THE INSTITUTE OF ACTUARIES OF AUSTRALIA

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 fund for the purposes of Australian Accounting Standard 25.

LEGISLATION/AUTHORITY

This Guidance Note should be read in conjunction with Australian Accounting Standard 25.

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CLASSIFICATION

Compliance with the provisions of this Guidance Note is mandatory.

1. INTRODUCTION

1.1 Australian Accounting Standard 25 (AAS 25) was issued by the Australian Accounting Research Foundation (AARF) on 29 August 1990. A revised version was issued in May 1992.

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).

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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. 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 and used in the Occupational Superannuation Standards Regulations.

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 but 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 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. However, the basis chosen must be appropriate having regard to the definition of benefits, in particular the early retirement benefits, under the governing rules of the fund.

3.2 The method used to apportion a benefit between past and future membership should not normally be altered from the method used in the previous calculation of Accrued Benefits for AAS 25 purposes. However, there will be some circumstances in which a change of method is justifiable. If the method is altered, the actuary should state the reasons for making the change.

Retirement Benefits

3.3 The two most frequently encountered approaches for determination of accrued retirement multiple are:

(a) **Proportionate Basis**

The accrued retirement benefit multiple under the proportionate basis is:

$$\text{Retirement Benefit Multiple at Normal Retirement Date} \times \frac{\text{Membership to Date}}{\text{Membership to Normal Retirement Date}}$$

If there is no one *"Normal Retirement Date"*, the actuary should choose the most appropriate *"Normal Retirement Date"* for the purpose of the calculation.

An appropriate adjustment should be made where benefits accrue at different rates in respect of different periods.

(b) Actual Accrual Basis

The accrued retirement benefit multiple under the actual accrual basis is:

The product of the accrual percentage applicable to a member and the period of completed membership relating to the particular accrual percentage. If there is more than one accrual percentage, then the products are summed to obtain the total accrued retirement benefit multiple for a particular member.

Under either approach, membership should include an appropriate allowance for membership of any previous fund the assets of which have been incorporated in the current fund.

If the actuary adopts a basis other than either of the two outlined above, then the actuary must describe the basis used and the reason for using it.

The accrued retirement benefit should be calculated by multiplying the accrued retirement multiple by final average salary or by current salary. If current salary is used as the base, final salary averaging should be allowed for when projecting current salary.

Death and Disablement Benefits

3.4 There are again two frequently used approaches:

(a) Accrued Retirement Benefits

The death and disablement benefit to be valued is equal to the product of the accrued retirement benefit multiple and the appropriate definition of salary.

If the death and disablement benefit does not equal the retirement benefit then this product might be increased or decreased by the ratio of the death and disablement benefit to the retirement benefit.

(b) Proportionate Membership

The death and disablement benefit to be valued is:

$$\text{Total Death Benefit Payable in year } t \times \frac{\text{Membership to Date}}{\text{Membership at end or middle of year } t}$$

Where t is the variable for each future year of membership until the Normal Retirement Date.

If the actuary adopts a basis other than the two outlined above, then the actuary must describe the basis used and the reason for using it.

Resignation Benefits

3.5 Resignation benefits relating to member contributions and interest should only relate to member contributions payable up to the date of calculation. Similarly, resignation benefits related to a defined accrued retirement benefit should only relate to membership up to the date of calculation in a manner consistent with the calculation of accrued retirement benefits.

There are two frequently used approaches to vesting, where a vesting scale applies on resignation -

(a) **Use Vesting Factor at Valuation Date**

This approach uses the vesting factor based on membership/service to the valuation date and is not increased for each year thereafter as the fund's future experience is projected.

(b) **Use Vesting Factor at Assumed Resignation Date**

Under this approach the vesting factor is the factor applying according to membership or service assumed to have been served at each future year of the projections.

If the actuary adopts a basis other than these, then the actuary must describe the basis used and the reason for using it.

4. CALCULATION OF VALUE 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".

Transitional Basis

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.

Interest Rates

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"*. The intention of AAS 25 is that accrued benefits should be valued using a set of assumptions which is consistent with the assumptions used by the market in arriving at the market value of the fund's assets.

4.5 The Institute interprets a *"risk-adjusted"* discount rate in this context to be a risk-free market rate, plus a premium for the additional return associated with the degree of risk attaching to the current investment portfolio, adjusted to allow for the factors referred to in paragraph 4.7 below.

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

the nature of the fund's current investment portfolio

the fund's expected future investment strategy

past investment returns

yields available on Commonwealth Bonds whose term is comparable with the term of the liabilities

likely reinvestment rates

the expected rates of taxation and investment expense on the fund's investment income and capital gains

the expected average lifetime of the existing membership

past returns for each investment sector and expected future returns

past volatility of these returns and expected future volatility.

4.7 The discount rate determined as described above should normally be reduced to allow for:

uncertainty of the amount and/or incidence of the benefit outgo

the relationship between the current investment mix and the nature of the liabilities.

That is to say, a mismatching deduction from the discount rate will normally be appropriate.

Salary Increases

4.8 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

4.9 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

4.10 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.

4.11 Accrued benefits should include appropriate amounts in respect of:

Accumulations of voluntary contributions

Pensions currently in the course of payment

Reversionary pensions

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 is inconsistent with the Institute's approach in Professional Standards 400 and 401.

4.12 The actuary may wish to make appropriate adjustments where the vested benefit exceeds the present value of accrued benefits, either on an individual member basis or a group basis. If such an adjustment is made, a suitable explanation of the adjustment should be given.

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 value of 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 this Guidance Note, a description of the method adopted and the reasons for its adoption.

(e) Reasons for any change in the method of attributing benefits to past membership.

(f) A summary of the assumptions used. 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.

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(g) Comment on who selected the assumptions and methods.

(h) Suitable qualification if the assumptions and/or methods are considered inappropriate.

(i) The amount of accrued benefits.

(j) The amount of Accrued Benefits (for defined benefits, this equals the present value of accrued benefits).

(k) An explanation of any adjustment made, either on an individual member basis or a group basis, where the vested benefit exceeds the present value of 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 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 and any discounted value of accrued benefits which has been 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 As already stated in section 2 of this Guidance Note, 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.