ED179 sub 17

AustralianSuper

2 October 2009

The Chairman
The Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

Dear Sir

ED 179 Superannuation Plans and Approved Deposit Funds

AustralianSuper (the "Fund") is one of the largest industry funds in Australia, servicing 1.461 million members, with $27.5 billion in net assets at 30 June 2009. We are supported by 110,000 employers contributing on behalf of their employees. We are primarily a defined contribution fund, but we also have 16 sub-plans that have a defined benefit component. In response to the release of AASB Exposure Draft 179 Superannuation Plans and Approved Deposit Funds ('ED 179') issued in May 2009, we attach our response to four issues arising from the various proposals within the ED which could specifically have practical ramifications for our Fund. We have restricted our comments to these four key areas within the ED where we believe alternative treatment should be considered. Our comments will make reference to the submission of our external auditor, Denis Thorn from Ernst & Young dated 29 September 2009, because we have experienced these issues together during our 30 June 2009 year end and we strongly agree with the conclusions drawn. Our submission will however seek to add weight to their submission by the practical issues the Fund would have to deal with in applying the proposals in the ED.

Similar with Ernst & Young, we are generally supportive of the proposals, as a whole, within the ED and believe that the proposals will provide great transparency and consistency across the industry and enhance the current financial reporting framework amongst superannuation funds to facilitate greater comparison across the industry and other non-super entities. We also believe the principles based approach adopted allows Trustees to tailor their financial reporting to focus on financial risks specific to the structure of their Fund.

While we are overall supportive of the proposals, we have raised some matters for your consideration and clarification. In particular, our response provides some general comments focusing on the following key areas:

- Consolidation of controlled entities
- Measure of defined benefit liabilities
- Insurance contracts, and
- Investment expenses.

Should you wish to discuss any aspects of our submission, please feel free to contact the undersigned on (03) 86483880.

Yours faithfully

Tony Cavanagh
General Manager Finance and Risk
AustralianSuper

This information is of a general nature and does not take into account your personal objectives, situation or needs. Before making a decision about AustralianSuper, consider your financial requirements and refer to the relevant Product Disclosure Statement (PDS). AustralianSuper Pty Ltd ABN 94 006 457 987 AFSL 233788 Trustee of AustralianSuper

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General Comments

Our response provides some general comments focusing on the following key areas:

- Consolidation of controlled entities
- Measurement of defined benefit liabilities and
- Insurance contracts
- Investment expenses.

1. Consolidation of controlled entities

Practical Issues:

Set out below is Ernst & Young's commentary and suggestions for consideration. We **strongly concur** with their comments and suggestions.

During the preparation of our 30 June 2009 financials we considered controlled entities and provided detailed notes to our financial statements on our special purpose entities (SPE); which we do not consolidate, because they are reported within the appropriate asset class on our balance sheet and there is very little debt within the SPE investments. We relied on materiality in this event.

The real issue for us was "technical temporary control" of passive investments at our balance date. We had 4 such investments in trusts where we owned greater than 51% of the units on issue. In the case of 3 of these we were able to prove **exceptional circumstances**, which meant we did not have a controlled entity situation. These were where the trust deed gave us no power to change the manager or trustee, or that would have required 75% voting to effect such changes. In the final case we owned in excess of 75% of units in a cash transaction trust. The trust deed required 75% ownership to effect change. To all intent and purpose this is a bank account, which we chose to invest in because of better returns. We had large holdings because our members had switched their investment options to our cash option during these volatile economic times. This level of holding was unusual. As members are converting back to riskier options, this cash balance is reducing. Technically we could not argue against control because we had no exceptional circumstances to rely on. The effect of consolidation would have been to gross up our cash by $260 million, with a corresponding current liability to meet cash calls on demand of $260 million. The form over substance position is that we are a passive investor in this trust, moving our cash based on our investment option selections of our members. In addition, if this trust was not providing better returns we would simply move our money. Our overriding decision criterion is to get the best return for our members in the asset classes they select. The issue for us that there was no clear guidance on what **exceptional circumstances** may mean. We believe that based on our investment practices and actions, that to have consolidated this investment and produce group accounts would have given the members and APRA the wrong view of why we invest members' money.

It is this context that we strongly agree with Ernst & Young's comments and suggestions in this area.

Should the Board not wish to provide guidance in this area, then the superannuation industry should take it upon itself to work with the accounting firms, practitioners, APRA and investment advisors to document examples for guidance to Trustees on control and when exceptional circumstances may or may not exist in determining control. It would be helpful if this project was also done with the input of the Board.

Extract from Ernst & Young Submission

"Commentary on proposals:

We acknowledge the extent of industry discussion regarding superannuation funds consolidating controlled entities and the desire of the AASB to apply the IFRS conceptual framework and policy of transaction neutrality across all reporting entities. Whilst we generally concur with the current proposals, we believe that the ED should provide some further guidance on the definition and application of control as the prima facie assumption of control, ie., in excess of 50%, results in the technical interpretation of super funds consolidating entities when actual 'control' may not exist. The presumption is only rebuttable when there are exceptional circumstances where it can be 'clearly demonstrated that such ownership does not constitute control'. We would like to see the ED consider the intricacies of the superannuation industry and

take a 'substance over form' approach when considering whether control exists and provide some further guidance on instances where '...ownership does not constitute control'.

We agree that there are some limited instances where a superannuation fund clearly satisfies the definition of control and should consolidate controlled entities. In particular, where a fund has established a special purpose entity, owns 100% of the equity, governs the financial and operational policies of the entity and has a majority of representatives on the Board is a clear example of control. An example of this is where a superannuation fund establishes a pooled superannuation trust ('PST') to hold all investments of the fund in exchange for all the units in the PST. Therefore, it is clear that 'active' control exists and we agree that the superannuation fund should consolidate the entity to provide greater transparency over the subsidiaries financial position, financial performance and financial risks.

We contrast the above scenario where 'active' control exists to the scenario where 'passive' control exists. Superannuation funds often have investments in collective vehicles which are operated by fund managers in order to benefit from the efficiencies of pooling investment monies with other investors and obtaining the relevant expertise from the fund manager. Such collective vehicles may be retail unit trusts, open to the wider public or a wholesale trust, limited to institutional investors of the fund manager. Typically, such investments are managed by a professional funds manager and the Trustee or Responsible Entity is generally related to the fund manager, not the Trustee of the superannuation fund. Investors, including superannuation funds, will apply for and redeem units based on their target asset allocation (and where applicable, any member investment choice elections) and/or liquidity needs. As the investment strategy (including asset selection and allocation) of the trust is determined by the fund manager, the Trustee of a superannuation fund would consider the appropriateness of the fund manager's strategy when deciding to purchase or redeem units or offer the trust within a member investment choice option.

Where other investors also own units in the collective investment, it is difficult to obtain and monitor the unit holding of collective investments especially retail trusts where there is a relatively high volume of applications and redemptions in unit holdings compared to wholesale trusts. Overall, it is usually the intention of the Trustee of the superannuation fund to act as a 'passive' investor and not be involved in the day to day operation of the collective investment. If the Trustee is dissatisfied with the performance of the collective investment or the performance of the fund manager, they would generally redeem their unit holding rather than exercise any form of control.

Furthermore, trustees of superannuation funds do not generally exercise control over such collective investments for the following reasons:

- The governing rules of the collective investment do not generally permit investors to govern the financial and operating policies. In most cases and certainly in recent deeds, such powers are unequivocally delegated to the fund manager
- The trustee of the superannuation fund has little or no control over the level of their ownership interest. It will regularly fluctuate relative to the holdings of other investors
- The overall objective of the Trustee of the superannuation fund is to be a 'passive' investor and benefit from the fund manager's expertise and from the efficiencies of pooling investment monies with other investors.
- The governing rules may provide a legal right to unit holders to change the Trustee, Responsible Entity and/or fund manager but this right is rarely used in practice and is usually a matter of last resort. If the trustee of the superannuation fund was dissatisfied, it would usually redeem its unit holding and exit the fund rather than step in and actively 'control' the trust.
- Generally, there is no process for general meetings and voting on financial and operating policies except for limited emergency powers that may exist and usually requires a special resolution of more than 75% of unitholders before unitholders can step in and control the trust
- The fund manager is not bound to seek approval of the investors on investment selection decisions although it is expected that the fund manager would adhere to a defined mandate or strategy as communicated to investors
- Typically, and based on our experience, the majority of collective investments that superannuation funds invest in are not permitted to borrow. Where borrowing is permitted, gearing is usually low. Therefore, for most trusts consolidating the balance sheet of the subsidiary has little impact on the presentation of financial statements. For example, trusts that are asset class specific eg., an equities trust which forms part of the equities investment class on the balance sheet of the parent entity is

unlikely to materially impact the balance sheet as the assets of the subsidiary will predominantly comprise equities with other assets or liabilities being immaterial. If there is gearing and/or minority interests, it is unlikely to be material when 'grossed up' on consolidation.

- At times, trusts are established and used as the preferred investment structure rather than using a direct mandate with an investment manager or directly holding of the underlying securities for ease and simplicity. For example, a cash management trust ('CMT') is a popular vehicle amongst superannuation funds to hold surplus cash over a bank account so that funds can earn higher returns on surplus cash. Once again, it is unlikely that the trustee will ever actively 'control' the CMT. Instead, they wish to benefit from earning a higher return on surplus cash in a highly liquid investments without holding the underlying securities eg. bank bills. Similarly, an equities trust may be the preferred approach to gain exposure to ASX 200 securities without holding the securities directly. Therefore, understanding the intentions of the Trustee and reason for holding certain investments needs to be considered.
- Our experience has also found that many superannuation funds have large unitholdings in collective investments as a result of member investment choice. Whilst the Trustee may select the collective investments that comprise its investment strategy and provide the various member investment choice options, it is the member of the Fund that selects the appropriate investment option and the underlying collective investments comprising the option. There are instances in the industry where superannuation funds are currently consolidating such unitholdings as a result of the technical interpretation of AASB 127 because they own greater than 50% of the unit holding despite being a 'passive' investor.

Finally, the *Superannuation Industry (Supervision) Act 1993* requires Trustees of superannuation funds to comply with the 'sole purpose test' which requires superannuation funds to be maintained for the purpose of providing benefits to members and their beneficiaries or for a limited number of other ancillary purposes. For example, the establishment of w holly owned entity to provide financial planning services to members or to structure an investment arrangement to generate returns from members would meet the sole purpose test. However, the establishment of a fund for the purposes of providing finance to the employer sponsor was recently deemed not to have complied with the sole purpose test. Similarly, the controlling of an entity such as a manufacturing company, a hospital or a hotel and the governing of the day to day operations of the entity may be in breach of the sole purpose test. Therefore, we recommend that the AASB consider whether the requirements of the sole purpose test would prevent a superannuation fund from controlling an entity and governing the operational and financial policies of an entity.

Suggestions for consideration:

The standard should include application guidance on the definition of control which will assist superannuation funds in identifying potentially controlled entities. The guidance should distinguish between instances of 'passive' versus 'active' control by taking a substance over form approach. Use of examples would assist in understanding how the definition of control and guidance should be applied and assist in ensuring that instances of 'active' control are clearly identified. Consideration should be given to many of the factors that are evidence of 'passive' control as identified above including:

- The existence of a fund manager who exercises unfettered operational control
- The appointment of a Trustee or responsible entity independent of the fund
- Whether the trust is open to other investors
- The ability to redeem units upon request

The application guidance will need to clearly identify factors that would constitute 'active' control so as not to dilute the requirement for funds to consolidate where control clearly exists such as:

- Establishment of special purpose entities ('SPE') where the board is not independent and governs the financial and operational policies of the SPE
- Controlled PST's
- Entities where the definition and factors supporting 'passive' control no longer exists such as instances where the Trustee's intention has changed as evidenced by the exercise of powers that would constitute 'active' control eg., terminating the fund manager, Responsible Entity, or Trustee."

2. Measurement of defined benefit liabilities

Practical Issues:

Set out below is Ernst & Young's commentary and suggestions for consideration. We **strongly concur** with their comments and suggestions.

AustralianSuper is public offer fund with 1,460,740 members and assets under management of $27.5 billion. The majority of these members are in our industry division and are defined contribution members. We have 16 defined benefit sub plans, consisting of a combination of defined contribution and defined benefit members. In total we have some 2116 defined benefit members across these 16 sub plans or 0.145% of our membership. The Fund is therefore technically a defined benefit plan. These sub plans have joined us as tailored corporate plans. They do not have separately identified assets (these are combined in the total investments of the Fund) but each sub plan's assets and liabilities are ring fenced, such that no other member or sub plan can, and is expected to, support the liabilities of that particular sub plan. We continue to be active in tendering for such sub plans as the employer decides from time to time which fund to be with, and the industry rationalizes to lower costs (one of the policy directions of the government).

Each of the sub plans appoints their own actuary (usually this appointment is made by the Trustee at the request of the employer) and consequently we deal with 7 different actuaries across the 16 sub plans.

When the sub plans join they come under our Trust Deed. Under this deed we cannot and do not guarantee a member's defined benefit. Our liability to the member is limited to the assets of the particular sub plan. Each sub plan actuary is responsible for recommending funding arrangements for that plan having regard to the requirements of the Trustee. The Trustee has a funding policy for defined benefit sub plans which focuses on the sub plan asset coverage of sub plan members' vested benefits. This is in keeping with the provisions of superannuation legislation which considers a defined benefit sub plan to be in an "Unsatisfactory Financial Position" if assets are insufficient to cover vested benefits. The funding policy of the Trustee is such that if there was a short fall in a particular sub plan's assets to that sub plan's members' vested benefits we would require the employer company to comply with the actuary's recommendations to make up the short fall. We are required to notify APRA of the shortfall and what action is being taken to rectify this position. In these circumstances it is the Trustee's policy to communicate to members the fact that the defined benefit sub-plan has entered an Unsatisfactory Financial Position and what action is being taken to rectify the financial position. In a case where the company does not enter into a suitable rectification program constructed under the guidance of the sub plan actuary and the Trustee, the Trustee will then need to consider invoking certain provisions of the Trust Deed that are set down to cover such circumstances. One such action would be to close the relevant sub plan. In such circumstances members' benefits accrued up to that point in time will be limited to the level of assets that the sub plan has to fund those liabilities. The Fund accepts no liability beyond the assets of the sub plan.

Each sub plan actuary will as part of their triennial (or more frequent, as has been the case over these difficult times) actuarial investigation of their sub plan focus on the complete range of liabilities and the relevant funding implications of these, This will include total liabilities, accrued benefits and various contingent benefits and liabilities. These investigations are much more extensive in their consideration of assets and liabilities than vested benefits or accrued benefits alone.

The proposal to put accrued benefits for defined benefit members on the balance sheet as liabilities raises the following practical issues for us:

1. Crediting Rates
   It is the policy of our Fund to credit all earnings to members. We do this by declaring daily crediting rates and the only allowance we make after tax is performance fees, member protection and a contingency reserve for errors. To avoid the possibility of negative reserves (see 2 below) the Fund would be required to determine a daily allowance for any shortfall that may exist between accrued benefits and sub plan assets of DB members. Apart from introducing another difficult level of estimation, it is not equitable to account for a shortfall in our crediting rates when most of our members will never be required to fund the shortfall. So the liability shortfall of 0.145% of our members could disadvantage 99.855% of our membership. The alternative would be to declare 17 different rates (our industry accumulation members plus 16 sub-plans) across all of our 15 investment options. This would require 255 rates per day, which would be

unmanageable and furthermore, in the event of a pricing error, could create an unworkable position to correct.

2. Negative Reserves
   If we do not provide for the possible shortfall in the crediting rates and distribute all our earnings to members (which is equitable), and if we are then required to put the accrued liabilities on the balance sheet (or risk a qualification) we could end up with negative reserves. This will need to be reported to APRA and our response will be yes we have negative reserves but this is due to the accrued benefits shortfall in DB members which we will not be required to fund as they are the employers liability. This circumstance would be extremely difficult to communicate and explain to any or all members. It should be noted that the requirement for the auditor to report deficiencies under Section 130 of SIS is based on the annual audited financials, upon which the APRA Return is based.

3. Equity between members/not our liability
   We make no guarantee to DB members. DC members cannot, and we would not let them, fund any shortfall in DB member accounts. To do so would be inequitable. To account for 0.145% of members in this manner ie accrued benefits is confusing to our wider membership and does not truly reflect the asset liability position to our DC members.

4. Availability of data
   Apart from the issue of estimation in daily rates we could not get the required information on accrued benefits from all 7 actuaries we deal with to complete our financials on time (31 October lodgment). This would also disadvantage the majority of our members in receiving their periodic statements. AustralianSuper issues half-yearly statements to members, covering the periods ending 31 December and 30 June. This is vital communication to members. Some would say the most important. Any delays in finalizing our numbers would delay this communication. It is conceivable that the delays could cause us to breach the Corporations Law requirement to provide periodic statements to members within 6 months of the end of the reporting period.

5. Future tendering
   The Fund would seriously need to consider its position in accepting tenders for DB/hybrid sub plans if it was required to deal with the complexities I have set out herein. This is not good for fund consolidation and the desire to lower costs to members.

6. Reserve Treatment as liabilities.
   Whilst all monies are members' money the issue arises as to reserves. Typically Funds run administration or contingency reserves to cover the issues raised by APRA in their Prudential Practice Guide SPG 235 – Use of reserves in superannuation funds. These reserves arise largely from not spending the administration fee charged to member accounts as opposed to a withholding of investment returns. Investment return withholding would typically be used to create a reserve against crediting rate or unit pricing errors. This reserve could be argued to be eventually payable to members and hence a liability. The administration reserve or contingency reserve would not typically be returned to members unless it was in excess of the needs it was put away for or in a wind up. To classify this type of reserve as a liability give the wrong impression to the member. In addition most superannuation fund trustees under their RSE licence issued by APRA are required to maintain a minimum of $100,000 in administration reserve. The treatment of the reserve as a liability may impact upon compliance with this requirement.

Extract from Ernst & Young Submission

"Commentary on proposals:

Firstly, we concur with the proposals within the ED that classify members benefits (defined benefit and defined contributions) as liabilities on the face of the balance sheet. Similarly, other amounts such as reserves, amounts not allocated to members etc should be treated as liabilities. However, we do not believe that the current proposals for measuring defined benefit liabilities are appropriate. Whilst we disagree with the measurement basis and would prefer a vested approach to measure the liability, we would be supportive of disclosures on accrued benefits.

The ED suggests that defined benefit entitlements of a superannuation fund should be measured and recognised using an approach that is conceptually similar to the requirements of AASB 119. AASB 119 has been drafted for the purposes of measuring and recognizing the liabilities of an entity in providing employee benefits including post retirement benefits through a defined benefit scheme. Whilst AASB 119 is considered appropriate to measure the value of employee benefits (including defined benefit liabilities) on an accrued basis by apportioning the cost of benefits over the relevant service period, we do not believe that this is an appropriate basis for measuring the liability of the Trustee of the superannuation fund for the following reasons:

- employers have made a promise to their employees to put in place certain retirement benefits and are, appropriately, required under AASB119 to measure these obligations which they are constructively and/or legally committed to by apportioning the cost over the expected service period. This is designed to ensure that the cost of providing employee benefits is attributed over the periods in which the employee renders the service to the employer. In contrast, the trustees of a defined benefit superannuation fund have not made the promise to the employees, have no control over the service period, the value of the benefit provided to the employee and the rendering of the services. They are simply the agent, acting on behalf of the beneficiaries, holding the contributed monies 'in trust' and are responsible for prudent management of the arrangement. Beyond paying the benefit 'vested' in the member at any given time, any residual assets contributed by the employer sponsor for defined benefit members is considered 'surplus' and is available to meet benefits as and when they vest at a future date
- employers have an obligation to make all practical efforts to fund these contractual obligations, and if necessary, to increase their contributions where a shortfall exists. In contrast, if a Trustee becomes aware of a potential shortfall, they would usually, in conjunction with the Fund actuary work with the employer to put in place a funding plan to rectify the shortfall. The Trustee would strongly encourage the employer to contribute in accordance with the recommended funding plan and request written commitment of the employer to the funding plan. Trustees, in their own right, are not liable for the shortfall as it is the employer's liability. Trustees generally do not have the financial capacity or legal authority to fund these liabilities in any other way, and they certainly cannot use funds that they hold for other members or for defined contribution members as this would amount to subsidizing the defined benefit members at the detriment of other members.
- Depending on the Deed, a Trustee of a superannuation fund may have various powers available to them to force the employer to make contributions. In addition, where an employer fails to contribute, the Trustee usually reserves the right to terminate the arrangement and distribute available net assets to members regardless of what the employer's contractual obligations to the members. Therefore, the Trustee would only be liable for the reduced benefit
- As noted above, the accounting requirements under AASB 119 are driven in part by the need to allocate the service cost of employment over the working life of members. This consideration is irrelevant to superannuation fund trustees who have no control, influence or economic interest in whether or not the employees remain in service. Once again, the employer can decide to terminate employment arrangements by terminating employees, divesting of business interest or a subsidiary etc. This may trigger additional employee benefits which the Trustee will only be liable to meet based on certain events occurring as determined by the employer. Until such events are triggered, the Trustee's liability would continue to be the current amount vested
- ED 179 should recognize that superannuation funds are legal entities in their own right. They are not subsidiaries of the employer sponsor. Therefore, the accounting needs to recognise their separate and independent status and not just mimic employer accounting. With the continuing decline in the number of stand-alone employer sponsored funds in favour of other sectors such as retail and industry funds as a result of employer sponsored plans winding up, this issue is becoming more evident as funds become multi-employer sponsored plans
- Few defined benefit funds are purely defined benefit funds. Even single employer sponsored funds typically have a substantial and growing defined contribution component. Large multi -employer funds are often mostly defined contribution but have a smaller defined benefit component. As most defined benefit funds are closed to new members and as existing defined benefit members are 'paid out', we expect the issue of measuring the value of defined benefits will, over time, become immaterial, if not already

- Deficits in defined benefit funds arising from inappropriate liability measurement and disclosure potentially create a misleading impression by suggesting that the overall fund is in deficit (due to volatility in assumptions such as interest rates). The consequences of applying AASB 119 during the global financial crisis clearly demonstrate the impact that volatility in interest rates has on liability measurement. For superannuation funds, we reiterate that introducing such volatility is not appropriate as it is not measured or managed by the Trustee.
- In any event, the Projected Unit Credit Method (PUCM) proposed by the ED does not necessarily suit all circumstances. EG – RD to provide an example.
- Whilst the AASB has attempted to align superannuation fund reporting with AASB 119, the results of an actuarial valuation conducted under AASB 119 and current proposals within ED 179 are likely to yield a different result due to different aims of users, different valuation assumptions, use of a risk-free rate versus high quality corporate bond rate, timing of the review etc.
- The ED does not recognize the existing actuarial valuations that are currently undertaken under SIS including the statements and certificates issued on the Fund's solvency position measured by the minimum requisite benefit, the recommended funding plan including the amount and timing of employer contributions and the triennial actuarial review which measures the accrued benefits of the Fund whereby the results are currently disclosed in the notes to the financial statements and summary attached to the financial statements. It is worth noting that many large defined benefits funds request their appointed Actuary to provide an annual update on the valuation of accrued benefits. Also, our experience suggests that some multi-employer sponsored plans also monitor the financial position of defined benefit sub-plans on a quarterly basis. Introducing another measurement basis for financial reporting purposes will create greater confusion amongst the industry including members and require further explanation and rationale to the differences arising under each calculation.

We believe that vested benefits is a more appropriate basis for measuring the liability of defined benefit members for the following reasons:

- Vested benefits represents the amount due and payable at balance date and is consistent with the values reported in individual member statements
- Vested benefits represents the amount that the fund is obliged to pay a member should they cease membership at any given point in time. They are not entitled to anything more other than what is 'vested' at that point in time
- Measurement of vested benefits does not require the use of judgment, methodologies and assumptions and therefore is considered a more reliable measure. The benefit is determined by reference to the terms and conditions of the Trust Deed.
- Usually, the calculation of vested benefits can be undertaken by the fund administrator and does not require the use of actuaries which results in additional costs and time to undertake calculations.
- Using vested benefits to measure defined benefit liabilities is consistent with the approach for defined contribution members
- It is the key measure of a plan's financial condition by which the regulators assess the financial position of the fund and whether a fund is in a satisfactory or unsatisfactory financial position. Vested benefits is also used in quarterly and annual APRA returns for the purposes of reporting the value of member benefits.
- In most current defined benefit plans vested benefits represent a realistic assessment of the obligation of the fund based on past service, though the calculation of vested benefits does not take into account future increases to the liability due to future service and future salary increases which can not be readily estimated by the Trustee. Information such as salaries, the strategy of the employer and other factors that are sourced from the employer are required to calculate accrued benefits.
- Where a defined benefit is in a deficit position and the Trustee has exhausted all efforts to persuade the employer to rectify the shortfall, the Trustee remains liable to meet vested benefits of defined benefit members up until it resolves to invoke discretionary powers that may be in the Deed such as terminating the plan and reducing member benefits on a proportional basis and allocating available net assets. At this point, it is the reduced benefit that vests in the member
- Likewise, some deeds provide that a Trustee may exercise discretion and 'augment' a members benefit. Assuming that the Trustee has exercised its powers in accordance with the Deed, the 'augmented' or increased benefit becomes the vested benefit.

- As the Regulator, Trustee and employer sponsors primary measure is the vested benefit index, funding plans are usually established and modified to ensure that the fund remains in (or returns to) a satisfactory financial position. Therefore as funding plans are targeted at ensuring net assets are available to meet vested benefits, a mismatch on the balance sheet will arise if another liability measure is used other than vested benefits.

We note that there are some drawbacks of using Vested Benefits as a measure of a liability for defined benefit members including:

- it is somewhat akin to a liquidation basis, rather than a going concern basis
- if a fund cannot pay vested benefits, (ie if vbi is less than 100%), then the superannuation funds arguably may not have the liability because , as above, the trustee cannot fund from other sources, except from the employer where a funding plan has been put in place and agreed to by all parties

Suggestions for consideration:
Based on our comments above, we believe the proposals within the ED should be revised as follows:

- recognise vested benefits as liabilities on the balance sheet
- measure defined benefit liabilities using the vested approach
- where an employer has contributed in excess of vested benefits, treat the surplus as a liability called "defined benefit reserve" as it represents an amount held in trust to be used in meeting future funding requirements as and when amounts 'vest' in the member. Under some deeds (although it is rare), an employer may request the return of surplus where certain conditions are met including some legislative requirements. Therefore, we are of the view that surplus amounts meet the criteria for recognizing a liability
- recognition of any defined benefit deficits on the balance sheet
- Detailed disclosures providing transparency and granularity regarding the status of defined benefit arrangements including any sub-plans. We acknowledge that the ED currently requires detailed disclosures regarding sub-plans including the credit risk of the employer sponsor and are supportive of such disclosure. At a minimum, we agree that disclosures should extend to:
-
    - Existence of a current funding and solvency certificate and when the certificate expires at this certified minimum funding levels
    - For each sub-plan, the value of the assets, vested benefits, accrued benefits (as currently measured under SIS) and the AASB 119 liability reported by the employer sponsor if materially different
    - Basis and methods for calculating the above amounts including any assumptions used, material changes in assumptions, demographics etc from the prior year or other factors that may significantly influence the calculation eg., retrenchments, redundancies subsequent to balance date
    - Detail of the funding plan in place including any remedial action agreed to by the employer eg., top up contribution, one off contributions etc and timeframe over which shortfall will be rectified
    - Details of employers that have not agreed funding plan in place and/or have reasonably complied with funding arrangements
    - Any contractual or constructive arrangements between employers and the Trustee
    - Trustees policies and risk management practices specific to defined benefit funds"

3. Insurance contracts

Practical Issues:

Set out below is Ernst & Young's commentary and suggestions for consideration. We strongly concur with their comments and suggestions.

The issue for our Fund is that our APRA license specifically precludes us from self insuring. We therefore outsource the provision of insurance to arms length insurance companies. Our Trust Deed and PDS also include comment that in the event the insurer denies a claim, we are not responsible to make good that claim. That is, the member will only get what the insurer is prepared to pay. Any other issues with respect to insurance relate not to the underwriting of insurance risk, but more the administrative issues associated

with providing the facility. The Standard we believe would not require us to account for insurance under AASB 1038 as we have a group plan, but we believe further clarity by what is meant by group plans and agency arrangements would be helpful.

Extract from Ernst & Young Submission

"Paragraph 21 of the ED proposes that obligations and assets arising from insurance contracts issued by a superannuation plan or approved deposit fund shall be measured in accordance with the principles and requirements applicable to life insurance contracts under AASB 1038 *Life Insurance Contracts*.

Paragraph 50 of the ED proposes that a superannuation Plan or approved deposit fund that issues insurance contracts shall disclose information in relation to such contracts in accordance with the disclosure principles and requirements applicable to life insurance contracts under AASB 1038.

Commentary on proposals:

Paragraph BC 57 of ED 179 identifies three types of insurance arrangement:
Plan as Agent: where life insurance cover is offered directly by a third party insurer, with the Plan acting only as an agent;
Group Plan: where insurance cover is offered to defined contribution members (usually offered through a group insurance plan); and
Self-Insurance: where insurance cover is provided directly to defined benefit members (sometimes this will be reinsured with an insurer).

We agree that the above arrangements are common amongst superannuation funds and note a group plan is usually outsourced to a third party acting as agent for the group plan.

We agree that Trustees that self-insure are exposed to insurance risk. Depending on the extent of self-insurance, we agree that risks to Trustees can be significant especially in closed funds that only offer defined benefits and provide self-insurance. Typically, self-insurance is provided by Trustees of defined benefit funds and an actuarial reserve is estimated to provide for future claims.

In instances where a Trustee enters into an agency relationship and provides insurance through a group plan offered by a third party insurer, insurance risk is substantially transferred to the third party. Whilst there may be remote instances where an element of residual risk may arise, we do not believe that such arrangements should be the subject of accounting for insurance contracts under AASB 1038 or any other standard other than to recognise insurance proceeds as income and insurance premiums as an expense in the statement of changes in members' benefits.

For such arrangements, we note that Trustee of superannuation funds may have undertaken the following to mitigate any residual risk:

Inclusion of clauses within the Trust Deed to limit any liability to the amount approved and remitted by the insurer under the policy
Prohibit in the Trust Deed and/or policies any discretionary payments above and beyond amounts approved and remitted by the insurer
Inclusion of appropriate disclosures within the product disclosure statement and other communication to members which states that insurance is provided through a third party provider
Maintaining proper records, policies and processes to administer and monitor insurance claims, remittance of premiums, requests for changes in cover and receipt of insurance proceeds etc in accordance with the terms and conditions of the insurance policy for the purposes of mitigating any potential risk of negligence or error that may arise

Provision of insurance is usually considered an ancillary benefit and is incidental to the primary purpose of providing retirement benefits. Termination of fund membership as a result of resignation, retirement, retrenchment and redundancy does not usually result in an insured component being paid. Insurance claims only arise in the event of death, total or permanent disability or ill-health.

Whilst we note that there may be some remote instances where such funds may carry some residual risk eg. in the event the insurer is insolvent, we accept that this risk is so remote and should not be recognised unless there is a high likelihood that the event may occur or has occurred.

However, we also acknowledge that there may be instances where the Trustee does accept insurance risk under group plan arrangements. For example, whilst group life cover might be placed with an external insurer, if the trust deed states that the Plan will pay, or has discretion to consider paying, any insurance claims if the external insurer fails to offer cover, or fails to accept a claim, then the Plan is accepting insurance risk which may or not be significant. Similarly, if the Trustee is in the practice of making ex-gratia payments without regard to the decision of the insurer, it may result in a constructive obligation regardless of any restrictions in the Trust Deed or arrangements with a third party provider.

In virtually all group plan arrangements, all self-insurance arrangements, and possibly in some arrangements where the Plan acts as agent, the Plans will need to consider whether the contracts with their members are insurance contracts or not. There may be many cases where the extent of insurance risk is not significant, however, if the final standard requires assessment at the insurance component level this could have quite a different outcome, effectively requiring a majority of contracts issued by Plans to be unbundled with the insurance component treated under AASB 1038. This would create a significant burden for Plans especially where risk is not significant.

Suggestions for consideration:

We recommend that the AASB undertake further consultation with the industry to understand the extent of insurance risk borne by the Trustee. The AASB should consider the significance of any risk to the member and Fund overall and consider whether there are other options to measure and disclose any risks arising other than as proposed under AASB 1038.

We would also recommend that the AASB allows adequate time for implementation, it may be that Plans may want to perform 'housekeeping' to eliminate any inadvertent insurance risk they may have exposed themselves to".

4. Investment Expenses

We understand that the Standard will continue to require disclosure of investment expenses that are paid or accrued by the Fund. In many cases the investment expenses are netted off returns or not easy to determine in fund of fund arrangements. Whilst we acknowledge this difficulty, the disclosure of only that component that is paid or accrued is misleading. Funds are required to disclose in their ICR (Indirect Cost Ratio) calculations in their PDS such information. It is information that rating agencies also collect for research and comparative reports. Whilst there may be some inconsistencies, the Funds normally put a great deal of effort to make such calculations, particularly as they are required by Law. It is information members find particularly interesting and useful in assessing performance of their fund. We would welcome the Board addressing this issue to improve disclosure of what is typically the largest cost to members.