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Consolidation of Subsidiaries by Superannuation Entities

Comments on Consultation Paper

Introductory comment

The consultation paper proposes alternatives for the measurement model that should be used by superannuation entities on consolidation. This is in preparation for the comprehensive revision of AAS25.

If, as a basic principle, it is accepted that the fair value model is the preferred model for a stand-alone superannuation entity (because fair value less disposal costs most readily reflects the current value of member's entitlements) it logically follows, in our view, that a fair value model should be applied in the preparation of consolidated financial statements of a superannuation entity and its subsidiaries.

On the presumption of the AASB that superannuation entities should prepare consolidated financial statements, a fundamental objective should be to maintain consistent measurement models between parent and group financial statements in order to maintain comparability and to avoid inconsistency in accounting policies between group and parent reports for a particular superannuation entity.

This is supported by Paragraph 28 of AASB 127 Consolidated and Separate Financial Statements which states that "Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances." Paragraph 29 further explains, "If a member of a group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements in preparing the consolidated financials statements."

Obviously, there will be situations where there is relatively little difference between the measurement policies adopted by the subsidiary and its superannuation fund parent. For example subsidiaries which hold investment properties measured at fair value, or subsidiaries whose assets and liabilities comprise highly liquid securities with a readily determined fair value.

However, practical problems can arise where a superannuation entity, using a fair value measurement model (adjusted for disposal costs) to measure its investment assets and liabilities, tries to determine the same fair value measurement policies at an individual asset level for its subsidiaries but those subsidiaries are not superannuation entities –they are operating entities (maybe infrastructure trusts) or venture capital entities (biotech or agricultural) and they use the measurement policies set out under IFRS and adopted by their peers as best practice in preparing their individual management and statutory financial reports.

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The appropriate measurement model for a stand-alone set of superannuation entity financial statements and the measurement of Defined Benefit ("DB") Obligations

As stated earlier, the fair value model is the preferred model for a stand-alone superannuation entity because fair value less disposal costs most readily reflects the current value of members' entitlements.

In relation to the fair value of DB obligations, while this is not a consolidation issue, it will impact stand-alone super fund financial reports and should be considered separately as part of the measurement framework for all super funds. It is our view that an active market for DB obligations does not exist and therefore fair value should be determined by reference to members' vested benefits. We recommend that the AASB obtain advice from the Institute of Actuaries on this matter.

Least preferred consolidation approach

Approaches B and D are not considered by us as appropriate. Any approach which provides the option of using cost in the consolidated financial statements is inappropriate for the following reasons:

1. It would be confusing to trustees and members to report assets and liabilities at anything other than at fair value. In the case of a defined contribution fund where the trust deed requires that the crediting rate is determined based on the change in the fair value of net assets for the year, and where assets are valued at cost in a set of consolidated financial statements and those assets are subsequently sold, members who exit the Fund prior to the assets being sold would not benefit from the realised gains that relate to assets they were entitled to whilst they were a member.

2. If a fair value model is required in a parent's accounts, then it would be misleading and inconsistent with the requirement of AASB 127 to permit consolidated financial statements to be prepared which result in the net asset value at the consolidated level to be different to the net asset value at the parent level.

3. If a defined contribution super fund invests in an investment that can only be measured at cost, then why is this an appropriate investment for a defined contribution fund?

Concerns relating to the use of a full fair value model:

While the full fair value model as set out under approach A is conceptually the best alternative, if such a model is applied, superannuation entities with investments such as private equity, venture capital or infrastructure funds will inevitably find it difficult to determine the fair value of individual line assets held by their subsidiaries.

A very basic example of this is a situation where a superannuation fund holds a 51% interest in a small listed entity that operates a coalmine. The subsidiary has a readily ascertainable market value for its issued shares and the superannuation fund reflects that value in its own accounts.

When it comes to prepare its consolidated financial statements, the superannuation entity then has to reflect the individual assets and liabilities at their fair values. Such information is not likely to be readily available as it would be difficult to envisage the management or the governing body of the coalmine subsidiary requiring such information for the purposes of managing the business.

Yet, to achieve a consistency of measurement at the net asset line between the parent and the consolidated financial statements, some adjustment will need to be made to the values shown in the subsidiary's financial statements. We consider this type of situation would only be exacerbated in cases where subsidiaries hold venture capital investments or operating infrastructure assets.

It should be noted that this issue is not isolated to super funds preparing consolidated financial statements. There are currently many stand-alone super funds that invest directly into private equity and venture capital investments that struggle to obtain fair values for these investments and unless the private equity investment is listed on a stock exchange or an active market, which is rare in practice, the fair values of the underlying assets and liabilities of the private equity investment will usually need to be valued individually in order to come up with an overall fair value for the investment in the super fund's financial statements. It would therefore be very rare that a parent super fund would measure a private equity investment at fair value as a whole in its financial statements without the material underlying assets and liabilities of the subsidiary having been valued at fair value.

Although it has proved difficult for super funds to obtain fair values for private equity and venture-capital investments, given the nature of the investments and the increased take-on of these types of investments by super funds, it is more important than ever to ensure that a fair value is sought for these investments. To measure material private equity investments at cost in the accounts of the super fund or the consolidated financial statements without considering whether cost actually represents the current fair value of the investment poses a significant risk that the investment could be misstated and does not reflect members' current entitlements.

Concerns relating to the use of EMVONA:

From a practical perspective, it could be argued that the use of an EMVONA item in the consolidated balance sheet of superannuation entities will assist with the difficulties currently experienced by super funds in obtaining fair values for the individual assets of subsidiaries, which can be extremely difficult in the case of private-equity or venture capital investments. Using the EMVONA balancing item could allow super funds to reflect the assets and liabilities as they are presented in the financial statements of the subsidiary, with some items being measured at cost, and to present EMVONA as the difference between the books of the sub and the financial statements of the parent super entity.

However, there are downsides to this as set out in the consultation paper. This is not appropriate for the following reasons:

a) this somewhat defeats the purpose of consolidation, as members may as well just receive a set of the subsidiary's financials appended to the super fund's stand alone financials;

b) The usefulness to members of having an EMVONA item in the balance sheet for the sake of bringing the consolidated position to that of the parent super fund is questionable. Users may question what the EMVONA really stands for and why the underlying assets of the subsidiary cannot also be fair valued.

c) The practical issues currently faced by super funds and managed investment schemes alike in fair valuing private equity investments is not confined to fair valuing the assets of subsidiaries. Stand-alone funds and managed investment schemes currently have the issue of fair valuing material private equity investments which are held directly and not through a subsidiary, and therefore EMVONA does not really solve this measurement problem.

Based on the above, EMVONA would only be a suitable option to be used on consolidation where the assets and liabilities of a subsidiary are still required to be measured at fair value, and EMVONA is a representation of the difference between the fair value of the identifiable net assets in the subsidiary and the fair value of the net assets of the subsidiary as a whole recognised in the parent super fund financials.

However, we are not aware of any instances in practice where the fair value of the identifiable net assets of a subsidiary would be materially less than the fair value of the business as it is booked in the books of the parent. For example, in the case of a subsidiary of a super fund which owns a hotel group, the independent valuers are required to include intangible items such as branding in the valuation of the land and buildings of the hotels.

Conclusion

The new financial reporting standard for superannuation entities should require a full fair value measurement model to be applied in the financial statements of all superannuation entities.

The consultation paper contains some concepts which appear to be somewhat anomalous. For example, at E3 (a), the statement is made that "there is little justification for requiring superannuation entities in Australia to adopt IFRSs since many of the accounting and disclosure issues they face are a consequence of the domestic environment". However, throughout the paper there is reference to the requirements of various IFRS and the need to follow them.

We appreciate that the consultation paper has been prepared with the intention of ensuring consistent application of the International Framework for the Preparation and Presentation of Financial Statements. However, it is our contention that more consideration needs to be given to the opportunity to more closely align the information needs of the trustees, member and employer contribntors, regulators and government policy makers through greater face to face interaction on the topic of meaningful and cost effective financial reporting than has been done to date.

We hope that our comments and observations on the alternatives set out in the consultation paper illustrate, to some extent, the peculiarities of financial reporting for superannuation entities. They are made with the consideration that superannuation fund investments are, more likely than not in the future going to be made in areas and entities where fair value accounting and reporting will present significant challenges to this industry.