ED179 sub 8

Watson Wyatt
Worldwide

30 September 2009

The Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS STREET WEST VIC 8007

Dear Sir

Subject: Watson Wyatt Australia Pty Ltd Submission
AASB Exposure Draft ED179

Watson Wyatt Australia Pty Ltd ("Watson Wyatt") is pleased to make this submission in response to the **AASB Exposure Draft ED179 of May 2009 titled "Superannuation Plans and Approved Deposit Funds"** ("Exposure Draft").

Watson Wyatt is part of the Watson Wyatt Worldwide consulting group and provides services to the financial industry including in relation to: actuarial and employee benefits, investment consulting, employee communication, financial planning, superannuation administration, human resources and human resources technology.

Watson Wyatt provides actuarial and consulting services to a large number of employer-sponsored corporate superannuation plans, many of which are defined benefit plans. Accordingly, our comments in relation to the Exposure Draft are made primarily from an actuarial perspective.

Executive Summary

Our detailed response is set out in the Appendix to this letter, and we would be pleased to discuss any of the responses with you further.

A summary of the key points raised in the Appendix are as follows:

- Watson Wyatt recommends the use of "Vested Benefits" as the primary measure of a plan's defined benefit obligations disclosed in any replacement to AAS 25. A Vested Benefits measure will be understood by members and consistent with the obligations shown on their periodic statement, as well as those reported to the Australian regulator. A Vested Benefits assessment will also be more readily obtainable, without significant time and costs of actuarial input. Cost is a key issue, given the closed (and running off) status of most of Australia's defined benefit plans. Other reasons supporting this measurement are set out in our response.

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- Watson Wyatt is particularly concerned that the proposed ED179 Accrued Benefits measure will provide misleading financial information to users. We are extremely concerned about the adoption of the proposed ED179 Accrued Benefit measure on the basis that:

  - it is likely to be a poor measure of Accrued Benefits for the purposes of members making any form of "benefit security" assessment. In our submission, we set out how the basis of the ED179's measurement will produce an obligation which is systematically higher than the levels of assets typically accumulated in Australian plans (i.e. even a plan with sufficient assets for actuarial funding purposes, and Australian local minimum funding requirements may disclose an ED179 deficit to members); and
  - it will therefore mislead defined benefit members about the financial security of the defined benefit plan. It is likely to result in members (and their financial advisors) making poor decisions.

  Even using the AASB119 measure will not overcome such concerns. The one advantage of the AASB119 measure over the ED179 measure is that it avoids the need for a further calculation of the obligation; however, it maintains all of the other disadvantages of AASB119 if it were used for this purpose.

- In our view, a case for making a "consistent comparison between plans" (such as that used to support the AASB119 Accrued Benefits measure) is now a less useful objective in Australia, given employees' inability to change into any new defined benefit plan. That said, the Vested Benefits measure meets this objective anyway, by providing a consistent, assumption-free source of comparison if one was needed.

- We do not support the introduction of Insurance clauses, given that in most cases the trustee is merely the holder of death and disablement insurance policy. In cases where the plan is exposed to some temporary timing differences, the amounts receivable from the insurer will be recognised as assets, and obligations in respect of outstanding disability claims will be recognised as liabilities.

- There are numerous arguments for the members' benefit obligations being classified as liabilities versus equity, depending on the hypothetical circumstances being considered, the requirements of the trust deed, and whether the plan is defined benefit or defined contribution. Often the analysis is undertaken considering only one such scenario. On balance, Watson Wyatt believes that a consistent and yet fully informative approach would be to maintain the current practice of a balance sheet which develops a "Net Assets available to provide members' benefits". This outcome can still be used in conjunction with a corresponding schedule of movements in members' benefit obligations (in our view, as measured by Vested Benefits) during the reporting period.

- We are particularly concerned about ED179's apparent requirement to make credit-worthiness assessments of a sponsoring employer; such employers are not always credit rated by agencies, and the cost of commissioning such an assessment would add a significant additional cost of compliance (particularly for smaller companies, who are typically "running off" such defined benefit plans).
- Watson Wyatt strongly believes that many of the additional disclosures contemplated in the standard duplicate information that is already provided to users of superannuation plans. Unlike other reporting entities, Australian superannuation plans must comply with a wide range of pre-existing disclosure requirements under Australian superannuation legislation. This includes prescribed and very detailed reporting to the regulator, members and trustee. Many of the ED179 required disclosures duplicate the same types of information and yet omit much of the detail which would be required to allow users to fully rely on the ED179 information. In many plans, the costs of preparing such information will be passed on directly and in total to plan members. In our view, the extra costs of preparing this repeated (and, due to space constraints, necessarily simplified) information in the financial statements will outweigh the value to users.

We do not intend to argue the technical merits of general purpose financial reporting versus "special purpose" reporting in its various types. However, we do strongly feel that any reporting should not *mislead* users of that information into poor decisions or incorrect conclusions about the financial security of their plan (particularly members, who are *potentially* the key recipients of that information, and yet are the worst-placed to understand what an ED179 Accrued Benefit does and does not represent). In summary, we would be particularly concerned:

- at any requirement to disclose reserves / deficits / surpluses that simply do not exist in financial terms (because an ED179 or AASB119 measure has been used for the measurement), or
- if the technical "equity vs liability" arguments results in disclosures of reserves to which members in practice have no entitlement.

We would be pleased to further discuss or clarify any aspect of this submission. Please feel free to contact Phil Collins (03 9655 5412) or Andrew Boal (03 9655 5103).

Yours faithfully

Andrew Boal Managing Director	Brad Jeffrey Director	Philip Collins Principal

APPENDIX

Our comments in relation to each AASB Matter for Comment are as follows.

1. Matters for Comment (a), (b) and (c)

> "(a) *whether the recognition principles in paragraph 10 of this Exposure Draft are appropriate for a superannuation plan or approved deposit fund".*
>
> "(b) *whether a superannuation plan or approved deposit fund should be required to measure at fair value adjusted for transaction costs all of its:*
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> *(i) assets, except for:*
>
> *(A) tax assets;*
>
> *(B) assets arising from insurance contracts issued by the entity; and*
>
> *(C) goodwill; and*
>
> *(ii) liabilities, except for:*
>
> *(A) tax liabilities;*
>
> *(B) obligations for defined contribution members' vested benefits;*
>
> *(C) obligations for defined benefit members' accrued benefits; and*
>
> *(D) obligations arising from insurance contracts issued by the entity".*
>
> "(c) *whether the guidance in paragraphs AG13-AG32 of Appendix B to this Exposure Draft is sufficient to facilitate reliable measurements of obligations for defined benefit members' accrued benefits and comparable measurements of such obligations between superannuation plans and over time. In particular, whether a superannuation plan with defined benefit members who will accrue materially higher levels of benefits as they near retirement age should be:*
>
> *(i) permitted to use a method of its choosing to attribute such members' benefits to reporting periods, provided that the method is appropriate for the plan's circumstances, as proposed in paragraph AG17 of Appendix B to this Exposure Draft;*
>
> *(ii) required to attribute such members' benefits on a straight-line basis in a manner consistent with the approach required under AASB 119 Employee Benefits for defined benefit obligations; or*
>
> *(iii) required to attribute such members' benefits to reporting periods on a basis other than a straight-line basis".*

1.1 We have significant concerns about the measures of benefit liabilities proposed, and these are expressed below.

1.2 The ED179 Accrued Benefit measure is a poor measure of Accrued Benefits for the purposes of financial reporting. This measure will mislead defined benefit members (and their financial advisors) about the financial security of the defined benefit plan.

1.2.1 ED179 will value Accrued Benefits at a lower discount rate (whether a risk-free rate, or corporate bond rate if the ED179 measure is aligned with the AASB119 measure) than that used by the actuary for funding purposes (which is typically valued using discount rates based on the plan's expected future investment returns).

Therefore, ignoring the impact of Vested Benefits, the ED179 Accrued Benefits measurement will be greater than the Accrued Benefits for funding purposes. (A pragmatic compromise is the Vested Benefit measurement. We discuss this measure below.)

1.2.2 In practice, actuaries make recommendations of future contribution levels that should be sufficient to bring the plan to a financial position whereby it has sufficient assets available to cover 100% or slightly more than 100% of the value of Vested Benefits, and (in the longer term) 100% of the Accrued Benefits for *funding purposes* (i.e. based on the longer term expected earnings of the plan's assets).

All other factors being equal, there will therefore be a systematic bias towards the plan's ED179 financial position being reported to members as being in deficit (even if assumptions are borne out in practice). It would not usually be considered appropriate to require contributions at a level that would bring the plan to 100% or greater funding of an ED179 or AASB119-type measure of accrued benefits. To fund towards ED179 is likely to result in overfunding of the plan, which would not be an efficient usage of the employer's financial resources.

1.2.3 Regularly reporting such deficits (which will tend to be systematic, due to the measurement approaches) will be misleading and alarming to defined benefit members. This will lead to poor financial decisions by those members (see our comments later.)

1.3 Other concerns of the proposed ED179 Accrued Benefits measure are that it will:

1.3.1 Introduce a fourth measure of a plan's benefit obligations. ED179 will join Vested Benefits, AASB119 benefits, and the actuary's funding basis of accrued benefits. This will confuse all users, and yet provide no additional useful information (when compared with what is already available to those users). Some commentators have expressed exasperation about the different conflicting measures of a defined benefit obligation.

1.3.2 Confuse members in particular, who will not understand why a measure based on a risk-free rate outweighs the other pre-existing benefit obligation measures. No amount of additional disclosure will outweigh the perception of this "black and white" figure in the plan's own financial statements.

1.3.3 In practice, this confusion is made worse because it is unlikely that members will be able to obtain sufficient level of access to an actuary to obtain clear explanation of how an ED179 Accrued Benefits measure differs from other measures of the obligation.

1.3.4 In our experience, trustees and Company Finance Directors have gradually developed such an understanding since the implementation of AASB119. Members, however, will be far less familiar with financial matters than trustees and Finance Directors, and will not be able to gain similar levels of access to the plan's appointed actuary to gradually build this technical understanding.

1.4 On balance, Watson Wyatt strongly advocates the use of "Vested Benefits" as the primary measure of a plan's defined benefit liability disclosed in any replacement to AAS 25.

1.5 A practical measure is needed, and we believe that Vested Benefits will be a more convenient and yet less misleading measure of a defined benefit plan's obligations than that proposed.

1.6 A Vested Benefit measure will be:

- understood by members;
- consistent with the obligations shown on their benefit statements;
- readily obtainable, without significant time and costs of significant actuarial input. Cost is a key issue, given the closed (and running off) status of most of Australia's defined benefit plans;
- a consistent measure across all lump sum plans (the vast majority), as no assumptions are required to measure the obligation. Some guidance will be required for pension-paying plans, although these are relatively uncommon in Australia;
- consistent with the legislative measurement of a plan's financial position. We are particularly concerned about the inevitable outcome of a trustee reporting that the plan is in a satisfactory financial position, but that the financial statements suggest a deficit using the proposed ED179 measure;
- consistent with the measure of funding being increasingly targeted by plan trustees. Increasingly, many funding policies seek to recover deficits (and allow the run off of surpluses) relative to Vested Benefits;
- quite a good proxy for a longer term measure of the benefit liabilities, whilst enjoying all of the practical and cost advantages set out above. Vested Benefits and the actuary's longer term funding measure of Accrued Benefits are generally quite close in Australia (most often within 10%, based on a review of our clients). These two measures will only become closer as the (closed) membership of virtually all Australian DB plans near retirement age;

- obtainable within the statutory reporting periods. Such reporting timeframes are currently sufficient to complete the accounts and insert a Vested Benefits figure. Any actuarial projection relies, however, upon complete and correct membership data – meaning such calculations could not commence until after the plan membership details have been completed. There are therefore significant practical issues around completing such work within the statutory four month reporting deadline;
- consistent with the liability measure proposed for defined contribution plans.

1.7	We are extremely concerned that the ED179 Accrued Benefits measure is likely to lead to poor decisions by defined benefit members.

1.8 One of the three primary users of the general purpose financial statements identified by the AASB is members and beneficiaries[1]. Because the ED179 Accrued Benefits measure is a poor measure of the liability for solvency purposes, we are extremely concerned that it will mislead defined benefit members into making poor decisions.

1.9 For example, a defined benefit member may note that the value of the assets of their defined benefit plan is lower than the ED179 Accrued Benefit liability (for the reasons already explained earlier) and decide to exercise an option (if offered) to convert out of the defined benefit section of the plan. The decision to convert will be based out of perceived fear of the security of their benefit, and could ignore the possibility that:

- the plan's Vested Benefit (i.e. required funding) measure; and
- the plan actuary's longer term funding measure of the Accrued Benefits

may be both adequately funded. The inclusion of the ED179 measure will be more prominent in any financial reports than the other two potential measures (which could presumably be noted).

1.10 Furthermore, the cost to the individual may be significant. Any such conversion from defined benefit to defined contribution will almost always provide less valuable future benefits for the remainder of the individual's working career. Typically, when defined benefit plan members "opt out" of their defined benefit benefits and convert voluntarily to defined contribution, it is very common practice for future defined contribution benefits to be based only on the minimum (and now market practice) 9% of earnings. These future defined contribution benefits will almost always be less valuable than those future service benefits that would have built up within the defined benefit section - and yet the member may be very willing to concede future service benefits based on an (incorrect) assessment of the financial security of their defined benefit (based on the ED179 or even AASB119 Accrued Benefit measure).

[1] Basis for Conclusions BC10

1.11 In addition, a defined contribution member of a defined benefit plan may be sufficiently concerned about the value of the plan assets being lower than the ED179 Accrued Benefit liability that he or she may decide to exercise choice of fund. Such a decision could potentially lead to a reduction in, or absence of, death and disablement insurance benefits and ultimately result in lower retirement benefits, particularly given that many employer sponsors of defined benefit plans subsidise the expenses of running their corporate plans.

1.12 We are extremely concerned about the significant role of the "black and white" figures within the financial statements, in shaping the member's opinion. Whilst we recognise that there is a role for "general purpose financial statements", we strongly feel that such general purpose statements should not mislead the most likely (potential) users of those statements – in this case, the members. We therefore have considerable concern about the appropriateness of the ED179 Accrued Benefit measure for these purposes.

1.13 A "consistent comparison" objective (such as that used to support the AASB119 Accrued Benefits measure) is of far less relevance for Australian users of ED179.

1.14 The AASB119 calculation was intended to provide stock analysts / investors with consistent comparisons of AASB119 disclosure information within corporate accounts. However, using or adapting an AASB119 measure to allow a "consistent comparison" is of less relevance for plan members than it is for stock analysts because there is virtually no opportunity for a defined benefit member to join a different defined benefit plan:

- defined benefit plans in Australia are not open to employees outside the sponsoring employers' group;
- even if employees did change employer – almost all Australian defined benefit plans are closed to new members. They would almost always be enrolled in a defined contribution section.

1.15 The proposed ED179 Accrued Benefit measure will provide no new useful information to trustees and APRA.

1.16 APRA, trustees and plan members already receive significant purpose-specific financial information which already measures defined benefit plan financial information using a variety of measures. Adding (and disclosing) a further measure will conflict with pre-existing information, add cost and may be challenging to complete within statutory reporting deadlines (without starting such work prior to balance date, and using various approximation techniques).

1.17 We would envisage that most trustees will want to introduce quite specific language warning users of the information about the likely relevance of any such figure, in terms of the plan's solvency, financial position monitoring, or longer term funding.

2. **AASB Matter for Comment (d):**

> ***"(d) whether any superannuation plans in Australia have defined benefit members whose level of benefits could be altered by externally imposed requirements, such as the level of state retirement benefits, as noted in paragraph 18(c) of this Exposure Draft and paragraph AG30 of Appendix B to this Exposure Draft. If so, please describe the nature of these externally imposed requirements and how they are currently incorporated into the measurement of defined benefit members' entitlements".***

2.1 We have no concerns about this provision.

2.2 There are very few Australian defined benefit plans that are integrated with social security (in the same way as is common for European plans).

2.3 The only common external requirement common for Australian defined benefit plans is the normal practice of subjecting their benefits to a minimum as required by the Superannuation Guarantee (SG) legislation. The minimum is normally based on earnings up to a government prescribed Maximum Contribution Base (indexed each year). Actuaries will already make assumptions about future increases in this Maximum Contribution Base in their valuation. The allowances typically made would comply with the existing ED179 wording.

3. **AASB Matter for Comment (e):**

"whether there are any significant practical difficulties that would inhibit the reliable measurement of obligations and assets arising from insurance contracts issued by a superannuation plan or approved deposit fund in accordance with the principles and requirements applicable to life insurance contracts under AASB 1038 Life Insurance Contracts as proposed in paragraph 21 of this Exposure Draft. If so, please describe the nature of these difficulties and how they might be overcome".

3.1 Each plan's insurance arrangements will need to be considered separately to determine whether they meet the definition of an insurance contract:

> "*insurance contract* means a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder".
>
> "*insurance risk* means risk, other than financial risk, transferred from the holder of a contract to the issuer".[2]

3.2 We do not support the Exposure Draft proposal that all obligations and assets arising from insurance contracts issued by a plan shall be recognised in accordance with the recognition criteria applicable to life insurance contracts under AASB 1038 *Life Insurance Contracts*[3].

[2] AASB 1038 Definitions at Paragraph 20.1
[3] Paragraph 10(b)

3.3 The nature of death and disablement insurance in the superannuation context is such that in most cases the trustee is merely the holder of the insurance policy that is issued by the insurer. It merely holds the policy for the benefit of the insured members. The legal entitlement of a member to insurance proceeds is a right of a beneficiary under the terms of the superannuation trust and is dictated by the governing rules of the plan.

While there may be temporary cash flow timing issues with premium payments and benefit payments, for most plans the longer financial impact arising from death and disablement insurance arrangements is not material. In cases where the plan is exposed to some temporary timing differences (e.g. proceeds from insurer yet to be received on balance date, with an outstanding approved disability benefit still to be paid to the corresponding recipient) the amounts receivable from the insurer will be recognised as current assets and obligations in respect of outstanding approved disability claims will be recognised as current liabilities.

3.4 In our view, however, no accounting provision should be made for the contingent future liabilities arising from insured portion of future death or disablement claims. We would regard such a requirement as contrary to one of the principles that we believe underlies the standard – i.e. that liabilities in respect of *accrued service* are to be recognised in the balance sheet. As insurance is invariably held in respect of death and disablement benefits payable over and above those related to accrued service, liabilities for these portion of these benefits should not, in our view, be recognised.

3.5 We hold this view regardless of whether the "insured" portion of death and disablement benefits is externally insured (in which case we would also argue that the value of future premiums to / recoveries from the external insurer should similarly not be recognised), or if the trustee chooses to "self insure" this portion of the benefits.

3.6 We note that self-insurance of death and disability benefits is uncommon. APRA's policy is:

> *APRA discourages funds from self insuring death and disability benefits because of the risks related to inadequate and unsegregated reserves and unrealistic pricing of the risks borne by the fund. APRA considers that life insurance companies registered under the Life Insurance Act 1995 are the best mechanism for superannuation funds to provide death and disability benefits to fund members.*[4]

3.7 Accordingly, very few plans would self insure. The defined benefit plans whose death and disablement benefits are fully self-insured are required to be under actuarial management in relation to the costs of providing the self-insured benefits. Where such self insurance does take place, then the actuary would already certify the amount of such provisions under section 295.465(2) of the Income Tax Assessment Act 1997 (C'th).

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[4] APRA FAQ Answer 10.1

3.8 It is not clear to us whether the current draft Standard would require funds to make a provision of incurred but not reported (IBNR) disability claims. In our view, any attempt to measure or report reserves in respect of IBNR claims (in the same way that life insurers are required to do) would likely result in a spurious assessment for virtually all DB plans in Australia. Most such plans are simply too small to derive any statistically significant or reliable IBNR estimate. And any such provision would simply change the timing of the expensing marginally (relative to the current cash basis), on a very arbitrary basis. By contrast, insurance companies typically have a far greater number of insured lives than any self insured superannuation plan.

Even if an IBNR reserve was determined, the total death and/or disability benefit set out in Trust Deeds are partially funded from the assets of the Fund. Under any attribution between past and future service, only the future service component of a death /disability benefit would not be funded out of assets. Therefore, assuming ED179 is seeking to measure obligations based on the past service component of benefit obligations, then no liability would be measured.

3.9 For some plans, the amount of premiums paid to the insurer will be greater than the proceeds received in any particular year. This should not imply that the plan has incurred some sort of loss; in fact it has paid to protect itself from loss. Similarly, in years where insurance proceeds received are greater than premiums paid, the plan is most unlikely to have made a profit, as the proceeds will have been passed on to claimant members.

3.10 Finally, we consider that the re-insurance risk of an insurer not being in a financial position to pay the insured benefits would not be material. (This would require some form of estimate of the likelihood of the insurer becoming insolvent in the normal course of events, adjusted by the likelihood of the government not assisting in meeting the insurer's short term commitments, adjusted by the likelihood of the plan being unsuccessful in obtaining cover through another Australian group life insurer prior to a claim emerging). Therefore, we would not expect any provision being material (or measurable).

4. AASB Matter for Comment (f):

"whether there are any circumstances in which a difference between a superannuation plan's or approved deposit fund's total assets and its total liabilities (including defined contribution members' vested benefits, defined benefit members' accrued benefits and any obligations to employer sponsors) would not be equity as defined in Australian Accounting Standards".

4.1 Our comments previously set out our concerns about the measurement of defined benefit obligations themselves. We advocate the use of Vested Benefits as the measure rather than a measure based on accrued benefits, for the reasons set out previously.

4.2 The Exposure Draft proposes that obligations for defined contribution members' vested benefits and defined benefit members' accrued benefits always be recognised as liabilities[5]. On balance, however, we believe that the unique nature of superannuation plans (and the nature of their benefit obligations to members – either defined contribution or defined benefit members) are more appropriately viewed as equity, rather than as liabilities of the plan. Liabilities within a superannuation plan are traditionally 'current liabilities' due and payable within 12 months such as accounts payable, taxation liabilities and member benefits payable (being benefits of those members who have left the plan).

4.3 In Watson Wyatt's view, an acceptable compromise would be to develop a "Net Assets available to provide members' benefits" within a Statement of Net Assets. This will not mislead members, and be a consistent form of presentation for all superannuation plans.

4.4 We are conscious that technical arguments can be made to support both an equity or a liability outcome, often depending on the hypothetical situation considered (and the resulting apparent rights of members).

4.5 We are strongly influenced by the fact that members' entitlements invariably rank behind other plan liabilities.

- The returns credited to defined contribution plan members at year end make allowance for all other incurred operating expenses, prior to the declaration of the crediting rate.
- Many defined benefit plans have a hierarchy within their governing rules that set out the order in which the obligations of the plan must be discharged. Again, other creditors tend to be paid first, and then a prioritised order of members.

4.6 One approach might be for trustees of plans to obtain legal advice with respect to their trust deeds and other governing rules regarding the legal obligations, if any, of trustees to pay accrued benefits to members and the circumstances in which the accrued benefits can be adjusted or reduced (e.g. upon the employer sponsor ceasing to contribute to the principal employer determining to wind up the plan). This approach is not practical, however, and would require trustees to incur substantial cost without adding any real value as a consequence. In our experience, trust deeds of defined benefit plans typically only require, on termination of the plan, assets to be distributed to members to the extent they exist i.e. assets are shared amongst members, according to a hierarchy in set out in the trust deed.

4.7 From the trustee's perspective, their responsibility is primarily to administer the net assets of the plan equitably and in accordance with the trust deed. It is fundamental to understand that superannuation plan trustees do not have an obligation to pay all defined benefit members their "accrued benefits". Furthermore, if assets are insufficient even members' vested leaving service benefits will be reduced.

[5] Paragraph 10(a)

4.8 We note, however, that a major characteristic of a liability is that payment may be required on demand, on a specified date, or the happening of a specified event. As previously mentioned, in the context of a superannuation plan, it is also likely that any liabilities are deemed to be 'current' and therefore payable within 12 months. Obligations to pay benefits to superannuation plan members can arise at any time when benefit payment conditions in the plan's governing rules and relevant legislation are satisfied (e.g. on death, retirement, total and permanent disablement, etc.) however at balance date the timing of these obligations are not known and would be expected to be greater than 12 months.

4.9 The key difficulty is that the legal obligations of trustees in respect of the payment of superannuation benefits are complex, and different trust deeds and plan types can result in a range of different "implied" outcomes in the equity versus liability debate.

4.10 In general we consider that members' benefits have more characteristics of equity. To the extent that the net assets of the plan are insufficient to cover members' benefits, those benefits are likely to be reduced.

4.11 Watson Wyatt strongly advocates that the Statement of Net Assets should not include members' benefits as a liability but it should continue to include only the "Net Assets available to provide members' benefits".

4.12 We are particularly concerned at the danger of introducing any sort of disclosure that could generate an expectation in users of the financial statements that any excess of net assets over vested benefits (or "surplus") in a defined benefit plan "belonged" to a particular group of users. "Surplus" in a defined benefit plan can be generated from a number of sources, including foregone benefits of members and earnings on employer contributions, as well as extra company contributions. Following several high profile cases ruling on ownership of rights to "surplus" in defined benefit plans in the early 1990s, many employers are reluctant to fund their defined benefit plans in a manner that might generate large amounts of "surplus", even though such "surplus" might imply better protection for members' benefits. Such a cautious approach would only be reinforced by plans being forced to disclose actuarial surpluses in a manner that might imply ownership by a particular group.

4.13 Furthermore, if the benefits were included in the balance sheet as liabilities of the plan, the statement would at first cut show either a deficit or a surplus. In an on-going defined benefit plan, however, the actuary and trustee would be assuming that deficits will be made good by the employer sponsor and any surplus would be removed by reduced contributions. This assumption enables the trustee to pay benefits unadjusted irrespective of whether the plan is in deficit or surplus. Hence, if members' benefits were to be included as a liability, it should equally be argued that an extra asset (contributions receivable) should be recognised in the case of a plan in deficit or that an additional liability should be recognised in the case of a plan in surplus. Accordingly, the net assets and liabilities recognised in an ongoing plan would always be zero.

5. **AASB Matter for Comment (g):**

"whether a superannuation plan that has members who are entitled to the higher of a defined benefit promise and a contributions-based amount upon their retirement or other event that qualifies as a condition for releasing superannuation benefits (refer to paragraphs BC52-BC56 of the Basis for Conclusions to this Exposure Draft) should recognise the 'higher of' benefit option separately from the defined benefit 'host promise'.

If you agree that a superannuation plan should separately recognise a 'higher of' benefit option, how might the option be measured?"

5.1	We do not recommend changing requirements regarding the measurement or disclosure of those superannuation plans with a "higher of" benefit option.

5.2 In practice, many actuaries already place a value on "higher of" benefits by deterministic projection techniques. Whilst the IASB's discussion paper on proposed amendments to IAS 19 suggested that a "higher of" benefit option be valued using option valuation techniques, the additional costs of making this theoretical measurement will almost certainly outweigh any additional value to the users of the information.

5.3 In addition, many defined benefit plans have a number of minimum benefits which may apply, from Superannuation Guarantee Minimum Requisite Benefits to minimums relating to membership of a previous plan. Which minimum applies at any particular time can change from year to year, or even from day to day, depending on various factors including investment returns, salary increases, and members' age and service periods. The meaning of any "higher of" option disclosed in these cases will not be clear and the costs of valuation are likely to be high.

6. **AASB Matter for Comment (h):**

"whether there are any significant practical difficulties that would inhibit the preparation of consolidated financial statements in accordance with paragraph 30 of this Exposure Draft. If so, please describe the nature of these difficulties and how they might be overcome".

6.1 Watson Wyatt is submitting no comments regarding this Matter.

7. **AASB Matter for Comment (i):**

"whether a parent superannuation plan or parent approved deposit fund should be permitted or required to separately recognise any internally generated intangible assets, internally generated goodwill, contingent assets or contingent liabilities that are attributable to a subsidiary and have arisen subsequent to the subsidiary's acquisition by the parent plan or parent fund when such items are reliably measurable".

7.1 Watson Wyatt is submitting no comments regarding this Matter.

8. AASB Matter for Comment (j):

"a parent superannuation plan or parent approved deposit fund should be required to recognise and present any excess of the amount of the net assets of a subsidiary that are recognised by the parent over the sum of the parent plan's or parent fund's interest and any non-controlling interests in the subsidiary as a remeasurement gain in the consolidated income statement in the reporting period in which it occurs".

8.1 Watson Wyatt is submitting no comments regarding this Matter.

9. AASB Matter for Comment (k):

"whether a parent superannuation plan or parent approved deposit fund should be permitted or required to measure any non-controlling interests at fair value of equity at the end of each reporting period in a manner consistent with the approach illustrated in Illustrative Example D of Appendix C to this Exposure Draft".

9.1 Watson Wyatt is submitting no comments regarding this Matter.

10. AASB Matter for Comment (l):

"whether the disclosure principles in paragraphs 32-50 of this Exposure Draft:

(i) are appropriate for a superannuation plan or approved deposit fund;

(ii) would provide useful information for users of the general purpose financial statements of a superannuation plan or approved deposit fund; and

(iii) would be sufficient to facilitate reliable and comparable disclosures between superannuation entities and over time".

10.1 We generally consider that the proposed requirements in respect of disclosures go well beyond what is appropriate for financial reporting of superannuation plans. There appears to be significant duplication of this information, when compared against that already provided under pre-existing legislation.

10.2 Furthermore, the pre-existing legislative requirements regarding disclosure to members are better tailored to the users of this information than the ED179 draft, and more completely communicate the information to the end users. We do not believe that users should be encouraged to ignore these other documents and make financial decisions solely on the basis of the plan's financial statements, which they could be encouraged to do when confronted with what might appear to be detailed disclosures. We also do not believe that plans should need to incur the expense of duplicating information already available elsewhere. It is important to remember that in many plans, this cost will be passed directly and in total to plan members, reducing their final benefit from the plan. We fail to see how it can be in their best interests to incur this additional cost.

10.3 **Paragraph 32: Nature of the Entity, Nature of Member Benefits, Expense Items and Fair Value Measurement.** This proposed paragraph would require disclosure in notes of information that provides users with a basis for understanding:

(a) the nature of the entity and the nature of the benefits it provides to its members;

(b) the nature and amount of expenses incurred by the entity; and

(c) how the fair values of assets and liabilities of the entity are determined.

10.4 In relation to subparagraph 32(a), we consider that the superannuation plan's Product Disclosure Statement ("PDS") already provides this information to members, employer-sponsors and other interested persons, and a copy of the plan's trust deed and rules is available on request. In addition, we do not believe that any meaningful description of the nature of members' benefits, particularly in hybrid plans with a number of different benefit categories, could be provided in just a few paragraphs.

10.5 For subparagraph 32(b), the nature and amount of expenses should already be detailed sufficiently in the income statement without requiring additional notes. The plan's PDS will also include information in relation to the nature of expenses incurred. To do so in a financial report would be challenging, and a duplication of legislative expense disclosure requirements (which require disclosure of expenses recovered directly from members, expenses indirectly recovered from members, expenses recovered within investment returns, and expenses paid by a sponsoring employer).

10.6 We consider that it is appropriate for the notes to disclose information as to how the fair values of assets and liabilities of the entity are determined for the purposes of subparagraph 32(c). The costs of establishing the Level 1-3 reporting of assets will be significant and are likely to result in challenges in collecting this data. But we accept that this framework is being introduced in US GAAP and IAS19 reporting.

10.7 **Paragraph 34: Nature, Extent and Management of Risks:** This paragraph would require disclosure in notes of information that provides users with a basis for understanding:

(a) the nature and extent of the financial risks to which the entity is exposed during the reporting period and at the end of the reporting period; and

(b) how the entity manages those risks.

10.8 This paragraph would expand on the risks that already are required to be disclosed under AAS 25.

10.9 We are extremely concerned that:

(a) this proposal would result in the duplication of information that is required to be disclosed in other public documents; and

(b) these disclosures read in isolation could be misleading to plan members.

10.10 We note that a superannuation plan's PDS is already required to disclose information about any significant risks associated with holding the financial product (section 1013D(1)(c) of the Corporation Act). The significant risks include both investment and non-investment risks. We do not believe that plans should be required to go to the expense of duplicating and summarising this information in the financial statements. Instead it would be far more appropriate if interested users were referred to the relevant plan disclosure documents.

10.11 In addition, we are particularly concerned about the ability to make credit-worthiness assessments of a sponsoring employer, as implied by ED179. In practice, many employers are not credit rated by agencies (most of our plans are sponsored by employers who are not listed and do not issue corporate bonds). The cost of commissioning such an assessment would add a significant additional cost of compliance (particularly for smaller companies, who are typically "running off" such DB plans, and are unlikely to commission such assessments from ratings agencies at adequately low costs). If such assessments are not envisaged by the AASB, then this should be clarified.

10.12 **Paragraphs 36 to 41: Arrangement and Management of Assets:** These paragraphs require disclosure of information in relation to the arrangement and management of assets including, where a superannuation plan manages its assets on a segregated basis, information that provides users with a basis for understanding:

(a) the type and nature of the assets within each segregated group of assets;

(b) the financial performance and financial position of each segregated group of assets; and

(c) the significant financial risks to which each segregated group of assets is exposed when the levels of such risks differ materially from the levels of the corresponding risks at the entity level.

10.13 If, as we expect, this requirement will apply to plans which offer their members separate investment options, the additional disclosure required could be substantial. In some cases, particularly with plans operated by retail providers, the number of separate investment options is very large.

10.14 This information will already be disclosed in other documents required to be produced by plans including the plan's annual report. We do not believe that plans should be required to go to the expense of duplicating and summarising this information in the financial statements. Interested users should seek this information from the source documents on in the plan disclosure documents prepared specifically for that purpose.

10.15 We do not consider that there is sufficient need or demand for information on a segregated basis to warrant the additional cost and expense that would be incurred to make the additional disclosures at an investment option level.

10.16 **Paragraph 42 Members' Benefits:** This will require a superannuation plan to disclose information that provides users with a basis for understanding the entity's obligation for members' benefits.

10.17 Again, in our view, a superannuation plan's PDS provides all information that a person reasonably requires for understanding the benefits provided by the superannuation plan to individuals. Such information is far more useful for plan members than the disclosures proposed under ED179.

10.18 To comply with Paragraph 41, it is necessary to disclose various pieces of information including:

- the amounts of defined benefit member's vested benefits and accrued benefits by member status;
- the actuary's recommended level of contributions in respect of defined benefit members for the reporting period and for the next reporting period;
- information in relation to the actuarial assumptions used in measuring defined benefit member's accrued benefits, including:
  - (i) the key actuarial assumptions used to measure members' accrued benefits at the end of the reporting period;
  - (ii) any uncertainties surrounding the key actuarial assumptions used to measure members' accrued benefits at the end of the reporting period, including the amount and timing of benefit payments;
  - (iii) the key actuarial assumptions used to measure members' accrued benefits at the end of the last annual reporting period;
  - (iv) how, if at all, the key assumptions used to measure members' accrued benefits at the end of the reporting period differ from the corresponding key assumptions used to measure members' accrued benefits at the end of the last annual reporting period; and
  - (v) whether the key assumptions used to measure defined benefit members' accrued benefits at the end of the last annual reporting period have been consistent with experience in the current reporting period.

10.19 As stated previously, we strongly recommend the recording of Vested Benefits for this purpose. In principle, however, to the extent that an Accrued Benefit figure is calculated on a Funding basis, we agree with the need to fully disclose the basis on which it has been calculated.

10.20 **Paragraph 44: Net Assets attributable to defined benefit members:** This paragraph will require the superannuation plan to disclose information that provides users with a basis for understanding the size, nature, causes of and any reasons why the amount of net assets attributable to defined benefit members does not equal the amount of defined benefit members' accrued benefits.

10.21 The text appears to imply that these amounts should be equal. As stated in our response to AASB Matter for Comment (f), however, it would be extremely unlikely that the amount of net assets attributable to defined benefit members would exactly equal the amount of defined benefit members' accrued benefits, and there are even strong reasons to avoid funding a plan with assets at broadly the level of the ED179 Accrued Benefits measure.

10.22 If there was an objective to increase the asset coverage of defined benefit assets, then any such objective of changing prudential funding requirements requires a separate, extensive review. The process of thoroughly reviewing "best prudential practice" worldwide is presumably not intended to be within the scope of ED179 or our response (and we feel that any such review is unlikely to advocate the use of an ED179 or AASB119 measure anyway).

10.23 It is normal and to be expected that a superannuation plan will experience periods of both surplus funding and deficit funding against vested benefits. We therefore consider that the text of Paragraph 44 should be amended so as not to suggest that net assets attributable to defined benefit members should equal accrued benefits.

10.24 In addition, we would query why there should be disclosures of any strategies for addressing the difference between the two amounts. The Australian Prudential Regulation Authority ("APRA") exercises prudential oversight of superannuation plans including plans that are in an "unsatisfactory financial position" or that are in "technical insolvency". Plans that are in "technical insolvency" are required to have a program to restore the plan to full funding of vested benefits within 5 years under the Superannuation Industry (Supervision) Regulations but APRA's current practice is to encourage restoration of full funding within a period of 3 years.

10.25 Further, we reiterate, as elsewhere in this submission, that this information will already be available in other documents required to be available to users such as the annual report, actuarial review summary, risk management plan and (if relevant) material change and significant event disclosure material[6]. We do not believe that financial statements should purport to be a summary of this information.

10.26 If there are to be any disclosures in relation to addressing funding issues, we consider that they should be confined to situations where the superannuation plan is in an "unsatisfactory financial position" or in "technical insolvency". To do otherwise, could in our view result in users of the financial statements becoming unduly concerned about apparent funding problems that do not actually exist.

10.27 **Paragraph 46: Components of Remeasurement Changes in Defined Benefit Members' Accrued Benefits**

10.28 It is proposed that a plan be required to disclose in the notes the following items in respect of remeasurement changes in its obligations for defined benefit members' accrued benefits for the reporting period:

- benefit cost;
- interest cost;
- actuarial gains and losses; and
- gains or losses on settlements[7].

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[6] For information about a trustee's obligations to report material changes and significant events to members, see Section 1017B(4) of the Corporations Act 2001 which requires trustees to give members the information that is reasonably necessary to enable them to understand the nature and effect of the change or event.

[7] Paragraphs AG91-AG96 of Appendix B provide guidance in relation to the disclosure of information

10.29 We would be pleased to provide further comments on these components, when the issue of the appropriate measure of the plan's defined benefit obligations has been reviewed by the AASB in light of comments received to the exposure draft from industry.

10.30 We believe that sensible and pragmatic measures (and titles) for the movement in Vested Benefits over the year could be determined, if the AASB accepts our recommendations.

10.31 **Paragraph 48: Related Parties**

10.32 Watson Wyatt has no comments on this issue.

10.33 **Paragraph 50: Insurance contracts**

10.34 Please see our comments regarding our concerns on these disclosures above.

11. AASB Matter for Comment (m):

"whether there are any significant practical difficulties that would inhibit a superannuation plan or approved deposit fund disclosing information in relation to any segregated groups of assets attributable to different groups of members, and the related obligations to those members, in accordance with paragraph 40 of this Exposure Draft and paragraphs AG80-AG88 of Appendix B to this Exposure Draft. If so, please describe the nature of these difficulties and how they might be overcome".

11.1 To ensure consistent (and a level playing field) in the financial reporting statements of multiemployer plans, versus standalone plans, we would suggest that an ED179 compliant report (as amended, following industry's comments) be mandated for each different "sub-plan" as that expression is used in the Corporations Regulations 2001. It would be important, however, that individual investment option portfolios not be treated as sub-plans.

11.2 If the AASB adopts ED179, it is likely that mastertrusts and multiemployer plans will be concerned about the length of their resulting ED179 financial statements, and the usefulness of these long reports to users (given the differing sponsoring employers of subplans). The suggestion above is not intended to combine each and every ED179 report into an extended disclosure report for the entity as a whole – however, individual ED179 could be issued for each sub-plan which meet the spirit of the required reporting standard. This will overcome the concern about length of the reports, and yet be tailored to meet the needs of each sub-plans users.

12 **AASB Matter for Comment (n):**

"whether the separate disclosure of the components of remeasurement changes in defined benefit members' accrued benefits, particularly benefit cost, interest cost and actuarial gains and losses, would provide useful information for users. If you agree that the proposals in paragraph 46 of this Exposure Draft would not be adequate for users' needs, please explain how this information should be presented".

12.1 Please see our response to Paragraph 46, above.

12.2 We would be pleased to provide further comments on these components after the issue of the appropriate measure of the plan's defined benefit obligations has been reviewed by the AASB in light of comments received from industry.

13. **AASB Matter for Comment (o):**

"whether it would be more useful if the Standard provided example financial statements for a superannuation plan comprising both defined contribution and defined benefit members rather than explaining how the financial statements of a plan with defined benefit members only would differ from those of a plan with defined contribution members only (as provided in Illustrative Examples A and B in Appendix C to this Exposure Draft)".

13.1 We agree with the AASB's suggestion.

14. **AASB Matter for Comment (p):**

"whether the approach adopted in drafting this Exposure Draft is helpful for understanding how a superannuation plan or approved deposit fund might apply the proposals in this Exposure Draft, particularly the disclosure principles, in conjunction with the relevant principles and requirements in other Australian Accounting Standards. If you do not consider the approach adopted in this Exposure Draft to be helpful, please describe the type of approach you would prefer".

14.1 Watson Wyatt has no comments on this issue.

15. AASB Matter for Comment (q):

"whether overall, the proposals would result in general purpose financial statements that would be useful to users".

15.1 Watson Wyatt is concerned that the proposed ED179 Accrued Benefit measure would fail to provide useful (and may even provide confusing) financial information to users.

15.2 The four primary users of these financial statements would appear to be APRA, trustees, employer sponsors and plan members. Our key area of concern is in the measure proposed as the basis for defined benefit plan financial measurement. Primary users of the financial statements already receive significant financial information, which will openly conflict with the conclusions implied by the proposed ED179 measure.

15.3 We are particularly concerned about the conclusions that would be drawn by members. As highlighted in this response:

- members will be less able to reconcile the differing messages implied by the different measures of the defined benefit obligations;
- we believe the ED179 Accrued Benefits measure (or even the AASB119 measure, for that matter) is a poor measure of the liabilities. Members (armed with the information required to be disclosed by Paragraph 44) will have an expectation that the ED179 benefit obligation will be fully funded. In fact, there are systematic reasons why funding up to an ED179 Accrued Benefits level will tend to overfunding the plan, when considered on a reasonable long term basis. These reasons were outlined in our response to AASB Matter for Comment (c) above.

15.4 If the measure can be changed (notably to Vested Benefits, as proposed in this response), then the risk of providing confusing users will be considerably reduced.

15.5 We also believe that the proposed standard duplicates the considerable body of information already available to all of these groups of uses under other disclosure obligations under applicable legislation, including plan Product Disclosure Statements, trust deeds, annual reports, risk management plans, statements of investment objectives and policy, and material change and significant event information. We do not believe that users should form opinions on a superannuation plan solely on the basis of the plan's financial statements without considering this other body of information. Therefore, we do not believe that plans should be required to incur the considerable extra cost of including significant amounts of repeated (and, due to space constraints, necessarily simplified) information in the financial statements. In many plan, these costs will be passed on directly and in total to plan members. We fail to see how plan members, in particular, will benefit from this duplication and the consequent reduction in their end benefits.

16. AASB Matter for Comment (r):

"whether the proposals are in the best interest of the Australian economy".

16.1 Watson Wyatt is extremely concerned about the costs of annually producing ED179 accrued benefits measure (and hence whether the value of the additional information is greater than the associated cost increases). The AASB should bear in mind that the average expected future membership periods of such (typically closed) defined benefit plans is typically 8-12 years.

16.2 Very roughly, the ED179 actuarial valuation might add at least one to two times the current audit fee. This additional expense will be incurred by each defined benefit plan or defined benefit sub-plan in the country.

16.3 This is a significant premium for trustees to incur in return for revaluing a single actuarial result (in addition to the concerns we have raised above as to the usefulness and appropriateness of that measure).

16.4 Our concern is increased by the additional cost of duplicating (or even simplifying) information already available elsewhere. We believe that the standard should recognise the existence of this considerable body of information, even if this requires variances from international accounting standards.

17. Other comments for consideration

17.1 We consider that the additional costs to employers of having actuarial reviews conducted on an annual basis would be so great that, in the present economic climate, it would no longer be viable for many employers to continue supporting their defined benefit plans. In our view, many employer sponsors would have no practical alternative other than to consider terminating their defined benefit plans or explore available options to convert the plans to defined contribution plans. The persons most adversely affected would be the members of the defined benefit plans.

17.2 The Superannuation Industry (Supervision) Act 1993 ("SIS Act") and SIS Regulations do not require that assets of defined benefit plans should be maintained at a level that covers members' accrued benefits. Regulation 9.04 of the SIS Regulations treats the financial position of a defined benefit plan as "unsatisfactory" if the value of the assets of the plan is inadequate to cover the value of the liabilities of the plan in respect of benefits **vested** in the members of the plan. An actuary's report following an actuarial investigation must, however, include a statement of the actuary's opinion on whether, at the valuation date, the value of the assets of the plan is adequate to meet the value of the liabilities of the plan in respect of accrued benefits in the plan (see SIS Regulation 9.31(1)(b)).

17.3 We are particularly concerned at the additional practical stresses to be placed on the financial reporting timetable by the proposed changes. The measurement of accrued benefits will need to be finalised before the income statement and statement of financial position can be finalised. At present vested benefits and accrued benefits are generally disclosed only in the notes so that the main statements can be finalised before the liability for members' benefits has been calculated.

Comments regarding Financial Statements

17.4 In relation to the proposed new requirements for the preparation of financial statements, Watson Wyatt offers these comments:

- We do not support any proposal to require a statement of financial position which includes members' benefits as any form of liability. Whilst technical arguments can be framed both for and against an "equity" argument, we strongly disagree with any proposal to treat members' accrued benefits as equity, given the significant likelihood of misleading members and other users about their legal rights to such "surplus".
- We acknowledge there is interest in including a Statement of Changes in Members' Benefits. Currently, we are concerned at the appropriateness of some of the particular line items to be included in any such reconciliation. After the key issue relating to the measurement of members' benefits by Vested Benefits versus the proposed ED179 Accrued Benefits measure has been finalised, we would be pleased to suggest specific alternatives.
- We recommend the continuation of the present requirement under AAS 25 to produce only a Statement of Net Assets for defined benefit plans.
- We support the proposal to require defined benefit plans to prepare a statement of cash flows.
- Consistent with our comments above regarding treatment of members' accrued benefits as equity, we disagree with the proposal to require the preparation of a Statement of Changes in Equity for plans.
- It is important to recognise that defined benefit plans do not generally have formal earmarked "reserves". Instead, they have an all-purposes plan which is held on an unallocated basis and which is used to pay all members' benefits and all costs and expenses associated with the plan. Contributions to that plan may vary in order to ensure its long term financial stability and actuaries play an active role in ensuring that the recommended rate of contributions is sufficient to ensure the long term stability of the plan.

- Any suggestion that defined benefit plans have reserves earmarked for specific purposes is important because it has important implications and flow-on effects for the disclosure obligations of trustees. trustees have legislative obligations:
  - to disclose movements in reserves for the past 3 years in annual reports (Regulation 7.9.37(1)(k) of the Corporations Regulations 2001); and
  - to formulate and give effect to a strategy for the prudential management of those reserves (see Section 52(2)(g) of the Superannuation Industry (Supervision) Act 1993).