



The Chairman
Australian Accounting Standards Board
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Our Reference: T11/00154
Your Reference:

11 AUG 2011

Dear Sir

INTERNATIONAL ACCOUNTING STANDARD 19, EMPLOYEE BENEFITS

As you may be aware, NSW Treasury has a number of concerns about the relevance and the appropriateness of IAS 19 Employee Benefits to the Australian Public Sector. This was discussed at the June 2011 Heads of Treasury meeting which has authorised NSW Treasury to convey the concerns of the Treasurers of all Australian Governments. This letter has been provided to all Australian government Heads of Treasury about the impact of the existing and proposed superannuation standard on the quality and relevance of public sector reporting. These concerns cover the following three issues:

- the discount rate for valuing defined benefits liabilities
- the revised net interest calculation methodology
- the application of the standard to the Australian Public Sector.

Discount Rate

Under IAS 19 the discount rate used to calculate the value of defined benefit superannuation fund liabilities and components of superannuation expense is based on the yield on high-quality corporate bonds at the reporting date or, as required in Australia, the yield on government bonds as there is no deep market for corporate bonds. The discount rate therefore differs significantly from the expected earnings rate used currently by actuaries to calculate the value of liabilities for employer funding purposes.

The assets of most Australian superannuation funds are invested in diversified portfolios, including equities, property and fixed interest securities. The expected rate of return on a portfolio of this nature is substantially higher than the discount rate required under IAS 19. Given this, the valuation of liabilities under IAS 19 is significantly higher than calculated for funding purposes causing significant confusion amongst employers, fund trustees and other readers of the financial reports.

Defined benefit superannuation liabilities are significant for the majority of Australian jurisdictions and the use of a government bond yield for valuation purposes causes significant volatility. For example, the discount rate required under AASB 119 in June 2008 was 6.55 per cent compared with 5.17 per cent in June 2010. This reduction in the discount rate increased NSW's reported superannuation liabilities on 30 June 2010 by approximately \$9.5 billion.

There is an in-principle concern that the use of a government bond yield takes no account of the countries credit quality. As shown in Attachment A, government bond yields as at 30

June 2011 varied significantly from 2.98 per cent in Germany to 16.05 per cent in Greece. In such circumstances, it is clearly possible for a country to report a lower level of liabilities despite the underlying required cash flows being much higher. Even more perplexing is the fact that should Australia suffered a credit rating downgrade, the reported level of superannuation liabilities would fall. Such outcomes make little sense and have resulted in credit ratings agencies adjusting reported superannuation liabilities to remove the impact of discount rate volatility.

Revised IAS 19 Net Interest Calculation Methodology

The revised IAS 19 standard, issued in June 2011, effectively requires an entity to calculate earnings on dedicated superannuation assets using the same bond yield used to value the superannuation liabilities. That is, the expected long-term portfolio investment earnings return is no longer included in the calculation of expenses and therefore in the net operating balance - the key financial measure for Australian government budgets. By way of illustration, the impact of the change on NSW budget result is highly material and is estimated to worsen the result by about \$750 million per annum.

Apart from the impact on government's net operating balance, the proposal also raises serious policy concerns. Under the proposed approach, there will be no benefit to the net operating balance from investing in a diversified superannuation assets portfolio or even from setting aside dedicating assets to fund superannuation other than higher earnings on accumulated balances achieved through investment returns unrecognised in the net operating balance. In fact, the outcome for the operating result on an accounting basis will be worse than if the government chooses to invest in these assets directly.

Besides the perverse incentives created by these outcomes, the approach seems to ignore the reality of the equity risk premium supported by long-term world investment history. For example, State Super NSW has approximately \$27 billion of financial assets invested in a 80 per cent growth portfolio. Over the last thirty years, which includes the full impact of the Tech Bubble and the Global Financial Crisis, State Super's average investment return has been approximately 9 per cent per annum.

State Super forecast long-term investment return is 8.6 per cent, after tax, per annum which takes into account the fact that State Super asset investment earnings are tax free as they back pension liabilities and the favourable tax impact of Australian equity franking credits.

The exclusion of forecast investment return revenue from the net interest calculation seems to be also based on a view there is no objective basis to forecast investment returns for the various asset classes which seems to ignore the existence of many independent indices such as:

Asset Class Indices

Cash Sector	UBSA Bank Bill index
Australian Shares	S&P/ASX 300 Accumulation index
Indexed Australian Shares	S&P/ASX 200 Accumulation index
International Shares	Morgan Stanley Capital International World (ex Australia) index
Indexed International Shares	Morgan Stanley Capital International World (ex Australia) index
Listed Property	UBS Global Real Estate Investors Index AUD Hedged
International Bonds	J P Morgan Government Bond Index, AUD Hedged, Global Non-Australia

A typical superannuation fund diversified portfolio forecast return could be based on say the return on these asset classes over a thirty year period.

Application of IAS 19 to the Australian Public Sector

The combined impact of a bond discount rate to value superannuation liabilities and to calculate net interest expense potentially results in Governments reporting budget deficit results which could have a major adverse impact on the formulation of government fiscal policy.

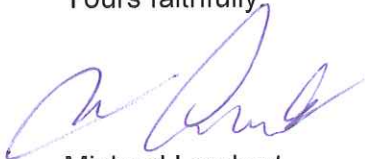
For example, when governments aim to achieve balanced budgets or small surpluses or deficits, seemingly small levels of liability/ expense volatility can have a significant impact. In order to be able to budget effectively and develop appropriate fiscal strategies, volatile movements in values need to be avoided.

There has been a long-term concern amongst Australian jurisdictions that a discount rate based on a borrowing rate at a point in time can give inappropriate outcomes. In the current environment, growth prospects remain relatively low and there have been substantial reductions in long-term government bond yields, except for countries such as Greece, where as previously noted their rates have substantially increased to reflect loan default risk. By contrast, commercial borrowers may find their rates have increased. It is not clear that either change reflects the underlying economic movements of the superannuation liability.

Applying all private-sector based accounting standard to Australian Public Sector entities may not appropriate, as the risks facing the Australian Public Sector are inherently different from those in the private sector and indeed many other international jurisdictions with lower credit ratings. This is particularly so where the solvency of the "employer" (the relevant government) is not in question. For example, when considering an appropriate rate at which to discount the funded superannuation liabilities of public sector schemes, the unlimited life span of these entities provides confidence for using a long-term best estimate rate and the long-term best estimate is the expected rate of return on assets (rather than a bond yield). Nevertheless, we accept that such an argument stands little prospect of acceptance.

Given the issues outlined above, it is requested that the Australian Accounting Standards Board seeks to have the proposed fundamental review of this area expedited by the International Accounting Standards Board. NSW Treasury will convey your response to this letter to all Australian Treasurers.

Yours faithfully



Michael Lambert
Acting Secretary

ATTACHMENT A**Government Ten Year****Bond Yields as at 30 June 2011 (for a selection of countries)**

Country	Yield %
Germany	2.98
United States	3.10
United Kingdom	3.24
Canada	3.47
France	3.65
Italy	4.82
Australia	5.21
Portugal	11.00
Ireland	11.33
Greece	16.05