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9 August 2010

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 195: Defined Benefit Plans (proposed amendments to AASB 119)

Mercer is pleased to respond to the Australian Accounting Standards Board's call for comments on Exposure Draft 195 in relation to proposed amendments to AASB 119, following the release of the International Accounting Standards Board's Exposure Draft.

Mercer is in broad agreement with the changes proposed by the IASB, as they will improve the comparability of financial statements between entities. However, we do have some reservations about the value of some of the new disclosure requirements, as well as the costs involved, particularly for multi-employer plans. The proposed changes to the standard also provide an opportunity to clarify some of the issues relating to the treatment of investment tax, and settlements and curtailments, particularly in the Australian context.

We also restate our view that public sector entities should not be covered by AASB 119.

Our comments on the specific questions raised in the AASB and IASB Exposure Drafts are contained in the Appendices to this letter.

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 whom we provide financial reporting information in accordance with AASB 119. Indeed we have the largest

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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

APPENDIX 1

AASB SPECIFIC MATTERS FOR COMMENT

Question 1

... do you think the proposed changes ... would have implications for GAAP/GFS harmonisation and, if so, how do you think those implications should be dealt with in the context of the principles in AASB 1049?

Response

We have no comments on this particular question (although we make some comments in 3(b) below regarding the applicability of the standard to public sector schemes).

Question 2

Do you agree that the proposed amendments to the definition of "return on plan assets" and paragraph 73(b)(iv) of IASB's ED/2010/3 Defined Benefit Plans clarify the treatment of superannuation contributions tax in accounting for defined benefit obligations? If not, please explain why.

Response

We agree that the proposed amendments clarify the treatment of superannuation contributions tax. The Exposure Draft confirms that an allowance for the value of contributions tax that relates to service before the reporting date should be included in the defined benefit obligation. This is consistent with the approach that we have been taking in preparing AASB 119 disclosures for our clients.

However, we believe that there still needs to be clarification of the treatment of superannuation investment tax.

The definition of return on plan assets states that any tax payable by the plan (apart from contributions tax) should be deducted. This suggests that the return on plan assets should be net of investment tax, which we support.

There is no reference to the treatment of investment tax in setting the discount rate or in calculating the defined benefit obligation, however. There is disagreement in Australia as to the appropriate allowance for tax in the discount rate – between actuaries and auditors, and even between actuaries. Some argue that a net of investment tax discount rate should be used, whilst others argue that a gross of discount rate is more appropriate.

Where the benefits in a plan are funded the tax on investment earnings imposes an additional cost on the provision of those benefits. If the tax did not exist the cost to the employer would be lower, as more would be financed via investment earnings. We therefore believe that the effect of investment tax on assets supporting benefits relating to service before the reporting date should be allowed for in calculating the defined benefit obligation.

We illustrate this by using a simplified example of a fund paying pensions that are exactly matched by a bond portfolio (on a gross discount rate). In a no-investment tax environment, the net interest cost is zero, and, assuming experience matches expectations, no gains and losses arise during the year. However, in Australia, the actual earnings on the assets will be reduced by investment tax, so an actuarial loss will automatically arise each year. It is our view that these actuarial losses arising from assets supporting accrued liabilities should be capitalised in the defined benefit obligation, as they are effectively known in advance. The allowance could either be made by deducting investment tax from the discount rate, or by including a specific provision for investment tax in the defined benefit obligation. In both cases, the defined benefit obligation increases, and the capitalised investment tax flows through to expense each year via a positive net interest cost.

Question 3

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 and public sector entities;

Response

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

However, we have previously recommended that the scope of AASB 119 be reconsidered in relation to public sector entities. We again raise this issue in light of the changes proposed. 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. This means that governments and their agencies are required to report pension liabilities. Many of these pension schemes are underfunded (or unfunded) but are supported by the sponsoring entity (ie the government).

Much of the disclosure information that is proposed in the Exposure Draft will be of limited or no value in the context of public sector entities, as ultimately the risks associated with the schemes reside with the relevant governments, rather than with the entities themselves. The time spent in producing the disclosures will not be reflected in the value gained from the information.

In addition, it has been suggested that a defined benefit public sector scheme sponsored by a State Government could fall under the definition of a state plan. Paragraph 36 of AASB 119 requires an entity to account for a state plan as a multi-employer plan. In turn, the standard states that a multi-employer plan can be accounted for as a defined contribution plan if sufficient information is not available to use defined benefit accounting. It is therefore possible that an argument could be made for using defined contribution accounting for a defined benefit public sector scheme, which would appear to be contrary to the purpose of including public sector entities in the scope of the standard in the first place.

We therefore recommend that either:

- public sector entities be excluded from the application of AASB 119; or
- International Public Sector Accounting Standard for Employee Benefits (IPSAS 25) be adopted for public sector entities;

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

Response

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.

(c) the proposals are in the best interests of the Australian and New Zealand economies.

Response

Subject to the comments above relating to the impact of the application of the standard to public sector entities, we believe that the proposals are broadly in the best interests of the Australian and New Zealand economies.

APPENDIX 2

SPECIFIC QUESTIONS IN THE INTERNATIONAL ACCOUNTING STANDARDS BOARD EXPOSURE DRAFT

Question 1

The exposure draft proposes that entities should recognise all changes in the present value of the defined benefit obligation and in the fair value of plan assets when they occur. (Paragraphs 54, 61 and BC9–BC12) Do you agree? Why or why not?

Response

We agree with the proposal to recognise all changes in the value of defined benefit obligations and plan assets in the period in which they occur. This will improve comparability of accounting disclosures by removing the current recognition options.

In Australia, only a small proportion of employers contributing to defined benefit funds apply the deferred recognition approach. The overall effect on balance sheets will therefore be immaterial. Those employers that currently recognise actuarial gains and losses in profit and loss will see a reduction in the volatility of their superannuation expense. This will assist in profit comparisons between entities.

Question 2

Should entities recognise unvested past service cost when the related plan amendment occurs? (Paragraphs 54, 61 and BC13) Why or why not?

Response

No comment.

Question 3

Should entities disaggregate defined benefit cost into three components: service cost, finance cost and remeasurements? (Paragraphs 119A and BC14-BC18) Why or why not?

Response

We agree with this approach to disaggregation of defined benefit costs. Separately identifying service cost and interest cost will assist in estimating future costs, by excluding the volatile remeasurement items. It should also improve the comparability of financial statements.

Question 4

Should the service cost component exclude changes in the defined benefit obligation resulting from changes in demographic assumptions? (Paragraphs 7 and BC19-BC23) Why or why not?

Response

We agree that changes in demographic assumptions should be excluded from the service cost. Service cost represents the cost of benefits accruing in a particular year, whereas the effect of changing demographic assumptions represents the impact on the value of liabilities accrued over the total past service of all current members.

Question 5

The exposure draft proposes that the finance cost component should comprise net interest on the net defined benefit liability (asset) determined by applying the discount rate specified in paragraph 78 to the net defined benefit liability (asset). As a consequence, it eliminates from IAS 19 the requirement to present an expected return on plan assets in profit or loss.

Should net interest on the net defined benefit liability (asset) be determined by applying the discount rate specified in paragraph 78 to the net defined benefit liability (asset)? Why or why not? If not, how would you define the finance cost component and why? (Paragraphs 7, 119B, 119C and BC23-BC32)

Response

We agree with the proposed approach as a pragmatic method of determining the finance cost component

Question 6

Should entities present:

(a) service cost in profit or loss?

(b) net interest on the net defined benefit liability (asset) as part of finance

costs in profit or loss?

(c) remeasurements in other comprehensive income?

(Paragraphs 119A and BC35–BC45) Why or why not?

Response

We agree with the proposed presentation approach as a means of improving comparability between entities.

Question 7

(a) Do you agree that gains and losses on routine and non-routine settlement are actuarial gains and losses and should therefore be included in the remeasurement component? (Paragraphs 119D and BC47) Why or why not?

(b) Do you agree that curtailments should be treated in the same way as plan amendments, with gains and losses presented in profit or loss? (Paragraphs 98A, 119A(a) and BC48)

(c) Should entities disclose (i) a narrative description of any plan amendments, curtailments and non-routine settlements, and (ii) their effect on the statement of comprehensive income? (Paragraphs 125C(c), 125E, BC49 and BC78) Why or why not?

Response

We believe that the proposed changes to IAS 19 provide an opportunity to clarify the definitions and accounting treatment of curtailments and settlements. This is one of the most complicated aspects of valuations performed in accordance with IAS 19, and the one open to most inconsistencies in approach.

We believe that the current wording of the standard does not clearly cover the issues relating to lump sum plans, and that the existing definitions of settlement/curtailment must be expanded to cater for the particular nature of lump sum benefits.

For example, if lump sum benefits are paid as a result of a particular event or transaction, it is possible to argue that any gain/loss could be treated as either a settlement gain/loss (where the difference between the benefit paid and the DBO is treated as a cost of settling the liabilities) or a curtailment gain/loss (where the difference is viewed as a change in the DBO as a result of the event or transaction). In our view, both interpretations can be justified. Because of this, we believe that there should be no distinction between the treatment of settlements and curtailments, and that both continue to be accounted for in profit and loss. By maintaining the current approach, differences in interpretations of what constitutes settlements and curtailments will not impact on profit.

Please note that these comments are made purely in the Australian context of defined benefit funds paying lump sum benefits. In a true pension fund, the distinction between curtailments and settlements may be more obvious, and hence different accounting treatment may be justified.

Question 8

The exposure draft states that the objectives of disclosing information about an entity's defined benefit plans are:

(a) to explain the characteristics of the entity's defined benefit plans;

(b) to identify and explain the amounts in the entity's financial statements arising from its defined benefit plans; and

(c) to describe how defined benefit plans affect the amount, timing and variability of the entity's future cash flows. (Paragraphs 125A and BC52–BC59)

Are these objectives appropriate? Why or why not? If not, how would you amend the objectives and why?

Response

We believe that the stated objectives as set out in the Exposure Draft are appropriate.

Question 9

To achieve the disclosure objectives, the exposure draft proposes new disclosure requirements, including:

(a) information about risk, including sensitivity analyses (paragraphs 125C(b), 125I, BC60(a), BC62(a) and BC63–BC66);

(b) information about the process used to determine demographic actuarial assumptions (paragraphs 125G(b) and BC60(d) and (e));

(c) the present value of the defined benefit obligation, modified to exclude the effect of projected salary growth (paragraphs 125H and BC60(f));

(d) information about asset-liability matching strategies (paragraphs 125J and BC62(b)); and

(e) information about factors that could cause contributions to differ from service cost (paragraphs 125K and BC62(c)).

Are the proposed new disclosure requirements appropriate? Why or why not?

If not, what disclosures do you propose to achieve the disclosure objectives?

Response

a) Whilst we agree with the intention to require disclosure of information about concentrations of risk (paragraph 125C(b)) and sensitivity of results to changes in assumptions (paragraph 125I), the descriptions of what is required should be more specific. In particular, the criteria for determining if a concentration of risk is significant enough to warrant specific disclosure should be clarified. Also, the meaning of a "reasonably possible" change to each significant actuarial assumption requires further explanation. It is not clear what a reasonably possible change to the discount rate would be when the rate is based on observed market yields at the specific balance sheet date. In respect of the sensitivity disclosures, it may be more appropriate to require disclosure of the effect of specified changes in particular assumptions, where significant (eg a 0.5% increase or decrease in the discount rate, a 0.25% increase or decrease in the pension increase rate, etc).

b) The requirement to disclose information about the process used to determine demographic actuarial assumptions appears reasonable, although it would probably be more useful if material changes to demographic assumptions since the last period were disclosed, as well as the date the demographic assumptions were last reviewed.

c) We do not believe that the disclosure of the present value of the defined benefit obligation, excluding the effect of future salary growth, will provide useful information to readers of the financial statements. This is not a liability measure that is used in Australia, and would only add to confusion. However, the calculation of this liability measure is unlikely to be particularly onerous.

d) We question the need to disclose information about a plan's asset-matching strategies, when most plans already have a statement of investment objectives. We believe that showing a plan's asset allocation (both actual and benchmark) will provide more useful information. By providing this information, along with a description of the plan, the user of the financial statements will get a feel for the appropriateness of the assets held by the plan, given the nature of liabilities.

e) We do not believe that the requirement to describe factors that could cause contributions to differ from service cost will achieve the desired objective, as there is no guarantee that the readers of the financial statements will have an adequate understanding of the operation of a defined benefit fund. If the intention is to disclose information on potential cash flow impacts for more than just one year, it would seem more appropriate to require an entity to disclose expected employer contributions for the next 5 years.

Question 10

The exposure draft proposes additional disclosures about participation in multi-employer plans. Should the Board add to, amend or delete these requirements? (Paragraphs 33A and BC67–BC69) Why or why not?

Response

Whilst most of the proposed disclosures are reasonable and the information should be available, we believe the time and effort involved in deriving the information will outweigh any value gained by users of the financial statements. This is particularly the case in Australia, where the standard covers public sector entities, and public sector schemes are generally considered to be multi-employer plans. The risks associated with public sector schemes reside with the relevant governments, rather than with the entities themselves, and therefore the value of disclosing information on these risks is limited.

Question 11

The exposure draft updates, without further reconsideration, the disclosure requirements for entities that participate in state plans or defined benefit plans that share risks between various entities under common control to make them consistent with the disclosures in paragraphs 125A–125K. Should the Board add to, amend or delete these requirements? (Paragraphs 34B, 36, 38 and BC70) Why or why not?

Response

We agree with the proposal to make the disclosure requirements for entities that participate in state plans or defined benefit plans that share risks between entities under common control consistent with the requirements for other defined benefit plans.

Question 12

Do you have any other comments about the proposed disclosure requirements? (Paragraphs 125A–125K and BC50–BC70)

Response

We have no other comments about the proposed disclosure requirements.

Question 13

The exposure draft also proposes to amend IAS 19 as summarised below:

(a) The requirements in IFRIC 14 IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction, as amended in November 2009, are incorporated without substantive change. (Paragraphs 115A–115K and BC73)

(b) 'Minimum funding requirement' is defined as any enforceable requirement for the entity to make contributions to fund a post-employment or other long-term defined benefit plan. (Paragraphs 7 and BC80)

(c) Tax payable by the plan shall be included in the return on plan assets or in the measurement of the defined benefit obligation, depending on the nature of the tax. (Paragraphs 7, 73(b), BC82 and BC83)

(d) The return on plan assets shall be reduced by administration costs only if those costs relate to managing plan assets. (Paragraphs 7, 73(b), BC82 and BC84–BC86)

(e) Expected future salary increases shall be considered in determining whether a benefit formula expressed in terms of current salary allocates a materially higher level of benefits in later years. (Paragraphs 71A and BC87–BC90)

(f) The mortality assumptions used to determine the defined benefit obligation are current estimates of the expected mortality rates of plan members, both during and after employment. (Paragraphs 73(a)(i) and BC91)

(g) Risk-sharing and conditional indexation features shall be considered in determining the best estimate of the defined benefit obligation. (Paragraphs 64A, 85(c) and BC92–BC96)

Do you agree with the proposed amendments? Why or why not? If not, what alternative(s) do you propose and why?

Response

a) We believe that incorporating the requirements of IFRIC 14 into IAS 19 is reasonable.

b) We believes that the definition of minimum funding requirement should be further tightened to define the situations in which a requirement to fund a plan is deemed to be enforceable.

c) See our response to Question 2 of the AASB Specific Matters for Comments above.

d) We question whether the time and effort required to determine an appropriate assumption for administration expenses to be included in the defined benefit obligation will be of value. For many funds it may not be clear how to identify the cost of future expenses relating to past service.

e) We agree with this proposal.

f) We agree that the clarification is appropriate.

g) No comment.

Question 14

IAS 19 requires entities to account for a defined benefit multi-employer plan as a defined contribution plan if it exposes the participating entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets and cost to individual entities participating in the plan. In the Board's view, this would apply to many plans that meet the definition of a defined benefit multiemployer plan. (Paragraphs 32(a) and BC75(b))

Please describe any situations in which a defined benefit multi-employer plan has a consistent and reliable basis for allocating the obligation, plan assets and cost to the *individual entities participating in the plan. Should participants in such multi-employer plans apply defined benefit accounting? Why or why not?*

Response

We believe that if the assets of a fund are segregated on a physical or notional basis then a defined benefit multi employer plan has a consistent and reliable basis for allocating the obligation, assets and costs.

In relation to public sector entities, there may be many government departments, agencies or enterprises with employees who are members of a partly funded pension scheme, and the plan assets may be apportioned according to the members' liabilities. Whilst such an apportionment may not be strictly accurate, it normally represents a reasonable approximation especially when the same Government supports all the entities

Question 15

Should entities apply the proposed amendments retrospectively? (Paragraphs 162 and BC97–BC101) Why or why not?

Response

No comment.

Question 16

In the Board's assessment:

(a) the main benefits of the proposals are:

> *(i) reporting changes in the carrying amount of defined benefit obligations and changes in the fair value of plan assets in a more understandable way.*
>
> *(ii) eliminating some presentation options currently allowed by IAS 19, thus improving comparability.*
>
> *(iii) clarifying requirements that have resulted in diverse practices.*

(iv) improving information about the risks arising from an entity's involvement in defined benefit plans.

(b) the costs of the proposal should be minimal, because entities are already required to obtain much of the information required to apply the proposed amendments when they apply the existing version of IAS 19.

Do you agree with the Board's assessment? (Paragraphs BC103–BC107) Why or why not?

Response

We agree that the proposals should increase the comparability and relevance of financial statements. However, we are concerned that the costs of some of the new disclosures will be significant for some entities.

Question 17

Do you have any other comments on the proposals?

Response

No comment.