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14 September 2009

The Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
VIC 8007
By email: standard@aasb.gov.au

Dear Sir,

AASB Exposure Draft ED 187: Discount Rate for Employee Benefits (proposed amendments to AASB 119)

Mercer is pleased to respond to the Australian Accounting Standards Board's call for comments on Exposure Draft 187 in relation to AASB 119 and the discount rate used to value employee benefits.

Mercer is in broad agreement with the changes proposed, as they will encourage greater consistency in the valuation of employee benefits in different countries.

However, we do have some reservations about:

- potential differences in methods used by entities within a country to determine an appropriate corporate bond yield; and
- if paragraph Aus78.1 of AASB 119 is retained, potential inconsistencies that will be created between different public sector entities, and between not-for-profit public sector entities and private sector entities.

We note a dilemma in the application of AASB 119 to both public and private sector entities. Whilst we agree that by using corporate bond yields as the basis for discount rates there is greater consistency between countries, the use of corporate bond yields is not inherently appropriate for public sector entities. However, if there is a distinction between the discount rates used for public and private sector entities, this will give rise to different valuations under the same accounting standard for similar liabilities depending on the type of entity. This is also difficult to justify.

There are a number of possible ways of resolving this issue, including:

- excluding public sector entities from the application of AASB 119;
- adopting the International Public Sector Accounting Standard for Employee Benefits (IPSAS 25) for public sector entities;
- deleting paragraph 78.1 from AASB 119; or
- requiring public sector entities to discount employee benefit liabilities at an alternative rate, such as an expected investment earning rate or a long-term bond rate (eg 6% pa).

Our comments on the specific questions raised in the AASB and IASB Exposure Drafts follow.

AASB Issues

2. The AASB would particularly value comments on whether:

(a) there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to not-for-profit entities;

We are not aware of any regulatory issues affecting the implementation of the proposals.

However, we believe that there needs to be additional guidance given on the method of determining an appropriate corporate bond yield for the purpose of setting discount rates given there is no established deep market in Australia. There are various sources of corporate bond yield curves in Australia (including the Commonwealth Bank, UBS and Bloomberg), which can give different rates for similar terms. Data for durations of more than 5 years is limited. In addition, swap rates at different durations are available. Depending on the particular source used (or if an alternative method is used to generate a corporate bond yield from the yields on specific bonds), entities could select different discount rates even if the duration of their liabilities is the same. Without clearer guidance on the method for setting discount rates, there will still be the potential for significant variations in the valuation of employee benefit liabilities by entities within Australia.

We suggest that the AASB and representatives from the accounting and actuarial professions in Australia agree on a standard approach to setting discount rates for AASB 119 purposes.

(b) overall, the proposals would result in financial statements that would be useful to users; and

We believe that in general the proposals will result in financial statements that are of more use to readers, in particular by improving the comparability between entities in different countries.

(c) the proposals are in the best interests of the Australian economy.

Subject to the comments below relating to the impact of the changes on public sector entities, we believe that the proposals are broadly in the best interests of the Australian economy.

3. Paragraph Aus78.1 of AASB 119 requires not-for-profit public sector entities to discount post-employment benefit obligations denominated in Australian currency using market yields on government bonds. The AASB has tentatively decided to retain paragraph Aus78.1. The AASB would value comments on:

(a) its decision to retain paragraph Aus78.1;

The proposal will result in not-for-profit public sector entities placing a higher value on their employee benefit liabilities than private sector entities and non not-for-profit public sector entities if paragraph Aus78.1 is retained. We question whether this is a desired outcome.

We acknowledge that it was initially decided that the Australian equivalents to International Financial Reporting Standards should cover public sector entities as well as private sector entities; even though this is not the case in other countries (a separate set of International Public Sector Accounting Standards exists, including IPSAS 25 relating to accounting for employee benefits). The proposed change to IAS 19 means that it is less applicable to public sector entities, and it may therefore be necessary to reconsider the scope of AASB 119 and whether it should continue to apply to public sector entities. An alternative could be to adopt IPSAS 25 for public sector entities.

On the basis that public sector entities continue to be covered by AASB 119, the retention of paragraph Aus78.1 will create a distinction between not-for-profit public sector entities (which will continue to discount liabilities using government bond yields) and other public sector entities, which will use corporate bond yields. Assuming this is the intention, there will need to be a clear distinction between the two groups of public sector entities.

A not-for-profit entity is defined in Australian accounting standards as an entity whose principal objective is not the generation of profit. Privatisation of government entities has given rise to a large number of entities with different characteristics. It is often not clear whether their aim is profit generation or not. Therefore at a minimum we recommend that the AASB clarify the criteria that must be met for an entity to classify itself as not-for-profit.

We are also aware of one State government that defines entities falling within the defined General Government Sector as not-for-profit, and the remainder are deemed for-profit. Such a distinction highlights the inconsistencies that will arise under AASB 119 for different public sector entities.

(b) in the limited context of the IASB's objective to have greater consistency, the manner in which not-for-profit public sector entities should discount long-term employee benefit liabilities and the basis for any suggestions.

We believe that it is appropriate for not-for-profit public sector entities to discount their benefit liabilities using government bond yields, as these are the rates at which they would borrow money in the marketplace.

IASB Issues

Question 1: Discount rate for employee benefits
Do you agree that the Board should eliminate the requirement to use government bond rates to determine the discount rate for employee benefit obligations when there is no deep market in high quality corporate bonds? Why or why not? If not, what do you suggest instead, and why?

We support the removal of the requirement to set discount rates using government bond yields in countries without a deep market in corporate bonds.

However, the IASB should be aware that public sector entities in Australia are covered by the Australian equivalent to IAS 19 (AASB 119), whereas we understand that public sector entities are not covered by IAS 19 in the majority of other countries that have adopted International Financial Reporting Standards. AASB 119 currently includes a specific paragraph that requires not-for-profit public sector entities to value liabilities using government bond yields.

Assuming this paragraph is retained in AASB 119, the change will result in public sector entities that are not classified as not-for-profit public sector entities discounting benefit liabilities using corporate bond yields whereas not-for-profit public sector entities will be required to use government bond yields. There will be an inconsistency in the discount rates used by not-for-profit public sector entities and all other entities.

Question 2: Guidance on determining the discount rate for employee benefits
For guidance on determining the discount rate, do you agree that an entity should refer to the guidance in IAS 39 Financial Instruments: Recognition and Measurement for determining fair value? Why or why not? If not, what do you suggest instead, and why?

We believe that there needs to be clearer guidance for determining an appropriate corporate bond yield in countries with no deep market to meet the objective of improved comparability between entities. Whereas government bond yields are readily available, corporate bond yields must be estimated, and a judgement made about the best source of yields or the most appropriate methodology to use to determine an appropriate yield. We believe that the guidance in IAS 39 still leaves the determination of yields open to wide interpretation, and hence entities in the same country could use different discount rates even if the duration of liabilities is the same.

Question 3: Transition
The Board considered whether the change in the defined benefit liability (or asset) that arises from application of the proposed amendments should be recognised in retained earnings or as an actuarial gain or loss in the period of initial application (see paragraph BC10). Do you agree that an entity should:

(a) apply the proposed amendments prospectively from the beginning of the period in which it first applies the amendments?

We agree that the amendments should only apply prospectively to minimise the costs associated with implementing the change.

(b) recognise gains or losses arising on the change in accounting policy directly in retained earnings? Why or why not? If not, what do you suggest instead, and why?

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We also agree that the initial impact of the change should be recognised in retained earnings. As it is a change to the wording and application of the standard, it does not seem appropriate that the impact should affect profit and loss.

About Mercer

Mercer is one of the leading providers of actuarial, consulting and administrative services to superannuation funds in Australia. We also operate one of Australia's largest superannuation master trusts. We have a large client base of employers contributing to defined benefit public sector and corporate superannuation funds to which we provide financial reporting information in accordance with AASB 119. Indeed we have the largest number of superannuation actuaries in Australia who prepare AASB119 reports for their clients.

Should you have any questions about the above comments or wish to discuss the matter further, please contact me on (03) 9623 5464.

Yours sincerely,

Dr David Knox
Senior Actuary