Technical update – Employee Benefit Plans in Australia

Discount rate: In May 2015, Auditors in Australia accepted a change in approach to deriving discount rates when accounting for employee benefit plans that is likely to lead to a material improvement in Balance Sheet position and P&L expense for Australian corporates.

Expected return on assets: Updating standard methodology to allow for a 'diversification bonus' could lead to an improvement in superannuation funding positions and the superannuation expense under US GAAP.

Aon Hewitt are able to leverage the latest ideas and tools from our global practice to advise clients on the best approaches available, which can lead to materially improved financial results on your balance sheet.

About the discount rate

- Deriving discount rates when accounting for employee benefit plans has been notoriously subjective.
- AASB119 and IAS 19 require discount rates to be based on market yields on "high quality corporate bonds".
- Historically auditors have not considered the Australian corporate bond market to be sufficiently active and liquid and required discount rates to be based on the yield on Australian Government bonds.
- A group representing the top 100 companies in Australia (the Group of 100) commissioned a study to investigate whether a deep market in corporate bonds really does exist.
- The results of this study revealed that a deep market in corporate bonds does exist in Australia and importantly, these results have been accepted by the 'Big 4' audit firms.
- This change is likely lead to a material improvement in the Balance Sheet and P&L expense for Australian corporates when valuing their employee benefit plans.
- The employee benefit plans most likely to be materially impacted by this change are **defined benefit superannuation funds** and **long service leave liabilities** in Australia.

Saffron Sweeney, Principal and Senior Actuary at Aon Hewitt, said:

"The success of this assessment of the Australian corporate bond market brings us in line with other developed economies. Australian companies are now permitted to use a higher discount rate than directly implied by Government bond markets."

Contact information

For direct consultation on these implications, please contact:

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Saffron continued:

“Using Government bond yields, which are at historical all time lows, as the point of reference has inflated defined benefit superannuation liabilities, increasing the deficits that companies have had to recognise on their balance sheets as well as inflating the costs of providing long service leave benefits to employees (where discounting has been applied). Unsurprisingly, auditors placed a lot of scrutiny on the discount rate assumption, with companies consequently adopting a narrower range of discount rates than could have been justified by the Australian corporate bond market last year.”

“Allowing for a ‘credit spread’ of up to 100 bps over the Government bond rate could reduce defined benefit superannuation liabilities and long service leave liabilities (where discounting has been applied) on a company’s balance sheet by around 10%, for a typical DB plan”.

Expected return on assets - diversification bonus?

- The expected return on the assets held by a superannuation fund is used to derive the discount rate for superannuation funding valuations in Australia – the critical assumption when assessing the funding position and future contribution requirements for the fund.
- It is also used to calculate the projected superannuation expense where there are defined benefits for any corporates that report under US GAAP.

Traditionally, the expected return has been constructed by using a building block approach – this means that the expected rate of return for each asset class is weighted by the proportion of assets held in that class.

Working with our colleagues in the global investment practice, we have developed a more sophisticated approach that considers the volatilities of and correlations between the different asset classes as well as the expected return for each asset class.

For a typical portfolio of assets, we expect this approach could add up to 1.0% pa to the expected return on asset assumption. As a result, not allowing for this additional return actually understates the overall expected portfolio return.

David Hughes, Senior Consultant and Actuary at Aon Hewitt, said:

“As a global firm, we are aware that an increasing number of superannuation funds in different geographies are recognising the effect of the diversification bonus when discussing the financing of plans and producing financial statements. In addition to the scientific explanation, empirical evidence supports the existence of the diversification bonus”.

If you would like to arrange a meeting to discuss how any of these issues could impact on your business, or to find out more about how we could help you through a range of complex issues, please contact your usual Aon Hewitt consultant, Saffron Sweeney or David Hughes.