Watson Wyatt
Worldwide

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Australian Accounting Standards Board
Level 7
600 Bourke Street
MELBOURNE VIC 3000

By email: standard@aasb.gov.au

To whom it may concern

Watson Wyatt Australia's response to IASB Exposure Draft "Discount rate for Employee Benefits (proposed amendments for IAS 19)"

In Australia, Watson Wyatt is one of the leading actuarial and employee benefit consulting firms, providing superannuation and actuarial consulting services in respect of both defined benefit and defined contribution superannuation plans.

Watson Wyatt commenced business in Australia in 1982 and since then has grown substantially. We have offices in Melbourne and Sydney, with approximately120 associates. We employ approximately 20 qualified superannuation actuaries and approximately a further 30 consultants and actuarial analysts who are studying towards the full actuarial qualification. We are the appointed actuary to more than 40 defined benefit corporate superannuation funds in Australia.

Globally, Watson Wyatt is submitting a response to the IASB regarding this Exposure Draft. Therefore, the comments in this response to the AASB have focused more specifically on the Australian application of the intended standard.

In this submission, we have:

- Responded to the specific Matters for Comment as requested by the AASB.
- Provided some analysis of the Australian corporate bond market.
- Made recommendations for consistent Australian implementation.
- Requested clarification for one specific area of the Exposure Draft.

Watson Wyatt Australia Pty Ltd ABN 45 002 415 349 AFSL 229921

Level 4, 1 Collins Street \ Melbourne VIC 3000 Australia \ +61 3 9655 5222 *Telephone* \ +61 3 9654 8227 *Fax*

AASB Specific Matters for Comment

Below, we have responded to the Australian Accounting Standards Board's specific "Matters for Comment", being:

1. *The IASB Exposure Draft contains proposals to eliminate the use by preparers of different discount rates by deleting from paragraph 78 of AASB 119 Employee Benefits the reference to using market yields on government bonds. Paragraph BC7 of the IASB Exposure Draft explains that the IASB has not yet considered whether the measurement of employee benefit obligations could be improved more generally and, in particular, the IASB has not yet considered whether the yield on high quality corporate bonds is the most appropriate discount rate for post-employment benefit obligations. The IASB's objective for publishing these proposals is only to introduce more consistency into the existing requirements.*

   To obtain global consistency, Watson Wyatt Australia support the removal of the requirement to set discount rates according to government bond yields in "non deep" bond markets.

   It is our understanding that it is the intent of the IASB to align all companies' reporting globally to high quality corporate bond yields (as required by the marked-up wording of paragraph 78 attached to the exposure draft). This is the basis on which the exposure draft has been communicated by the IASB.

   There are some legitimate practical concerns in Australia, for example that the need for local judgement will result in less domestic consistency than currently obtained under AASB119. Therefore, achieving both local and global consistency will be dependent on the development of some form of localised and common guidance. We believe many Australian professional firms will be interested in preparing such common guidance (please see our later comments, under "Recommendations for Implementation").

   We note that the AASB has flagged the comments in BC7 and agree that any fundamental review of IAS19 should consider the discount rate requirements in more detail and have therefore assumed in this response that the AASB will align AASB119 to avoid any divergence with the intended changes to IAS19.

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;

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

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

In the Exposure draft, the IASB has commented that the goal of greater global consistency outweighs the need for greater professional judgement at the local level.

Given this goal:

- We recommend that the discount rate provisions of AASB119 be aligned with IAS19 (any divergence would reduce consistency globally, and introduce duplicate reporting for Australian subsidiaries of multinationals reporting under IAS19). This will result in a (proxy) AA rated corporate bond being adopted globally.
- The exposure draft references the principles in IAS39 for guidance when setting discount rates. IAS39 is very broad and will permit a range of different approaches. This will mean that IAS39 will allow divergence in professional practice to emerge, undermining the "consistency" goal within the country (and potentially increasing the costs of preparing AASB119 disclosures as professionals reconcile differing approaches which comply with IAS39). We have therefore addressed this issue under "Recommendations for consistent Australian implementation" (see below).
- The Australian experience has shown that convergence of practice has not automatically emerged if the debate is left to the local auditors and actuaries. For example, a key Australian learning has been that the treatment of investment taxes has still not converged, five years after the effective implementation of IAS 19. The measurement of published Defined Benefit Obligations of Australian companies therefore continues to differ. Importantly, we would expect that similar differences will emerge following this exposure draft without sufficient Australian guidance.

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; and

   (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 note that the AASB has tentatively decided to retain paragraph Aus 78.1 requiring not-for-profit public sector entities to set discount rates based on government bond yields. There are technical arguments which will either support or oppose this proposal depending on the AASB's key objective for AASB119. This highlights the key issue of whether the yield on high quality corporate bonds is the most appropriate discount rate for post-employment benefit obligations, which should be addressed globally as part of the IASB's wider review.

2. Review of Australian corporate bond market

In the Appendix to this submission we set out extracts of our recent analysis of the Australian corporate bond market. It can be seen from the Appendix that actuaries and auditors will need to work through some (often unclear and conflicting) issues when setting discount rates based on corporate bond yields in Australia.

3. Recommendations for consistent Australian implementation

The Appendix highlights several practical (but differing) approaches that could be considered by a working committee in Australia. However, in our view none of the issues outlined in the Appendix are beyond resolution, or should be taken as reasons **not** to adopt the exposure draft's key recommendations.

We strongly recommend that the AASB facilitate a working committee of industry representatives to establish specific Australian guidance (having consideration to Australian conditions). In particular, we recommend that:

- The working committee review available local market conditions and available data and develop an appropriate and common methodology for setting discount rates for AASB119 purposes.
- Such guidance could be considered mandatory, or even "safe harbour" guidance (i.e. which a practitioner could apply, and be confident that the principles could not be challenged).

We are aware that local accounting standard boards have preferred to remain "principles-based" in the past and we understand that there may be practical limitations on the AASB's ability to drive such detailed analysis. Therefore, the above recommendation is specifically intended to involve the AASB but be driven by the industry participants with an expectation that some commonly agreed working principles are determined.

Our firm, like those of auditors and other actuaries, would be prepared to contribute to a mandated AASB facilitated working committee. In our view, the upfront investment of time in such a committee will substantially reduce future advisory costs and lead to Australian consistency more quickly.

4. Area for clarification within Exposure Draft

We note there appears to be an inconsistency in certain materials made available by the IASB regarding the prospective application. In our global submission, we will be seeking the IASB's clarification of this:

- Under paragraph 156A and BC9 of Exposure Draft, it states that any resulting net change in the defined benefit liability (or asset) is adjusted through retained earnings at the beginning of that period and disclose the amount of that adjustment;

  In the case of an early adopter, we have taken this to mean that the 2009 accounts would include changes to the ***beginning of year Defined Benefit Obligation*** (with a retained earnings adjustment at that point), and the ***2009 service cost and interest cost will be restated*** to be on a "high quality corporate bond" basis.

- However, in a summary on the IASB website, it states that "Entities would apply the proposed amendment prospectively from the end of the accounting period in which the amendment is adopted, with any adjustment arising from the change in accounting policy going direct to retained earnings" (Please refer to http://www.iasb.org/Current+Projects/IASB+Projects/Post-employment+Benefits+%28including+Pensions%29/Discount+rate+for+Employee+Benefits/Discount+rate+for+Employee+Benefits.htm

  The summary therefore suggests that an early adopter would adjust its 2009 ***end of year Defined Benefit Obligation*** only, presumably ***without restating the 2009 service cost and interest cost*** (i.e. it would first impact Profit and Loss in 2010).

In Watson Wyatt's global submission, will be asking that the IASB clarify its intent. We have a preference for making the adjustment at the **end** of the accounting period as this is consistent with a prospective approach and we do not see any added value in restating the prior year's service cost and interest cost.

* * * * *

We would welcome the opportunity to further discuss the points raised in this submission with the AASB.

Yours sincerely

Philip Collins
Principal
Watson Wyatt Australia

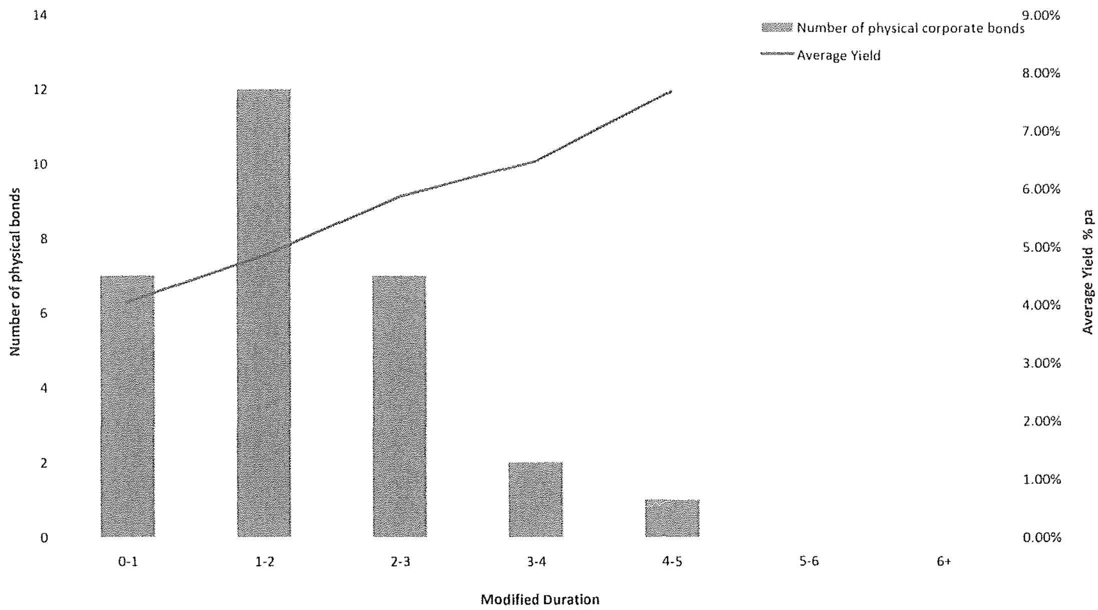
Brad Jeffrey
Director
Watson Wyatt Australia

Appendix

Review of Australian corporate bond market

- Market corporate bond data is often sparse at best. Chart 1 below shows the number of AA corporate bonds available in Australia at 30 June 2009.

Australian bond market - Physical corporatebonds at 30 June 2009



Source: UBS AG

The number of existing corporate bonds on issue is often very small, particularly at the longer durations required to measure retirement benefit obligations. There are currently no AA rated corporate bonds with terms to maturity of greater than 5 years. Those that are longer dated are lower rated than AA.

The typical duration of an Australian DB Plan is 8-12 years. The lack of available bonds at this duration is therefore a challenge in discount rate setting (as is reliance on the yields of the small number of bonds that *do* exist at the 4-5 durations).

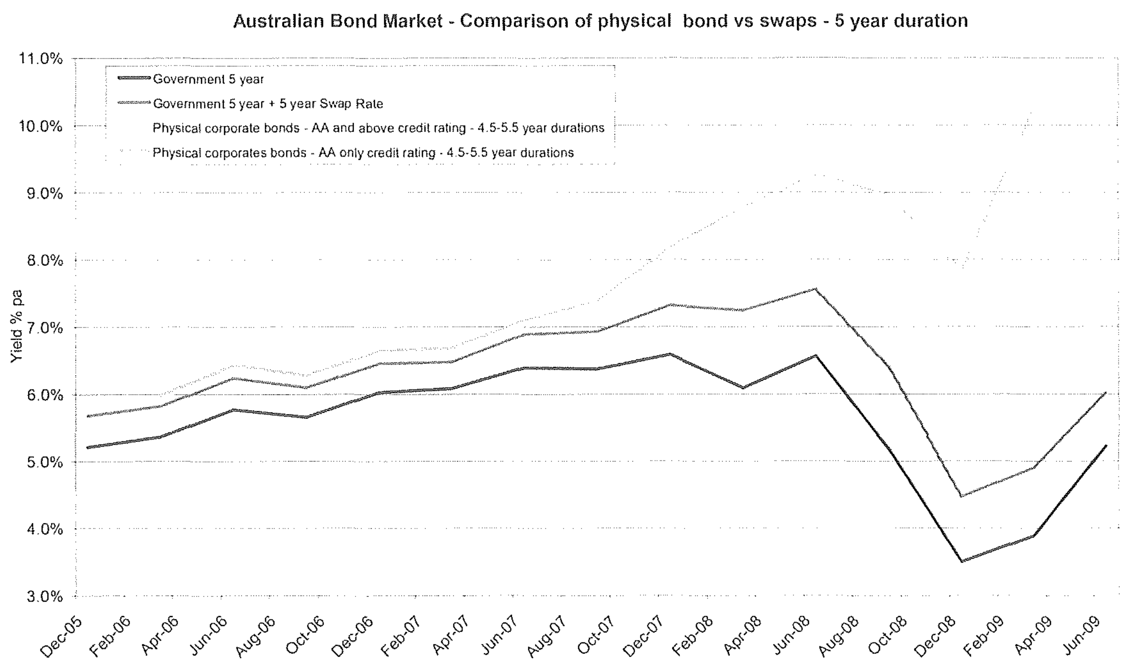
- Where some bond data exists, the trading volumes of such bonds are almost always extremely small. "Rate sheets" maintained by investment banks in Australia market places are best estimates by those institutions only. Such rates sheets are updated based on any trading activity in Australia, but also movements in overseas bond markets and credit spreads. Whilst each "rate sheet" reflects UBS' market assessment of corporate bond yields, it should not be taken to imply that a trade could actually be undertaken at such yields. Yields actually obtainable in the marketplace if a physical bond trade was actually initiated will often differ.

- Other markets could be used to determine an implied corporate bond spread, such as the yields on interest rate swap securities.

  In the Australian market place, the advantages of using swap yields are:

  1. Longer terms – it is possible to obtain swap rates for terms of up to thirty years.
  2. Trading volumes are substantially higher than physical corporate bond markets. Given the illiquidities of the market, the aim of this approach is to determine an objective proxy for the credit spread which maximises the amount of market data (as far as possible) objectively determines the proxy.

Such a "soft spread" could then be applied on top of government bond yields. This methodology would meet the (broadly worded) provisions of IAS39. The relationship between the corporate bonds implied, versus (any available) actual corporate bonds available will differ, often significantly where bond markets become distressed (as has been the case over the last year) as demonstrated in the graph below.



Sources: RBA, UBS AG, Datastream

The difference between a hard spread and soft spread has diverged, in recent times, due to the stressed nature of underlying financial markets and, in particular, due to the loss of liquidity in corporate bond markets.

Again, data on actual AA rated bonds is difficult to obtain beyond 5 years' duration (which is necessary, given the typical duration of Australian DB Plans). We have slightly extended the analysis by including AA and more highly rated bond yields to gain slightly more data.

- It is very subjective which method is more desirable – an implied soft spread, based on a market which maintained some reasonable degree of trading over this period, versus the "hard spread" approach, which is based on Rate Sheets maintained by investment banks, for securities are not necessarily physically being traded.
- Where data is considerably lacking in a particular country, it has been suggested (for example in FRS17) that corporate bond spreads in other countries be used as a proxy. This has its own issues. Past analysis by Watson Wyatt has shown that the relationship between global and local spreads is often poorly correlated. But some countries may feel there are very few alternatives.