Institute of Actuaries of Australia

PRACTICE GUIDELINE 499.04

ACCOUNTING FOR SUPERANNUATION AND LONG SERVICE LEAVE OBLIGATIONS UNDER AASB 119

June 2011

INDEX

1 INTRODUCTION

1.1 Application

This Practice Guideline applies to Members giving advice in respect of superannuation obligations and long service leave obligations under Australian Accounting Standard AASB 119 - Employee Benefits (“AASB 119”).

1.2 Classification

1.2.1 This Practice Guideline has been prepared in accordance with Council’s Policy for Drafting and Developing Practice Guidelines. It must be applied in the context of the Institute’s Code of Professional Conduct.

1.2.2 This Practice Guideline is not mandatory.

1.2.3 Nevertheless, if the Professional Services provided by a Member are covered to any extent by this Practice Guideline, a Member should consider explaining any significant departure from this Practice Guideline to the Principal, and document such explanation.

1.3 Background

1.3.1 The AASB 119 standard was most recently revised by the Australian Accounting Standards Board (“AASB”) in October 2010. This Practice Guideline is written to provide guidance in respect of the November 2010 compilation of AASB 119. The current version of the standard is available from the AASB.

1.3.2 This Practice Guideline covers the role of the Member in advising on accounting for superannuation obligations under AASB 119 for an Australian resident company in respect of an Australian resident superannuation plan. The same principles apply to overseas superannuation plans to which AASB 119 applies, except to the extent that the principles need to be adjusted to reflect the conditions relevant to the jurisdiction of the overseas Plan.

1.3.3 This Practice Guideline also covers long service leave. It does not cover any other employee benefits which are the subject of AASB 119.

1.3.4 Bold paragraphs shown below are taken directly from AASB 119 unless otherwise stated.

1.4 Purpose

1.4.1 This Practice Guideline has been issued to provide assistance to Members preparing actuarial advice in respect of superannuation obligations under AASB 119.

1.4.2 In particular, it is noted that the Member's role is as an adviser and that final decisions on assumptions and methodology remain the responsibility of the Entity. Following the instructions of the Entity represents reasonable grounds for departure from this Practice Guideline. However, the Member should document in the final report any instructions received, especially those that lead to results that the Member believes are unreasonable.

1.5 Previous versions

There are no previous versions of this Practice Guideline.

1.6 Legislation

1.6.1 This Practice Guideline has been drafted based on the November 2010 compilation of AASB 119 and should be read in conjunction with any amendments to AASB 119 subsequent to that date.

1.6.2 Other useful guidance may be found in:

(a) Australian Accounting Standard AASB 1 – First-time Adoption of Australian Accounting Standards;

(b) Australian Accounting Standard AASB 101 – Presentation of Financial Statements;

(c) Australian Accounting Standard AASB 134 – Interim Financial Reporting;

(d) Australian Accounting Standard AASB 1031 – Materiality;

(e) International Accounting Standard IAS 19 – Employee Benefits – Basis for Conclusions; and

(f) for work conducted for government entities, governing circulars from the respective State or Federal government Treasury or Department of Finance.

1.6.3 This Practice Guideline must be considered in the context of applicable legislation. If there is a conflict between this Practice Guideline and any applicable legislation, then the legislation takes precedence. In this context, legislation includes regulations, prudential standards, subordinate standards, rules issued by government authorities and standards issued by professional bodies which have the force of law. In particular, it is noted for the avoidance of doubt that accounting standards have the force of law.

1.6.4 A reference to legislation or a legislative provision in this Practice Guideline includes any statutory modification, or substitution of that legislation or legislative provision and any subordinate legislation issued under that legislation or legislative provision.

2 COMMENCEMENT DATE

This Practice Guideline is effective for advice given to an Entity in relation to balance dates of 1 August 2011 or later.

3 DEFINITIONS

3.1 In this Practice Guideline:

'**Code**' means the Code of Professional Conduct of the Institute.

'**Entity**' means the reporting entity (for example, employer) for which the reporting is taking place.

'**Multi-employer plan**' has the same meaning as that term in the AASB 119 standard.

'**Plan**' means a superannuation fund, plan, scheme or other arrangement in respect of which calculations are being prepared.

3.2 A word that is derived from a defined word has a corresponding meaning.

3.3 Other capitalised terms used in this Practice Guideline have the same meaning as set out in the Code.

4 ASSUMPTIONS

4.1 Introduction

The assumptions used for the financial reporting in compliance with AASB 119 are the responsibility of the Entity. The Member will typically be called on to provide advice on the "actuarial assumptions". The guidance in this section is provided in the context of the Member's role as an adviser to the Entity.

4.2 Market expectations

> 77. **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.** [Source: November 2010 compilation of AASB 119]

4.2.1 This statement precludes the Member advising any financial assumptions, such as discount rates or salary increase rates, at an artificial level. Note that the requirement under AASB 119 is to consider current market expectations. These expectations may differ from the Member's normal best estimates.

4.2.2 As the AASB 119 assumptions are the responsibility of the Entity, not the Member, the Member should consider including a note in his or her report that the assumptions are those agreed to or specified by the Entity. When necessary, the Member should consider liaising with the Entity to ensure that the sensitivity of the results to assumptions is understood.

4.3 Discount rate

> **78. The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.**
> [Source: November 2010 compilation of AASB 119]

4.3.1 Prior to providing any advice on the discount rate, the Member should consider whether the advice will suggest that there is a deep market in high quality corporate bonds or whether any instruction on that matter has been received from the Entity. There is no accounting guidance on the term 'deep market', so in providing advice the Member may wish to consider the economic definition of the term (that is, whether the price of securities in the market is distorted by trading). Also, there is no accounting guidance on the term 'high quality corporate bond', so in providing advice the Member may wish to consider what characteristics a high quality corporate bond should have.

4.3.2 To select the bond(s) on which to base advice on the discount rate(s), it is generally accepted that the Member first consider the estimated term(s) of the benefit obligations and then match this/(these) term(s) as closely as possible with the term(s) of the bond(s), and determine a weighted average discount rate that reflects the estimated timing and amount of benefit payments.

4.3.3 In advising on the discount rate, the Member should consider the basis on which the yield is quoted (for example, as an annual rate payable half-yearly). It is reasonable for a Member either to convert or not to convert a quoted yield to an effective annual rate to calculate the discount rate.

4.3.4 The term of the benefit obligations will depend on when amounts are expected to be paid from the Plan and the proportion of the current obligations that relates to each of the expected future payments. Hence, in considering the term of the obligations, the important considerations are:

(a) the demographic assumptions (affecting the timing of payments);

(b) the proportion of benefits paid as pensions (both current and future pensions); and

(c) the relative weight of obligations related to specific individuals or groups.

4.3.5 The estimated term of pension liabilities will depend on the practices adopted within the Plan and the proportion of lump sum and pension benefits normally paid.

4.3.6 When the estimated term of the obligations is longer than the duration of the longest dated bond available in the market, paragraph 81 of AASB 119 requires that market rates be extrapolated along the yield curve.

4.3.7 If the Member wishes to round the discount rate that is used, taking into account overall materiality, rounding to the nearest 0.1% or 0.25% pa would be considered reasonable practice. It is generally accepted that a consistent approach should be used from year to year.

4.4 Salary increase rate

> **84. Estimates of future salary increases take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market.** [Source: November 2010 compilation of AASB 119]

4.4.1 Advice provided on the salary increase assumption should be realistic and related to the circumstances of the particular Entity. The salary increase rate is generally also consistent with current economic conditions and inflationary expectations that may be assessed from several sources, including current market yields, the real yields on government CPI-indexed securities and the inflation assumptions underlying the expected return for each asset class used to determine the expected return on assets. Members may also wish to consider CPI expectations implicit in the yield curve based on models of the yield curve that include an allowance for CPI.

4.4.2 If any of these approaches are taken, the salary inflation assumption can vary from year to year with movements in the inflation expectations underlying market yields. Again, as with discount rates, it is generally accepted that the approach should be consistent from year to year.

4.5 Expected return on Plan assets

> **106. The expected return on plan assets is based on market expectations, at the beginning of the period, for returns over the entire life of the related obligation. The expected return**

on plan assets reflects changes in the fair value of plan assets held during the period as a result of actual contributions paid in the fund and actual benefits paid out of the fund. [Source: November 2010 compilation of AASB 119]

4.5.1 The advice on the expected return on Plan assets recommended by the Member generally reflects the Member's view of market expectations of the expected return of each major asset class in which the Plan is expected to invest over the expected term of the defined benefit obligation.

4.5.2 In considering whether to recommend any changes to this assumption, accepted practice is for the Member to consider whether there has been a change in market conditions that influence the expected return of an asset class.

4.5.3 The advice on the expected return on assets should also consider tax and investment expenses, as discussed in clauses 5.2.8 and 5.3.2 below.

5 METHODOLOGY

5.1 Introduction

As with assumptions, issues of methodology remain the responsibility of the Entity. However, as with assumptions, the Member may be called on to advise on the appropriate methodology to adopt. In advising on issues of methodology, the Member should be familiar with the relevant provisions of the accounting standards. The Member may also wish to discuss issues with the Entity's auditors where matters are unclear.

5.2 Allowance for tax

5.2.1 There has been significant disagreement on the interpretation and application of the standard in respect of taxes. The standard is almost silent on taxes which means that it does not provide guidance on:

(a) whether future taxes in respect of past service (or the existing defined benefit) obligation should be included as a current obligation (the alternative being that those taxes are accounted for as they fall due); or

(b) how future taxes may be incorporated into the components set out in AASB 119.

5.2.2 Given these comments, sections 5.2.3-5.2.10 of this Practice Guideline provide indicative guidance only. Note that there is a range of interpretations which may be valid.

5.2.3 There are two main taxes that may be considered as part of the defined benefit obligation provision and superannuation expense, namely the tax on future investment income (refer clause 5.2.4 of this Practice Guideline) and the tax on future employer contributions (refer clause 5.2.5 of this Practice Guideline).

5.2.4 Tax on future investment income

(a) As indicated above, there are different views on the treatment of future taxes on existing defined benefit obligations. If the taxes are accounted for as they fall due, this will typically be included in the return on Plan assets. Conversely, if an obligation is established, that will typically be included in the defined benefit obligation.

(b) A generally accepted accounting principle is that the discount rate is not adjusted. Therefore, any allowance for investment taxes should be determined separately as the present value of the cashflows in respect of those taxes and added to the defined benefit obligation.

(c) In practice, Members may use shortcut methods that achieve substantially the same result. For example, a provision for the tax on future investment income for a funded scheme may be determined by adjusting the discount rate.

(d) Any allowance for investment tax will generally take into account the expected future levels of current pension liability exemption (if any).

(e) The funding arrangements of public sector schemes may also be taken into account in determining any adjustment for investment tax. For example, a completely unfunded public sector scheme may have no investment tax provision. Any allowance for a partially funded scheme (for example, where a separate tax free vehicle has been established), should take into account the proportion of its liabilities expected to be funded from assets subject to investment tax, based on the current funding policy of the scheme.

(f) It is recommended that the method of allowing for investment tax be determined in conjunction with the Entity and its auditor.

5.2.5 Tax on future employer contributions

(a) As with investment tax, there are different views on the treatment of future taxes on existing defined benefit obligations. One view is that contributions taxes should be accounted for as they fall due.

(b) Alternatively, if a provision for the tax on future employer contributions is to be determined, it will depend on the funded status of the scheme. For the purposes of calculating this provision, the funded status of the scheme at the end of the reporting period is defined as:

[fair value of assets] minus [the value of the defined benefit obligations (including any provision for the tax on future investment income)]

(c) The tax impact of the funded status should be determined as the present value of any cashflows in respect of tax payable because of the deficit (or reduction in tax available because of any surplus).

(d) In practice, Members may wish to use a shortcut approach that achieves substantially the same result. If the funded status is a deficit, the shortcut for the provision for the tax on future employer contributions may be 17.65%[1] of the scheme's deficit. Similarly, if a surplus exists, the shortcut for the provision may be 17.65% of the scheme's surplus and will be negative (that is, an asset).

(e) The Member should note that while surpluses and deficits are substantially two sides of the same issue, they may not be viewed the same way under accounting rules. Hence, the Entity and its auditors may have a different view depending on whether there is a surplus or deficit.

(f) In advising the Entity, the Member should note that the size of the surplus must be capped in line with paragraph 58 of AASB 119. The tax provision may be adjusted to reflect the extent that, in the case of a surplus, the Entity is not expected to be able to fully utilise the surplus or, in the case of a deficit, the entity is not expected to fully fund the deficit.

(g) The allowance for contributions tax may reflect the taxation arrangements of the scheme, including deductibility of expenses and insurance premiums. When benefits are paid at least partially on an untaxed basis, or the Plan is able to take advantage of pre-1 July 1988 funding credits, the allowance may be adjusted accordingly.

5.2.6 Where the allowance for tax is included as part of the defined benefit obligation, the calculation of gains and losses may take place after including the full tax provision in the defined benefit obligation.

5.2.7 The Member should consider whether the costs of any other taxes are met by the employer and, if necessary, make an appropriate allowance.

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1 Assuming 15% contributions tax applies $1/(1-15\%) - 1 = 17.65\%$

5.2.8 The expected return on Plan assets is net of tax on investment income, where the tax allowance is based on the expected tax to be incurred on the asset classes in which the Entity will invest over the expected term of the defined benefit obligation.

5.2.9 The allowance for contributions and investment taxes in the superannuation expense should be consistent with the change (or expected change) in the defined benefit obligation (including provisions for these taxes) over the relevant period.

5.2.10 In determining the provision for long service leave obligations that are not met through funding arrangements that are separate from the Entity, no allowance for tax is required.

5.3 Allowance for expenses and insurance premiums

5.3.1 In determining the service cost, it is recommended that the Member consider whether an allowance is required for the cost of insurance and non-investment expenses incurred in running the Plan (investment expenses should be taken into account in developing the expected return on Plan assets).

5.3.2 The allowance for investment expenses is generally the best estimate and should be deducted from the expected return on Plan assets.

5.3.3 The allowance for insurance premiums may be calculated using the projected unit credit method or based on current premium costs.

5.4 On-costs

5.4.1 For long service leave calculations, some on-costs vary depending on whether the underlying benefits are taken in-service or paid on exiting the employer, and will vary by State and possibly sub-class of membership (for example, superannuation fund). Payroll tax is generally levied on both forms of benefit payments, whereas workers compensation is only generally levied on benefits taken in-service (although there is some uncertainty regarding whether or not a workers compensation on-cost should be allowed for in long service leave calculations). The application of superannuation costs to exit payments will depend on the actual employer's practice and it is recommended that this issue be discussed with the Entity and their auditor, as should annual leave / recreational leave costs and long service leave costs which generally only accrue on benefits taken in-service. On-costs may also accrue on other on-costs.

5.4.2 Contributions to finance a current deficit may be subject to certain on-costs such as payroll tax. Similarly, a current surplus may provide savings in payroll tax through savings in future contributions. In some cases, these costs or savings will not be material.

5.4.3 It is not clear whether on-costs are part of the employee benefits expense or another type of expense. Hence, the Member should confirm the Entity's accounting policy on this matter. The role of the Member, if any, will be to provide any information required by the Entity to allow it to estimate potential on-costs. In some cases, when measuring the impact on costs some disaggregation of the liabilities may be required. This particularly applies to long service leave taken in-service versus leave taken on resignation.

5.5 Multi-employer Plans

29. An entity shall classify a multi-employer plan as a defined contribution plan or a defined benefit plan under the terms of the plan (including any constructive obligation that goes beyond the formal terms). Where a multi-employer plan is a defined benefit plan, an entity shall:

(a) account for its proportionate share of the defined benefit obligation, *plan assets* and cost associated with the plan in the same way as for any other defined benefit plan; and

(b) disclose the information required by paragraph 120A.

30. When sufficient information is not available to use defined benefit accounting for a multi-employer plan that is a defined benefit plan, an entity shall:

(a) account for the plan under paragraphs 44-46 as if it were a defined contribution plan;

(b) disclose:

(i) the fact that the plan is a defined benefit plan; and

(ii) the reason why sufficient information is not available to enable the entity to account for the plan as a defined benefit plan; and

(c) to the extent that a surplus or deficit in the plan may affect the amount of future contributions, disclose in addition:

(i) any available information about that surplus or deficit;

(ii) the basis used to determine that surplus or deficit; and

(iii) the implications, if any, for the entity.

32. ... However, in some cases, an entity may not be able to identify its share of the underlying financial position and performance of the plan with sufficient reliability for accounting purposes. This may occur if:

(a) the entity does not have access to information about the plan that satisfies the requirements of this Standard; or

(b) the plan exposes the participating entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan.

In these cases, an entity accounts for the plan as if it were a defined contribution plan and discloses the additional information required by paragraph 30.

[Source: November 2010 compilation of AASB 119]

5.5.1 If the Member is asked to consider or advise on the application of paragraph 32(b) of AASB 119, and whether sufficient information is available for an Entity to use defined benefit accounting, whether the following criteria apply should be taken into account:

(a) assets are not segregated within the Plan according to the employees of each entity;

(b) benefits for employees from all participating Entities are determined according to the same formulae and without regard to the Entity;

(c) contribution rates for each Entity do not vary according to the experience relating to the employees of that Entity;

(d) the same actuarial assumptions are used in respect of the employees of each Entity;

(e) the allocation of any surplus, or the funding of any deficit, does not have regard to the actual experience in respect of members from individual Entities; and

(f) the consideration of taxation and the treatment of expenses are the same for all Entities.

5.5.2 The above factors may indicate that the actuarial risks, and the subsequent actuarial gains and losses from the Plan's experience, to the extent that they are not borne by members, are shared between Entities and therefore do not cause contribution rates from each Entity to vary according to the experience related to the Entity's members in the Plan. In other words, participation in such a multi-employer Plan creates different assets and liabilities for the participating employers than would arise if the employers had single Entity Plans. If this is the case, then the additional reporting under paragraph 30 of AASB 119 is required.

5.5.3 For Plans which satisfy paragraph 32(b) of AASB 119, and therefore report as defined contribution plans, the additional reporting under paragraph 30(c) of AASB 119 must fully disclose the impact on employer contributions of any surplus or deficit. If there is a contractual agreement between the multi-employer Plan and its participants that determines how surpluses and deficits are dealt with, then the assets or liabilities arising from this agreement must be accounted for as set out in paragraph 32A of AASB 119.

5.5.4 The presence of some of the following features may also indicate that the Plan satisfies the requirements to report under paragraph 30(c) of AASB 119:

(a) history and/or employer expectations suggest that the existence of surplus or deficit is not used to adjust the level of employer contributions;

(b) the terms of the Plans are such that there is no obligation to fund a deficit or benefit from a surplus if a participating employer ceases to participate in the Plan;

(c) the financial consequences for a participating employer could change if other employers joined or left the Plan; or

(d) there is a fixed relationship between the level of member and employer contributions.

5.5.5 However, satisfying the criteria for the application of paragraph 32(b) of AASB 119 does not automatically mean that an Entity does not have access to information that would meet the defined benefits reporting requirements of AASB 119. For example, if an employer is a dominant participant of a multi-employer Plan, it is reasonable to suggest that the necessary information will be available for the Entity to satisfy the defined benefits reporting requirements.

5.5.6 Also, and under paragraph 32(a) of AASB 119, if there is consistent, reliable and ongoing information available that will enable an individual Entity to assess its current obligations and future costs, then defined benefit reporting must apply.

5.6 Hybrid Plans

5.6.1 AASB 119 specifies different treatment for defined benefit ("DB") Plans and defined contribution ("DC") Plans. In Australia, it is relatively common to have DB plans with DC sections. AASB 119 does not specifically consider the treatment of hybrid Plans. However, it does envisage situations where more than one Plan may be covered by the one legal structure, for example group administration Plans (paragraph 33 of AASB 119).

5.6.2 The International Accounting Standards Board ("IASB") Framework for Preparation of Financial Statements states that transactions should be accounted for according to their substance rather than their legal form:

> "Substance over Form
>
> 35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction)."

5.6.3 This suggests that when the substance of a hybrid superannuation Plan is separate DB and DC arrangements, and the separate arrangements are material, they may be accounted for as separate Plans.

5.6.4 Note that the Entity and/or its auditors may apply their own tests of the substance of the arrangements.

5.6.5 Treating the DB and DC components separately means that the expense should be calculated separately in accordance with the DB and DC requirements of AASB 119 and appropriate disclosure made. The separate treatment is a matter of accounting policy and hence the responsibility of the Entity, and subject to review by its auditors.

5.6.6 It may also be appropriate to treat the additional accumulation accounts of DB members as part of the DC component, if that reflects the substance of those arrangements.

5.6.7 When a surplus is being used to meet accumulation contributions, the total expense may include the surplus amounts credited to members' accounts. Where the use of surplus is material, it may assist users of the Member's report to have documentation on the approach taken and separate disclosure of the amounts met from surplus.

5.6.8 When the benefit for an individual is the greater of DB and DC formulae, it may be appropriate to treat the entire benefit as DB or to treat the benefit as DC with a DB top-up. Again, the substance of the arrangement may be an important consideration.

5.7 Vested benefit or other minimums on liabilities

5.7.1 AASB 119 requires calculation of the present value of the defined benefit obligation. The standard does not require a minimum of vested benefits when calculating the defined benefit obligation. The basis for conclusions for IAS 19 specifically noted a decision not to require a vested benefit minimum on the liability.

5.7.2 In general, applying a minimum of vested benefit to a defined benefit obligation is not consistent with a "going concern" basis in preparing financial statements. It is not required under AASB 119. However, as it is not prohibited, it may be considered if there are specific circumstances that warrant it. If a minimum is applied, the Entity should be made aware of the reasons for, and impact of, adopting this approach.

5.7.3 In other areas (for example, funding valuations of superannuation Plans), it is not uncommon for a vested benefit minimum to be applied to the determination of the value of a liability. The suggestion that a vested benefit minimum is generally not appropriate for AASB 119 purposes reflects the different purpose of the AASB 119 calculations and has no reflection on actuarial calculations for other purposes.

5.8 Asset valuations

Fair Value of Plan Assets

102. The fair value of any plan assets is deducted in determining the amount recognised in the statement of financial position under paragraph 54. When no market price is available, the fair value of plan assets is estimated; for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with

the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).

103. Plan assets exclude unpaid contributions due from the entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.

[Source: November 2010 compilation of AASB 119]

5.8.1 If the Member is being asked to value the Plan assets, they should note the requirements of Professional Standard 404 which applies to the valuation of superannuation Plan assets.

5.8.2 The Member may wish to rely on the superannuation Plan's audited financial statements when determining the fair value of Plan assets for AASB 119 purposes. Note that the superannuation Plan's audited statements provide a "net market value of assets" which is defined differently under AAS 25 to the "fair value of plan assets" under AASB 119. "Net market value" is often based on last sale prices less realisation costs. "Fair market value" can be interpreted as requiring use of last bid price. Consideration should be given to whether the differences in definition would lead to a material difference in the asset figures.

5.8.3 If other sources are used to determine the asset value, it is appropriate to note the source, any checks that have been applied and any reliance that the Member has made.

5.8.4 Note the requirement in paragraph 103 of AASB 119 to exclude unpaid contributions (for example, contributions receivable in the superannuation Plan's accounts) due from the employer.

5.9 Classification of Plans

25. Post-employment benefit plans are classified as either *defined contribution plans* or *defined benefit plans*, depending on the economic substance of the plan as derived from its principal terms and conditions. Under defined contribution plans:

(a) the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment

benefit plan or to an insurance company, together with investment returns arising from the contributions; and

(b) in consequence, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee.

26. Examples of cases where an entity's obligation is not limited to the amount that it agrees to contribute to the fund are when the entity has a legal or constructive obligation through:

(a) a plan benefit formula that is not linked solely to the amount of contributions;

(b) a guarantee, either indirectly through a plan or directly, of a specified return on contributions; or

(c) those informal practices that give rise to a constructive obligation. For example, a constructive obligation may arise where an entity has a history of increasing benefits for former employees to keep pace with inflation even where there is no legal obligation to do so.

27. Under defined benefit plans:

(a) the entity's obligation is to provide the agreed benefits to current and former employees; and

(b) actuarial risk (that benefits will cost more than expected) and investment risk fall, in substance, on the entity. If actuarial or investment experience are worse than expected, the entity's obligation may be increased.

[Source: November 2010 compilation of AASB 119]

Note the definition of defined benefit and defined contribution Plans set out in AASB 119. Note that a superannuation Plan that is a defined contribution Plan for legal or prudential purposes may be a defined benefit Plan for accounting purposes in some limited cases (for example, a target funding arrangement in a defined contribution Plan).

5.10 Accrual of benefits for long service leave

The employee benefits covered by AASB 119 are to be valued using projected unit credit funding. Importantly for long service leave calculations, if accrual rates vary with years of service, an adjustment may be required to the amounts stored in human resources records if a valuation using a uniform rate of accrual is required.

5.11 Actuarial gains and losses and past service cost for long service leave

5.11.1 Paragraphs 92, 93 and 93A of AASB 119 set out the options the company has to expense actuarial gains and losses arising from a defined benefit superannuation Plan.

5.11.2 However, paragraph 129(d) of AASB 119 requires that actuarial gains and losses arising from long service leave benefits be recognised immediately, and paragraph 129(e) of AASB 119 requires that past service costs arising from long service leave be recognised immediately.

6 MATERIALITY

6.1 Materiality is a technical accounting term reflecting the importance of a monetary amount to the employer's financial results. The relevant amount may differ for the balance sheet and the income statement. It may be appropriate to seek from the employer an indication of the materiality levels applicable for each accounting report (interim or full year results). The Member may also wish to consider the Australian Accounting Standard AASB 1031 (Materiality).

6.2 The Member may be asked to advise on the steps required to achieve, within the reporting timescale, the degree of accuracy required in the valuation.

7 RELATIONSHIP, CONTEXT AND INFORMATION

7.1 The employer's financial report is the responsibility of the directors (or equivalent) and may be public documents. It may be appropriate for the Member to seek to establish the significance of the AASB 119 results to the employer's financial report and measures of financial performance. The Member should endeavour to discuss and seek instructions from the employer on any material assumptions or methodologies.

7.2 The auditor may have specific requirements and the Member may liaise directly with the auditor if requested to do so by the client. Note that auditors are subject to Audit Guidance Statement GS 005 issued by the Auditing and Assurance Standard Board in using the work of an actuary. Members should also refer to Practice Guideline PG 199.02.

7.3 It may be appropriate for the Member to discuss with the employer the time constraints of the employer's financial reporting regime and any requirements to meet those time constraints. The Member may, if necessary, initiate discussions with the employer and auditor on other relevant aspects of the reporting exercise including assumptions, any split of work between different actuaries and the timescales for reporting.

7.4 The relevant aspects include any reliance placed on the work of others, for example the use of audited financial statements to develop a market value of assets.

7.5 For each reporting exercise, it is advisable for the Member to make arrangements with the employer to ensure access to all relevant information. The employer should be made aware of the sort of events, actions or changes which could have a material impact on the Member's calculations.

8 VALUATION UPDATES (ROLL FORWARDS)

> **56. An entity shall determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.**
>
> **57. This Standard encourages, but does not require, an entity to involve a qualified actuary in the measurement of all material post-employment benefit obligations. For practical reasons, an entity may request a qualified actuary to carry out a detailed valuation of the obligation before the end of the reporting period. Nevertheless, the results of that valuation are updated for any material transactions and other material changes in circumstances (including changes in market prices and interest rates) up to the end of the reporting period.**

[Source: November 2010 compilation of AASB 119]

8.1 The employer's reporting timetable will typically require AASB 119 valuation figures within a tight timescale. The results of a full valuation at the end of the employer financial year will not normally be available when the AASB 119 figures are required. As such, a valuation update is necessary. AASB 119 envisages this issue and permits the use of earlier data.

8.2 Depending on materiality, the valuation update would normally be based on the asset and membership information from the Plan's most recent annual review. This may be a year prior to the employer's reporting date. The most recent annual review date is likely to be more recent than the most recent formal actuarial investigation.

8.3 The Member cannot be definitive about the degree of accuracy of an updated valuation, as this can only be assessed against the results of a full valuation. The

Member may advise the employer on the key aspects of the valuation which could mean that the approximate AASB 119 figures differ materially from those produced by a full actuarial valuation, and seek to investigate as many of those aspects as possible. The Member may consider materiality when advising the Entity on the approach to the roll forward and, in particular, the time period between the effective date of the data and the reporting date.

8.4 Using data that is more than 12 months old is normally not advisable.

8.5 The Entity may use short-hand estimation techniques for long service leave calculations between full actuarial valuations. It is acceptable for a Member to advise the Entity on an appropriate short-hand method to apply for a period following a full valuation.

8.6 Because the data availability, timescale, date of previous valuation, materiality levels, scheme experience and benefit structure will vary in each case, no particular valuation update process or approach can be specified or recommended in this Practice Guideline. However, measurement of the assets and liabilities on a consistent basis is important.

8.7 In making a consistent measurement, the Member may decide not to use the most recent available asset information (although the Member should use the most recent investment performance implied by that asset information – see clause 8.8 of this Practice Guideline). The Member may review more recent asset information (if available) for any inconsistencies with the roll forward approach.

8.8 AASB 119 specifically requires consideration of interest rate and market price movements (that is, changes in the discount rate and investment performance) when a valuation update is used. The impact of these key variables will be material in most cases.

8.9 Other actual experience or variations from assumptions that may be taken into account include:

(a) actual employer and member contributions;

(b) salary growth or pension increases, which are materially different from those expected;

(c) demographic experience that is materially different from that expected;

(d) settlements, curtailments and other material scheme changes; and

(e) other material events of which the Member has been advised.

8.10 The Member may have in place a process for monitoring experience to determine whether experience is materially different to the assumption basis.

9 DISCLOSURE IN FINANCIAL STATEMENTS

9.1 Introduction

Paragraph 120 of AASB 119 requires an Entity to disclose information that enables users of financial reports to evaluate the nature of the defined benefit Plans and the financial effect of changes in those Plans during the period. Paragraph 120A of AASB 119 also contains a detailed list of the information required about defined benefit Plans.

9.2 Interim financial statements

9.2.1 The preparation of interim financial statements following the adoption of AASB 119 is covered by AASB 134. AASB 134 states that, in general, interim financial statements shall apply the same accounting policies applied in the annual financial report.

> **28. An entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an entity's reporting (annual, half-yearly, or quarterly) shall not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes shall be made on an annual reporting period-to-date basis.** [Source: November 2010 compilation of AASB 134]

9.2.2 The standard provides further advice regarding the calculation of the pension cost for an interim period.

> **B9. Pension cost for an interim period is calculated on an annual reporting period-to-date basis by using the actuarially determined pension cost rate at the end of the prior annual reporting period, adjusted for significant market fluctuations since that time and for significant curtailments, settlements or other significant one-time events.** [Source: November 2010 compilation of AASB 134]

9.2.3 Therefore, in providing advice on interim financial statements, the Member should consider this Practice Guideline and follow broadly similar principles (for example, with respect to roll forward valuations) to those applied for the annual financial statements.

9.2.4 Where the company has adopted the corridor approach to recognising actuarial gains and losses, or is recognising gains and losses directly through retained earnings, the pension expense for the interim period can be based on the annual expense calculated at the start of the year (but taking into account any significant event, such as a retrenchment program, affecting the provision of defined benefits).

9.2.5 Where actuarial gains and losses are recognised immediately in expense, the pension expense for the interim period should allow for any material market fluctuations; for example, as a minimum, a significant investment gain or loss should be taken into account.

9.3 Long service leave

> **131. Although this Standard does not require specific disclosures about other long-term employee benefits, other Australian Accounting Standards may require disclosures, for example, where the expense resulting from such benefits is material and so would require disclosure in accordance with AASB 101. When required by AASB 124 an entity discloses information about other long-term employee benefits for key management personnel.** [Source: November 2010 compilation of AASB 119]

9.3.1 Specific disclosures are not required for long service leave under AASB 119. However, a Member may be asked to provide information to the company to enable the company to comply with its reporting standards under other accounting standards.

9.3.2 For long service leave calculations, the long service leave liabilities may be provided split into current and non-current liabilities, with superannuation as well as other on-costs both shown separately and also split. The Member may wish to refer to AASB 101 for guidance on current and non-current liabilities. Members should note that the classifications of current and non-current liabilities under AASB 101 do not necessarily align with the definitions of short-term and long-term employee benefits respectively under AASB 119.

10 OTHER ISSUES

10.1 Qualifications

AASB 119 encourages the use of a qualified actuary although it does not specifically require the use of an actuary. However, actuaries are commonly understood to have expertise in defined benefit superannuation so accordingly, reports for AASB 119 purposes represent Professional Services under the Code and are subject to the qualification requirements set out in the Code. In particular, a Member must comply with clauses 4.3 and 8.1 of the Code.

10.2 Retrospective benefit improvements (past service costs)

The treatment of past service costs is covered in paragraphs 96 to 101 of AASB 119. The past service cost is measured as the change in the defined benefit obligation that arises from the introduction of a new Plan or a change to existing benefits. To the extent that the improvement to benefits vests immediately, the past service cost is recognised immediately. The remainder is vested over the vesting period.

10.3 Business acquisitions or mergers that involve defined benefit plans (business combinations)

10.3.1 AASB 3 (Business Combinations) covers the general treatment of business combinations such as mergers and acquisitions. The cost of a business combination (that is, the purchase price) is assigned to identifiable assets and liabilities, with any excess assigned to goodwill. Paragraph 108 of AASB 119 also discusses business combinations. It specifies that the asset or liability recognised as part of the business combination is the present value of the obligation less the fair value of Plan assets – that is, the acquiree's accounting policy on the recognition of actuarial gains and losses will not impact the asset or liability recognised by the acquirer.

10.3.2 Therefore, the amount determined in accordance with paragraph 108 of AASB 119 together with all other identifiable assets and liabilities acquired is compared to the purchase price, with the excess of the purchase price over the identifiable assets and liabilities being recognised by the acquirer as goodwill.

There will be no impact on the defined benefit asset or liability recorded in the acquiree's financial report.

10.4 Termination or reductions in future accruals of defined benefits, due to benefit changes, transfer offers, retrenchments or other causes (curtailments and settlements)

10.4.1 Settlements and curtailments are discussed in paragraphs 109 to 115 of AASB 119.

10.4.2 A curtailment occurs when there is a reduction in the future defined benefits likely to accrue under a Plan, for example if the numbers of members covered by the Plan is reduced or if the level of their benefits is reduced. Hence, a curtailment is related to the future service impact of the specified event.

10.4.3 A settlement occurs when all legal and constructive obligations are extinguished for all or a part of the existing defined benefit obligation. The settlement is related to the past service impact of the event.

10.4.4 Events such as retrenchments, plant closures, benefit changes and transfer offers may be settlements or curtailments or both.

10.4.5 In the event of a settlement or curtailment, the impact on the defined benefit obligation and Plan assets is recognised in the profit and loss statement. Also recognised are any unrecognised actuarial gains or losses or past service costs that can be attributed to the affected members.

10.5 Foreign exchange gains and losses related to changes in value of foreign plans

10.5.1 AASB 121 (The Effects of Changes in Foreign Exchange Rates) covers the treatment of an Entity's assets or liabilities that are held in a foreign currency that is not the "functional" currency used in the Entity's financial report.

10.5.2 Typically, the foreign Plan will be part of a foreign subsidiary or operation and the financial statements of that subsidiary will be translated to the currency used by the parent company to allow consolidation. Under AASB 121, translational differences for consolidation are recognised in a separate component of equity.

10.5.3 Therefore in those circumstances, when reconciling the AASB 119 asset or liability shown in the employer's balance sheet from one year to the next, there may be an additional item for foreign currency impacts.

10.5.4 There may be other situations when the impact is not just at an individual company and consolidated level, and hence where different accounting treatment may apply.

11 REPORTING

It is considered best practice for the Member to prepare a letter or report with any advice. The report would cover each of the following items that are relevant:

(a) identifying details – for example, effective date, name of Plan, purpose of report, Member's name and the Entity for whom the report is prepared;

(b) summary details of membership data used (for example, numbers and salaries);

(c) details of asset data used, in particular whether audited asset data is used;

(d) any reliance on the work of others (for example, financial statements for asset data);

(e) details of financial and demographic assumptions (or a reference to other sources), whether the demographic assumptions are consistent with the last actuarial investigation and any comments on determination of assumptions, if relevant;

(f) a statement as to whether the assumptions have been agreed with the Entity;

(g) any instructions received from the Entity, especially those that lead to results that the Member believes are unreasonable;

(h) details of any roll forward of assets or liabilities, including details of the date from which amounts are rolled forward and the basis for rolling forward;

(i) other relevant comments on methodology and any important implications of assumptions, data or methodology (including the treatment of any hybrid elements in the Plan, the application of a vested benefits minimum, the application of the asset cap in paragraph 58 of AASB 119, the treatment of on-costs and the allowance for contributions and investment taxes);

(j) results and other information required for AASB 119 disclosures;

(k) details of any significant departures from this Practice Guideline and the reasons for those departures; and

(l) a statement that the report has been prepared in accordance with this Practice Guideline.

END OF PRACTICE GUIDELINE 499.04