) Regulations 1986, SI 1986 No. 1046.
- 3 The Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996, SI 1996 No. 1975.
- 4 The Occupational Pensions Schemes (Minimum Funding Requirement and Actuarial Valuations) Regulations 1996, SI 1996 No. 1536.
- 5 The Occupational Pension Schemes (Pensions Compensation Provisions) Regulations 1997, SI 1997 No. 665.
- 6 The Occupational Pension Schemes (Scheme Administration) Regulations 1996, SI 1996 No. 1715.
- 7 The Occupational Pension Schemes (Disclosure of Information) Regulations 1996, SI 1996 No. 1655.
- 8 Technical Release 97/17 Small Self-Administered Schemes and the Pensions Act 1995, The Institute of Chartered Accountants in England & Wales 1997.
- 9 Financial Reports of Pension Schemes — A Statement of Recommended Practice, Pensions Research Accountants Group 1996.
- 10 The Occupational Pension Schemes (Miscellaneous Amendments) Regulations 1997, SI 1997 No. 786.

Appendix

Table 3: Defined contribution scheme

Fund account	Note	1998 £'000s	1997 £'000s
Contributions and Benefits			
Contributions receivable	3	276	302
Transfers in	4	33	34
Other income	5	11	180
		<u>320</u>	<u>516</u>
Benefits payable	6	–	177
Leavers	7	63	55
Other payments	8	47	44
Administrative expenses	9	18	22
		<u>128</u>	<u>298</u>
Net additions from dealings with members		<u>192</u>	<u>218</u>
Returns on investments			
Investment income	10	13	10
Change in market value of investments	11	805	(210)
Investment management expenses		(7)	(5)
Net returns on investments		<u>811</u>	<u>(205)</u>
Net increase in the fund during the year		1,003	13
Net assets of the scheme at 1st January, 1998		<u>4,461</u>	<u>4,448</u>
At 31st December, 1998		<u>5,464</u>	<u>4,461</u>

Table 4: Defined contribution scheme

Net Assets Statement	Note	1998 £'000s	1997 £'000s
Assets not designated to members			
Investments			
Managed funds	10	239	204
Current assets and liabilities			
Bank balances		5	4
Debtors and prepayments	11	2	3
Creditors and accruals		(6)	(8)
		<u>240</u>	<u>203</u>
Assets designated to members			
Investments			
Managed funds	10	5,205	4,240
Debtors and prepayments		19	18
		<u>5,224</u>	<u>4,258</u>
Net assets of the scheme at 31st December, 1998		<u>5,464</u>	<u>4,461</u>

Table 5: Defined benefit scheme

Fund account	Note	1998 £'000s	1997 £'000s
Contributions and Benefits			
Contributions receivable	3	3,879	2,937
Transfers in	4	244	6,693
Other income	5	596	33
		4,719	9,663
Benefits payable	6	5,193	3,950
Leavers	7	8,603	312
Other payments	8	69	53
Administrative expenses	9	321	425
		14,186	4,740
Net additions (withdrawals) from dealings with members		(9,467)	4,923
Returns on investments			
Investment income	10	5,435	5,263
Change in market value of investments	11	17,309	10,324
Investment management expenses	12	(282)	(288)
Net returns on investments		22,462	15,299
Net increase in the fund during the year		12,995	20,222
Net assets of the scheme			
At 1st January, 1998		96,467	76,245
At 31st December, 1998		109,462	96,467

Table 6: Defined benefit scheme

Net Assets Statement	Note	1998 £'000s	1997 £'000s
Investments	10		
Fixed interest securities		10,467	8,111
Equities		78,222	69,549
Index-linked securities		2,003	1,563
Managed and unitised funds		6,176	8,736
Properties		4,281	5,443
Cash deposits		250	–
Other		4,818	1,456
AVC investments		3,266	3,062
		109,483	97,920
Borrowings	13	–	(1,639)
		109,483	96,281
Current assets and liabilities	14	(21)	186
Net assets of the scheme at 31st December, 1998		109,462	96,467