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Sydney

Level 15, 255 Pitt Street
Sydney NSW 2000 Australia
GPO Box 3698
Sydney NSW 2001
www.challenger.com.au

Telephone 02 9994 7000
Facsimile 02 9994 7777

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

Dear Mr Stevenson,

Established in 1985, Challenger Limited is an ASX100 listed Australian financial institution (ASX: CGF). Our business is dedicated to providing safe, reliable and high-performing fixed income products to a wide range of institutional, superannuation and retail clients. Challenger is prudentially regulated by APRA and our annuity products are unique in the Australian marketplace.

This letter contains Challenger's observations on, and responses to, the Australian Accounting Standards Board's Exposure Draft 220 *Investment Entities* (ED220).

Primary issue

Our major, immediate, practical concern arising from the proposals is the potential loss of fair value accounting for investments in associates and joint ventures held by our APRA regulated life company and the consequential impact on the Challenger Limited consolidated financial report.

Challenger invests in a wide range of long-term debt, property and infrastructure entities to match the duration of, and earn a margin over the rates offered on, annuity liabilities.

Due to the nature of these assets, Challenger, along with other long-term investors, will often purchase a significant share of the available equity. As a result, these investments often meet the definition of an associate or joint venture.

AASB 1038 *Life Insurance Contracts* requires life companies to utilise the fair value option in AASB 128 *Investment in Associates and Joint Ventures* when the assets back life insurance or life investment contracts. The removal of this option for non-investment entities as proposed by ED220 will create an accounting mismatch for life companies as the assets will be equity-accounted and the liabilities they back will be recognised at either fair value or Margin on Services value (which in most cases approximates fair value).

Impact on commercial decision-making process on infrastructure investment assets backing life contract liabilities

For debt and property asset class backing insurance contracts this exposure draft is considered to have less of an impact as the underlying assets of the equity-accounted vehicle are likely to be materially held at fair value. It is in the infrastructure sector that this may impact the commercial decision-making process on asset purchases as the equity-accounted vehicle will include assets held at amortised cost.

The proposals are likely to result in a reduced appetite for life insurance companies to subscribe for 'significant influence' size stakes in projects as doing so may lead to increased volatility in their reported statutory profit.

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Potential solutions

If these proposals are to progress, we would be keen to seek a solution to this particular issue as a matter of priority. As discussed in the answer to question 9(b) below, Challenger's preferred option would be to retain the current definition of entities able to choose fair value or equity accounting in AAS 128 and to keep the AASB 1038 rule that insurers choose the fair value option. The Board can then introduce a separate paragraph directing investment entities to fair value associates and joint ventures without impacting insurers.

Other solutions may include:

- Opening up the choice of either equity or fair value accounting in AASB 128 to all entities;
- Extending the definition of an investment entity such that it would include life insurance statutory funds (and allowing the resulting treatment to flow up the group structure to the consolidated head entity); or
- Introducing a specific requirement in AASB 1038 for assets meeting the definition of associates or joint ventures that back life insurance or life investment contract liabilities to be recognised at fair value, regardless of whether the entity itself meets the definition of an investment entity.

Other issues and comments

Other observations and answers to the question posed directly in ED220 are contained in the main body of this response below.

If there are any questions on this response or if the Board would like to discuss any of the matters raised in more detail, please do not hesitate to contact either myself or Gareth Mitchell, Group Financial Controller on +61 2 9994 7374 or gamitchell@challenger.com.au.

Yours sincerely

Brian Benari
Group Chief Financial Officer / Group Chief Operating Officer
Challenger Limited

Question 1
Do you agree that there is a class of entities, commonly thought of as an investment entity in nature that should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?

From a consolidated Challenger Limited Group perspective, we are neutral on this issue, particularly if the exemption from consolidation does not flow-up the group structure to the head entity. Other than for Challenger Life Company Limited, which itself is unlikely to be an investment entity anyway, individual controlled entity reporting is largely irrelevant to external investors and regulators.

To the extent that Challenger manages separately listed funds, the nature of the underlying investments in a vehicle may affect the answer to the question due to the differing needs of the investors.

For example, investors into Challenger's listed property funds are likely to be neutral to fair value v consolidation as long as there is adequate disclosure of the nature of the underlying property exposure in the non-consolidated entities. This is because the results on a fair value basis will be materially the same as a consolidated view as the majority of the net assets of the underlying entity would be held at fair value anyway.

For investors into Challenger's infrastructure funds however, the answer could be very different. Investors are likely to have a preference for the consolidated approach as this would reflect the amortised cost value of the underlying assets. This removes unwanted short-term volatility experienced under the fair value approach, particularly in the current market environment, and focuses on the intrinsic underlying value for the predominantly long-term investors.

From a conceptual and accounting framework perspective, the carve-out and exemption from consolidation for a defined set of entities appears to be at odds with the principles-based approach under IFRS. This reduces comparability across entities and industries and could open the door for structuring and manipulation of reported results.

Principles that apply across all entities are preferable and it is not generally considered an administrative burden to consolidate entities that are controlled.

Question 2
Do you agree that the criteria in this exposure draft are appropriate to identify entities that should be required to measure their investments in controlled entities at fair value through profit or loss? If not, what alternative criteria would you propose, and why are those criteria more appropriate?

As stated in the answer to question 1, the carve-out and exemption from consolidation for a defined set of entities appears to be at odds with the principles-based approach under IFRS.

Question 3
Should an entity still be eligible to qualify as an investment entity if it provides (or holds an investment in an entity that provides) services that relate to:

(a) its own investment activities?

(b) the investment activities of entities other than the reporting entity?

Why or why not?

As stated in the answer to question 1, the carve-out and exemption from consolidation for a defined set of entities appears to be at odds with the principles-based approach under IFRS.

Question 4
(a) Should an entity with a single investor unrelated to the fund manager be eligible to qualify as an investment entity? Why or why not?

(b) If yes, please describe any structures/examples that in your view should meet this criterion and how you would propose to address the concerns raised by the Board in paragraph BC16.

As stated in the answer to question 1, the carve-out and exemption from consolidation for a defined set of entities appears to be at odds with the principles-based approach under IFRS.

Question 5
Do you agree that investment entities that hold investment properties should be required to apply the fair value model in IAS 40, and do you agree that the measurement guidance otherwise proposed in the exposure draft need apply only to financial assets, as defined in IFRS 9 and IAS 39 Financial Instruments: Recognition and Measurement? Why or why not?

As stated in the answer to question 1, the carve-out and exemption from consolidation for a defined set of entities appears to be at odds with the principles-based approach under IFRS.

Question 6
Do you agree that the parent of an investment entity that is not itself an investment entity should be required to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities? If not, why not and how would you propose to address the Board's concerns?

As stated in the answer to question 1, the carve-out and exemption from consolidation for a defined set of entities appears to be at odds with the principles-based approach under IFRS.

However, if the Board were to introduce this concept, it does not make sense for this reporting to be isolated to the entity and not be available for Group reporting. In a principles-based framework, if that principal applies at one level, there is no theoretical argument as to why it should not equally apply at each level of the corporate structure above it.

Whilst the concerns raised by the Board in respect of the potential for structuring are valid, this arises more as a result of the move from a principles-based approach rather than the point in a corporate structure where the investment entity definition is met or not.

Question 7
(a) Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosure requirements?

(b) Do you agree with the proposed application guidance on information that could satisfy the disclosure objective? If not, why not and what would you propose instead?

Challenger has no strong view on the disclosure proposals.

Question 8
Do you agree with applying the proposals prospectively and the related proposed transition requirements? If not, why not? What transition requirements would you propose instead and why?

Challenger agrees that retrospective application would be problematic and that prospective application is the best option.

Question 9
(a) Do you agree that IAS 28 should be amended so that the mandatory measurement exemption would apply only to investment entities as defined in the exposure draft? If not, why not?

Challenger does not agree with the proposal that only investment entities would fair value associates and joint ventures. It is not clear why the specific carve out from consolidation for a small, defined sub-section of entities would result in the closing of an option to fair value in another standard. If equity accounting provides more decision-useful information for one entity and fair value is deemed more appropriate to another, then accounting standards should leave the option open to all entities.

In particular for Challenger, where such assets are held to back life insurance and life investment contracts, denying fair value accounting for non-investment entities would result in increased income statement volatility and an accounting mismatch as the assets would be equity accounted whilst the related liabilities would be at fair value or MoS value.

(b) As an alternative, would you agree with an amendment to IAS 28 that would make the measurement exemption mandatory for investment entities as defined in the exposure draft and voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds? Why or why not?

Challenger is neutral on mandatory application of fair value accounting for investment entities as long as the option to fair value or equity account remains open to the current defined entities, and AASB 1038 continues to mandate that insurers take this option when the assets back life insurance and life investment contracts.