Invitation to Comment **December 2005**

Superannuation Plans – Financial Liabilities

Prepared by the
Australian Accounting Standards Board

Commenting on this Invitation to Comment

The AASB is seeking comments on the application of a number of Australian equivalents to International Financial Reporting Standards in conjunction with AAS 25 *Financial Reporting by Superannuation Plans* to superannuation plans, including a proposed amendment to AAS 25 in relation to the accounting for liability balances resulting from a plan's investment activities. Constituents are encouraged to respond to the AASB by 30 November 2005. Comments should be addressed to:

The Chairman
Australian Accounting Standards Board
PO Box 204,
Collins St West Vic 8007
AUSTRALIA
E-mail: standard@aasb.com.au

A copy of all non-confidential submissions will be placed on public record on the AASB's website: www.aasb.com.au.

Obtaining a Copy of this Invitation to Comment

This Invitation to Comment is available on the AASB's website www.aasb.com.au. Enquiries about publication should be directed to:

The Customer Service Officer Australian Accounting Standards Board Level 4 530 Collins Street Melbourne Victoria AUSTRALIA	Phone: (03) 9617 7637 Fax: (03) 9617 7608 E-mail: publications@aasb.com.au **Postal address:** PO Box 204 Collins St West Vic 8007 AUSTRALIA

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Purpose of this Invitation to Comment

The AASB issued AAS 25 *Financial Reporting by Superannuation Plans* in August 1990 and revised AAS 25 in May 1992. AAS 25 requires superannuation plans to measure assets at net market values and immediately recognise changes in net market values as revenues for the reporting period. These requirements override the requirements in other Accounting Standards in respect of recognising and measuring assets, including AASB 132 *Financial Instruments: Disclosure and Presentation* and AASB 139 *Financial Instruments: Recognition and Measurement* in respect of financial assets. However, AAS 25 does not contain recognition and measurement requirements for financial liabilities held by superannuation plans, which include hedging instruments[1] and derivatives[2] that have liability balances. There is currently some uncertainty about the application of AASB 132 and AASB 139 in conjunction with AAS 25 in these circumstances, and discrepancies in the accounting treatments under these Standards may lead to inconsistent accounting treatments being applied in the financial reports of superannuation plans.

To remove the uncertainty, the AASB has reached a preliminary conclusion that superannuation plans should be required to treat the liability balances of hedging instruments and derivatives, that would otherwise be recognised as financial liabilities in accordance with AASB 132 and AASB 139, in a manner consistent with the approach adopted in AAS 25 with respect to assets. Accordingly, the AASB proposes to amend AAS 25 to require that financial liabilities held by superannuation plans be measured at net market values and any changes in these values be recognised in the profit or loss for the reporting period. The AASB plans to amend AAS 25 before 31 December 2005 to be effective for annual reporting periods ending on or after 31 December 2005. The AASB is seeking comments from constituents before finalising these amendments.

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1 Paragraph 9 of AASB 139 defines a hedging instrument as a designated derivative or (for a hedge of the risk of changes in foreign currency exchange rates only) a designated non-derivative financial asset or non-derivative financial liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item.

2 Paragraph 9 of AASB 139 defines a derivative as a financial instrument or other contract within the scope of this Standard with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’);

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date.

The amendments proposed in this Invitation to Comment are measures that will be reviewed when the AASB undertakes its comprehensive review of AAS 25.

Background

When considering its strategy for converging with IASB standards, the AASB decided in March 2003 that it would deal with IAS 26 *Accounting and Reporting by Retirement Benefit Plans* as a separate project relating to AAS 25 and not as a convergence issue.

In respect of superannuation plans, the requirements of AAS 25 override any conflicting requirements in Australian equivalents to International Financial Reporting Standards (IFRSs). Uncertainties have recently arisen in respect of the application of AAS 25 in conjunction with the application of the AASB 132 and AASB 139.

AAS 25 currently requires the assets of superannuation plans, including financial assets[3], to be recognised on the balance sheet and be measured at net market values[4]. AAS 25 also prescribes the recognition and measurement of accrued benefits, but it does not contain the recognition and measurement requirements for financial liabilities[5], which include hedging instruments and

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3 Paragraph 11 of AASB 132 defines a financial asset as any asset that is:
- (a) cash;
- (b) an equity interest of another entity;
- (c) a contractual right:
  - (i) to receive cash or another financial asset from another entity; or
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- (d) a contract that will or may be settled in the entity's own equity instruments and is:
  - (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

4 Paragraph 10 of AAS 25 defines net market value as the amount, which could be expected to be received from the disposal of an asset in an orderly market after deducting costs expected to be incurred in realising the proceeds of such a disposal.

5 Paragraph 11 of AASB 132 defines a financial liability as any liability that is:
- (a) a contractual obligation:
  - (i) to deliver cash or another financial asset to another entity; or
  - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) a contract that will or may be settled in the entity's own equity instruments and is:
  - (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity

derivatives that have liability balances. It is acknowledged that, in these circumstances, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* would require the superannuation plans to follow the hierarchy of accounting standards, which would lead to the application of AASB 132 and AASB 139.

A superannuation plan might have liability balances arising from the plan's contracts that are used as hedging instruments, and/or as derivatives. Section 67 of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act) generally prohibits, with limited exceptions, regulated superannuation plans from borrowing and Regulation 13.14 of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) prohibits trustees from giving a charge over an asset of the plan. Despite these general prohibitions, SIS Regulation 13.15A permits the trustees of superannuation plans to create a charge over the assets of a plan where the charge is in relation to a derivative or hedging transaction conducted on a recognised stock exchange. Because the trustees of superannuation plans are only permitted to purchase derivatives and/or hedging instruments that do not create a pledge over the assets of the plan (i.e. derivatives and hedging instruments that are financial assets of the superannuation plan), derivatives and hedging instruments that have liability balances are currently not recognised as liabilities of the plan. Additionally, the trustees can appoint a mandated investment manager who, in turn, invests in derivatives and hedging instruments not transacted on a recognised stock exchange. In these circumstances, it is possible that the liability balances of the derivatives and hedging instruments could occur such that they should be recognised as financial liabilities of the plan.

As mentioned above, AAS 25 does not prescribe the accounting treatment for financial liabilities of a superannuation plan. In contrast, paragraph 43 of AASB 139 requires hedging instruments and derivatives to be recognised at their fair values, regardless of whether they have an asset or liability balance. Paragraphs 86, 89 and 95 of AASB 139 require hedging instruments to be categorised as cash flow or fair value hedges and changes in fair values are recognised in equity for a cash flow hedge or in profit or loss for a fair value hedge.

Under AAS 25, expected transaction costs are adjusted in determining the net market values of assets, whereas under paragraph 46 of AASB 139, as a subsequent measurement, the fair values of financial assets or financial liabilities (with certain exceptions applicable to financial liabilities) do not adjust for the expected transaction costs, which may occur on a sale of assets or on extinguishing liabilities.

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instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

The above discussion highlights that the application of AASB 132 and AASB 139 instead of AAS 25 to financial liabilities would give rise to inconsistencies in the measurement of a superannuation plan's assets and liabilities. Accordingly, the AASB decided that superannuation plans should be required to treat all hedging instruments and derivatives, that would otherwise be recognised as financial liabilities in accordance with AASB 132 and AASB 139, in a manner consistent with the approach required in AAS 25 with respect to assets.

Operative Date

It is proposed that the amendments apply to annual reporting periods ending on or after 31 December 2005.

Request for Comments

The AASB invites comments on following specific matters:

(a) the proposal that financial liabilities of a superannuation plan that might otherwise be treated under AASB 132 and AASB 139 should be required to be measured at net market values under AAS 25 and any changes in the net market values recognised in the profit or loss for the reporting period; and

(b) the manner in which the AASB proposes to amend AAS 25 as shown in the Appendix.

APPENDIX

This Appendix shows relevant paragraphs of AAS 25 marked up for the amendments needed to ensure that superannuation plans treat the liability balances of all hedging instruments and derivatives, that would otherwise be recognised as financial liabilities in accordance with AASB 132 and AASB 139, in a manner consistent with the approach adopted in AAS 25 with respect to assets. Accordingly, hedging instruments and derivatives held by superannuation plans would be measured at their net market values and any changes in these net market values recognised in the profit or loss for the reporting period.

Liabilities

COMMENTARY

24 Liabilities arise when, as a result of past transactions or other past events, an entity has a present obligation to make a disposition of economic benefits to other entities in the future. Liabilities of a superannuation plan may include the liability for accrued benefits, income tax liabilities, ~~and~~ sundry liabilities and financial liabilities[1]. Sundry liabilities may include accounts payable, borrowings, pre-paid contributions and, in the case of defined contribution plans, other liabilities arising from benefits which have been forfeited and which have not been designated for the benefit of existing plan members as at the reporting date. For defined contribution plans, benefits which have been forfeited and have not been designated for the benefit of existing plan members may encompass amounts held for the benefit of future members, amounts to be returned to employers and amounts held as an offset to future employer contributions. Financial liabilities may include the liability balances of hedging instruments[2] and derivatives[2].

Assets

COMMENTARY

27 The assets of a superannuation plan may include the following:

…

1 Financial liabilities are the financial liabilities that would otherwise be recognised as financial liabilities in accordance with AASB 132 *Financial Instruments: Disclosure and Presentation* and AASB 139 *Financial Instruments: Recognition and Measurement*.

2 As defined in AASB 139.

(b) investments of the plan, which may include equity or debt securities, ~~and~~ real estate and the asset balances of hedging instruments and derivatives;

…

Employer undertakings or guarantees to fund benefit payments

Measurement of Accrued Benefits and Financial Liabilities

STANDARDS

49 …

50 …

50A Financial liabilities of a defined contribution plan and a defined benefit plan shall be measured at net market values as at the reporting date.

50B For a defined contribution plan and a defined benefit plan, the change in net market values of the plan's financial liabilities since the beginning of the reporting period shall be included in the profit or loss for the reporting period.

Disclosure Requirements

Defined contribution plans

Statement of financial position

STANDARDS

57 The statement of financial position of a defined contribution plan shall disclose:

…

(d) by way of note:

…

(iii) …; ~~and~~

(iv) …; and

(v) the method adopted in determining net market value for financial liabilities.

Operating statement

STANDARDS

58 The operating statement of a defined contribution plan shall disclose, by way of note or otherwise:

…

(d) by way of note:

…

(ii) …; and

(e) changes in net market values of financial liabilities that have been recognised in the profit or loss for the reporting period.

Defined benefit plans

Statement of net assets

STANDARDS

60 The statement of net assets of a defined benefit plan shall disclose:

…

(d) by way of note:

…

(v) …; and

(vi) the method adopted in determining net market value for financial liabilities.

<u>*Statement of changes in net assets*</u>

STANDARDS

61 **The statement of changes in net assets of a defined benefit plan shall disclose:**

…

(k) by way of note:

…

(ii) …;<u> and</u>

<u>(l) changes in net market values of financial liabilities.</u>