THE INSTITUTE OF ACTUARIES OF AUSTRALIA
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GUIDANCE NOTE 454
AAS 25- *"ACCRUED BENEFITS"* UNDER DEFINED BENEFIT SUPERANNUATION FUNDS

APPLICATION

Actuaries who are required to calculate *Accrued Benefits* for a defined benefit superannuation fund for the purposes of Australian Accounting Standard AAS 25 (Financial Reporting by Superannuation Plans).

LEGISLATION/AUTHORITY

This Guidance Note should be read in conjunction with Australian Accounting Standard AAS 25 and Accounting Guidance Release AAG 13 (Determination of Discount Rates for Measuring Certain Liabilities at Present Value).

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CLASSIFICATION

Compliance with the provisions of this Guidance Note is mandatory.

1. INTRODUCTION

1.1 Australian Accounting Standard AAS 25 was issued by the Australian Accounting Research Foundation (AARF) on 29 August 1990. Revised versions were issued in May 1992 and March 1993.

1.2 Terms used in this Guidance Note are as defined in paragraph 10 of AAS 25.

1.3 AAS 25 requires that defined benefit superannuation funds must at least triennially, and in certain circumstances annually, disclose the value of *Accrued Benefits* in the fund's accounts. The purpose of this Guidance Note is to provide guidance to actuaries who are required for the purposes of AAS 25 to calculate *Accrued Benefits* for a defined benefit fund. Note that the AAS 25 definition of a defined benefit fund encompasses funds of a mixed defined benefit/defined contribution nature.

1.4 AAS 25 also requires disclosure of either:

(a) *"the benefits which have accrued since the last measurement date"* (by funds which elect to prepare statements of net assets in the form described in paragraph 60 of AAS 25), or

(b) *"the amount of benefit expense that has been accrued during the reporting period"* (by funds which elect to report in the format described in paragraph 62 of AAS 25).

1.5 For defined benefit funds AAS 25 defines *Accrued Benefits* in a way which equates to what an actuary would normally describe as the present value of accrued benefits, or the *actuarial value of accrued benefits* determined in accordance with Professional Standard 402. In this Guidance Note *Accrued Benefits* relates to the AAS 25 definition, while *accrued benefits* relates to the normal actuarial meaning of the term, which is commonplace in the superannuation industry, used in the Occupational Superannuation Standards Regulations and described in Professional Standard 402.

1.6 AAS 25 defines *superannuation plan* as *"an arrangement whereby it is agreed, between trustees and* *employers, employees or self-employed persons, that benefits be provided upon the retirement of plan members or upon their resignation, death, disablement or other specified event(s)".* While this definition appears to include, for example, stand-alone employment arrangements providing for payment or supplementation of superannuation-type benefits, it is understood that the definition is intended to be read less broadly than this. The intention is to require *"consolidated"* financial statements to be prepared only for multiple superannuation arrangements which cover substantially the same group of members.

1.7 Application of AAS 25 became mandatory for reporting periods ending on or after 30 June 1992. However, its use was encouraged for earlier reporting periods.

2. REPORTING FORMAT

2.1 There are two alternative formats for reporting under AAS 25.

(a) The Institute's Preferred Approach

Under this approach, covered by paragraphs 60 and 61 of AAS 25, the *Accrued Benefits* figure is reported in notes to the accounts of the fund and need only be measured each time an actuarial review is conducted.

(b) The Alternative Approach

Under the alternative approach, covered by paragraph 62 of AAS 25, the *Accrued Benefits* figure

(i) must be calculated at the end of each reporting period,

(ii) is actually contained within a Statement of Financial Position, and

(iii) is used in the determination of the excess of Assets over Liabilities (or vice versa).

2.2 For private sector superannuation funds, the Institute has very strong misgivings about the recording of the *actuarial value of accrued benefits* within a fund's Statement of Financial Position because:

(a) it could be widely misinterpreted by fund members and other parties and it has the potential to be used in an inappropriate context, and

(b) the trustees have no powers to deliver *"performance"* in respect of liabilities exceeding fund assets.

2.3 For these reasons, actuaries should seek to persuade the trustees and the fund's auditor that the Institute's preferred approach should be used, except where the alternative is clearly applicable and will not mislead users of the accounts. For example, the alternative approach might be suitable for some public sector funds or other funds where there is an obligation undertaken by the employer to guarantee promised benefits. Where, in the actuary's opinion, the alternative approach is used in inappropriate circumstances, the action referred to in paragraph 6.5 of this Guidance Note should be taken.

3. APPORTIONMENT OF BENEFITS BETWEEN PAST AND FUTURE MEMBERSHIP

3.1 The actuary is free to determine a reasonable basis for apportioning benefits between past and future membership, subject to the requirements of Professional Standard 402 (PS402).

3.2 The actuary should indicate which of the methods described in PS402 has been used to determine *accrued benefits.* If the actuary adopts a basis other than one described in PS402, then the actuary must describe the basis used and the reason for using it.

4. CALCULATION OF *ACCRUED BENEFITS*

4.1 Paragraph 50 of AAS 25 states that:

"Accrued Benefits of a defined benefit fund shall be measured, except where the transitional provisions set out in paragraph 74 are applied, using actuarial assumptions and valuations where appropriate, as the present value of expected future payments arising from membership of the plan up to the measurement date. The present value of expected future benefit payments shall be determined by discounting the gross benefit payments at a current, market-determined, risk-adjusted discount rate appropriate to the plan".

<u>Transitional Basis</u>

4.2 Paragraph 74 of AAS 25 states that for reporting periods ending on or before 30 June 1995, the amount of *Accrued Benefits* as calculated at the date of the last actuarial review (using the assumptions and methods adopted in that review) may be reported in the fund's accounts, as an alternative to calculating *Accrued Benefits* in accordance with the assumptions required under paragraph 50. The assumptions adopted in the last actuarial report will therefore be appropriate, notwithstanding paragraph 50.

4.3 The actuary is free to use the exemption contained in paragraph 74 of AAS 25 for reporting periods up to those ending on 30 June 1995, but once the actuary uses the assumptions indicated in the definition contained in paragraph 50, it would not be appropriate to adopt the paragraph 74 exemption for later reporting periods. Where this exemption is used, *the actuarial statement for AAS 25* (refer to paragraph 6.2(f) and (g)), should indicate that assumptions and methods consistent with the last actuarial review have been used. In such cases it is not necessary to disclose the weighted average term of the liabilities.

<u>Discount Rates</u>

4.4 The wording adopted in relation to the interest rate assumption in AAS 25 (quoted in paragraph 4.1 above) is *"current, market-determined, risk-adjusted discount rate appropriate to the plan".* In July 1993 AARF issued Accounting Guidance Release AAG 13 to "provide guidance on determining the discount rates to be used when measuring liabilities at their present value in accordance with...AAS 25...". AAG 13 provides that either:

(a) the anticipated rate of return on plan assets should be used, where this can be reliably determined; or

(b) a rate based on Commonwealth Government guaranteed securities should be used where an anticipated rate of return on plan assets cannot be reliably determined.

4.5 In either case the discount rate(s) used must be **current** and must be appropriate to the term of the liabilities. "Current" means that the discount rate must be reviewed or revised at each reporting date, based on conditions applying at that date.

4.6 Although not stated in AAG 13, the discount rate used should be net of an appropriate allowance for tax on investment income. Where the “return on assets” approach is used the allowance for tax should reflect the likely level of tax which will apply in future based on the trustee's investment policy and the likely future asset allocation. If the discount rate is based on yields on Government guaranteed securities, allowance should be made for tax at a rate which the actuary believes to be appropriate in the particular circumstances, which may be the full rate of 15%, or a lower rate based on an assumed investment policy.

4.7 In general, the anticipated rate of return on plan as sets (net of tax) should be used as the discount rate for AAS

25 purposes where accrued liabilities are fully funded or where sufficient assets exist for the return on those assets to be indicative of the return that could be achieved if accrued liabilities were fully funded. Where a plan is unfunded or substantial unfunded liabilities exist, and the actuary is of the view that the anticipated rate of return on assets is **not** able to be reliably determined or would not be indicative of the return that could be achieved if accrued liabilities were fully funded, the discount rate should be based on the yields (net of tax) on Government guaranteed securities of appropriate terms to maturity.

4.8 The intention of the plan sponsor with regard to funding and the payment of future contributions may be relevant in deciding the approach to be used in setting the discount rate. Where the plan sponsor intends to pay contributions to progressively fund accrued liabilities in future then it would normally be appropriate to use a discount rate based on the expected return on assets held, or expected to be held, in future to meet the liabilities. In other circumstances the Plan may be regarded as "unfunded" and so the discount rate should be based on net yields on Government guaranteed securities.

4.9 A discount rate based on the expected return on plan assets should represent the actuary's best estimate of the "risk-adjusted" rate of return expected to be able to be earned on plan assets over the weighted-average term to settlement of the related liabilities, without any margins for conservatism. This **may** be consistent with the interest rate used for actuarial valuation purposes. (In this context, "risk-adjusted" is taken to mean the expected return after allowing for any adjustment determined in accordance with paragraph 4.11 below.) The weighted-average term of the liabilities should be determined by the actuary in an appropriate manner, and may be taken to mean the expected average future working lifetime of the existing members.

4.10 In arriving at an appropriate rate of discount the actuary should consider the following factors:

(a) the medium/long-term investment policy of the Trustees;

(b) yields available on Commonwealth Bonds whose term is comparable, or as comparable as possible, with the term of the liabilities;

(c) data on long-term investment returns for various asset classes relative to bonds;

(d) the outlook for any inflation of the liabilities;

(e) the weighted-average term of the liabilities;

(f) likely reinvestment rates;

(g) appropriate allowance for rates of taxation (as described in paragraph 4.6) and investment expense on the fund's investment income and capital gains;

(h) any evidence that the actual investments are not being made in accordance with the Trustee(s) policy;

(i) past investment returns relative to comparable portfolios; and

(j) any other factor which, in the opinion of the actuary, is relevant.

4.11 The discount rate determined as described above may be varied to allow for:

(a) uncertainty of the amount and/or incidence of the benefit outgo,

(b) uncertainty in relation to assets (i.e. capital and income), and

(c) the relationship between the current investment mix and the nature of the liabilities.

4.12 AAG 13 recommends, where the discount rate is based on the expected return on assets, disclosure of information to enable assessment of the sensitivity of *Accrued Benefits* to changes in the discount rate. Where the actuary is requested to provide such information, the actuary should provide a general indication of the effect on the disclosed amount of *Accrued Benefits* of an increase or reduction in the discount rate.

Salary Increases

4.13 AAS 25 does not give any guidance as to an appropriate salary increase assumption. The actuary should make his or her best estimate of the expected rate of salary increases over the appropriate period, without any margins for conservatism.

Other Assumptions

4.14 The actuary should make realistic assumptions regarding the other elements which would normally form part of a valuation basis. Undue conservatism should be avoided.

Adjustments and Special Cases

4.15 In a defined benefit fund which has some defined contribution style retirement benefits, the accrued benefits in respect of the latter should be calculated as the total accumulated amount held in respect of both member and employer contributions.

4.16 *Accrued Benefits* should include appropriate amounts in respect of:

(a) accumulations of voluntary contributions;

(b) pensions currently in the course of payment;

(c) reversionary pensions; and

(d) deferred pensions payable from a future date, and deferred lump sum benefits payable at a future date.

Note that inclusion of such amounts in accrued benefits is required for conformity with AAS 25, but may be inconsistent with the Institute's approach in Professional Standards 400 and 401.

4.17 The actuary should consider whether to make adjustments where vested benefits exceed *Accrued Benefits*, in accordance with PS402. The actuary should indicate whether such an adjustment is made, and provide a suitable explanation of the adjustment.

5. RESPONSIBILITY FOR SELECTING ASSUMPTIONS AND METHODS

5.1 It is the responsibility of the actuary, in consultation with the client, to select appropriate valuation assumptions and methods. However, because the fund's auditor is responsible for expressing an opinion on the fund's accounts, the auditor should be advised of the assumptions and methods and the basis for their selection. In appropriate circumstances, the auditor might be invited to attend meetings between the actuary and the client at which assumptions and methods are discussed, or be sent copies of correspondence dealing with the subject.

5.2 If the actuary is asked to use assumptions or methods which the actuary considers will produce misleading results, an attempt should first be made to persuade the client that the assumptions are inappropriate. Failing this, the actuary should include an appropriate qualification in the actuarial statement referred to in the next section of this Guidance Note, or decline to determine the *Accrued Benefits*. In either case, the actuary should advise the fund's auditor, provide the auditor with a copy of any relevant report and explain the reasons for the action taken.

6. ACTUARIAL STATEMENTS FOR AAS 25

6.1 Whenever an actuary is asked to calculate *Accrued Benefits* for accounting purposes under AAS 25, the actuary should present the results in the form of a letter to the appropriate party, (referred to in this section of the Guidance Note as an *actuarial statement for AAS 25*).

6.2 An *actuarial statement for AAS 25* should include:

(a) The fact that it has been prepared for the purposes of AAS 25, and at whose request.

(b) The effective date of the valuation.

(c) The name of the fund.

(d) An identification of the method used for attributing benefits to past membership and, where this differs from the methods described in PS402 a description of the method adopted and the reasons for its adoption. Reasons for any change in the method of attributing benefits to past membership should be provided.

(e) Separate identification of liabilities measured at their present value and other liabilities, such as separate accumulation entitlements.

(f) The basis used for determining the discount rate (i.e. whether the return on assets approach or a rate based on Commonwealth Government guaranteed securities has been used).

(g) A summary of the assumptions used. In particular the discount rate and the weighted-average term of the liabilities must be disclosed. Where these differ from assumptions which have been used for other purposes, such as funding purposes, or from the assumptions last used for AAS 25 calculations, attention should be drawn to the differences and the reasons for these differences.

(h) If the assumptions and methods were not chosen by the actuary and they are considered by the actuary to be inappropriate, an indication of who selected the assumptions and methods and the reasons why they are considered inappropriate.

(i) The amount of *Accrued Benefits*

(j) If requested, information as described in paragraph 4.12 of this Guidance Note to enable assessment of the sensitivity of *Accrued Benefits* to changes in the discount rate.

(k) An indication of whether an adjustment has been made, and an explanation of any adjustment, either on an individual member basis or a group basis, where the vested benefit exceeds *Accrued Benefits*.

(l) Where the methods of calculation and/or assumptions adopted differ from those used for other purposes, commentary to the effect that the results should not be used for any other purpose than preparation of accounts in accordance with AAS 25.

(m) A statement to the effect that the amount of *Accrued Benefits* has been calculated in a manner consistent with Professional Standards and Guidance Notes produced by the Institute of Actuaries of Australia.

(n) The name and qualifications of the actuary.

6.3 The actuary should be aware of the reasons for any difference between the amount of *Accrued Benefits* determined for AAS 25 purposes and the amount of *actuarial value of accrued benefits*, if any, determined in accordance with Professional Standards 400 and 401.

Liabilities for *Accrued Benefits*

6.4 The Institute has obtained advice from the Law Council of Australia, relevant to use of the expression *"liability for accrued benefits"* in AAS 25. A summary of the advice, originally published in the July 1991 issue of *"Actuary Australia",* is appended to this Guidance Note.

6.5 The Institute considers that the benefits to be valued by actuaries for the purposes of AAS 25 will, in many cases, not constitute legally-enforceable *"liabilities"* of the fund. If such benefits are nonetheless described as liabilities in the financial statements or notes, users of the financial statements may be misled. The actuary should seek to ensure that this risk is minimised, by requesting appropriate wording of the notes to the accounts, (for example by asking that references to *"accrued benefit liabilities"* be replaced by references to *"Accrued Benefits"*) and/or including an appropriate explanation in the *actuarial statement for AAS 25*.

6.6 This is particularly important in circumstances where, notwithstanding the actuary's best efforts, and despite the fact that in the actuary's opinion the presentation is likely to be misleading, the accounts are to be presented in accordance with *"The Alternative Approach"* referred to in paragraph 2.1(b) of this Guidance Note.

6.7 If *"liabilities"* which have been included in *Accrued Benefits* are to be met directly by an employer and not by the trustees from fund assets, the actuary should specifically mention this fact and identify the amount of these *"outside liabilities"*.

APPENDIX

AAS 25 LEGAL ADVICE

The Institute received legal advice from the Superannuation Committee of the Law Council of Australia in respect of AAS 25 in a letter dated 27 May 1991. The following is a summary of the advice:

> AAS 25 is regarded as *"more controversial in the context of defined benefit funds than accumulation or defined contribution funds".* Nevertheless, the following comments may also be relevant for accumulation fund accounts, especially where prepared in accordance with the Full Provisions of AAS 25.
>
> It is acknowledged that it is a matter for the accounting profession to decide what is meant by the term *"liabilities"* in paragraph 23. However it is noted that the meaning adopted in the Professional Standard may cause confusion because it refers to the claims of beneficial owners, whereas in other contexts the term *"liabilities"* is *"used in arriving at the net assets which are available to meet the claims of ownership".*
>
> Paragraph 25 describes the benefits accrued for membership to the reporting date as representing a *"present obligation"* which the trustee has to make in the future. However *"as a matter of law the obligation is (usually) subject to reduction either for lack of vesting on early withdrawal or for inadequacy of fund assets".*
>
> If the trustee adopts accounts which are not prepared in accordance with the Accounting Standards the auditor will be obliged to qualify his/her certificate. This does not in itself mean that the fund will be treated as non-complying.
>
> *"Trustees must also have regard to the implications of the Corporations Law, since interests in superannuation funds are* 'prescribed interests'. *Whether or not a prospectus is required to be lodged or registered, liabilities may arise under sections 995 and 996 for misleading conduct in the distribution of information about the fund."*

> *"Trustees will therefore wish to be satisfied that the accounts they distribute are not misleading, or that anything in the accounts which might be regarded as misleading is explained in notes or certificates accompanying the accounts".*

The Institute suggests that trustees should discuss this matter with the fund's auditors and if necessary obtain legal advice specific to the fund. An actuary who wishes to obtain a copy of the 27 May 1991 letter should contact the Institute Secretariat.

END OF GUIDANCE NOTE 454