ED223 sub 3

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30 April 2012

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

E-mail: standard@aasb.gov.au

Dear Mr Stevenson

Australian Accounting Standards Board Exposure Draft 223 – Superannuation Entities

Mercer is pleased to respond to the Australian Accounting Standards Board's call for comments on Exposure Draft 223 in relation to the proposed new standard governing the financial statements of superannuation plans and approved deposit funds.

General Comments

Consistent with our comments on Exposure Draft 179 in September 2009, we believe that some of the requirements of the new standard fail to provide information in the financial statements that is appropriate for the needs of the users.

In particular, we recommend that the benefit measure used for defined benefit members in a fund's financial statement be the vested benefit, rather than an actuarial value of accrued benefits. This would be consistent with the approach used for defined contribution members.

We believe that further clarification is needed regarding the recognition of liabilities arising from insurance arrangements and the disclosure of disaggregated financial information.

We are also concerned about the duplication of the net superannuation liability (or asset) in the financial statements of both the superannuation fund and the sponsoring employer of the fund.

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.

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: SPECIFIC MATTERS FOR COMMENT

(a) Are there any superannuation entities that would meet the criteria in AASB 1053 *Application of the Tiers of Australian Accounting Standards* for applying Tier 2 disclosure requirements, that is, they need to prepare general purpose financial statements but do not have 'public accountability' [as defined in AASB 1053]?

Mercer Response

We do not have any comment on this requirement.

(b) Are there any significant practical difficulties that would inhibit a superannuation entity disclosing:

(i) information about defined contribution or defined benefit members' benefits in accordance with the relevant principles and requirements in AASB 7 *Financial Instruments*: *Disclosures* [as proposed in paragraphs 37, 38 and AG27 – AG28 of this Exposure Draft]? If so, please describe the nature of these difficulties and how they might be overcome;

Mercer Response

We do not have any comment on this requirement.

(ii) in relation to defined benefit members, qualitative information about non-performance risk and/or economic dependency risk to which the plan is exposed in respect of employer sponsors of such members [as proposed in paragraphs 39 and 40 of this Exposure Draft]? If so, please describe the nature of these difficulties and how they might be overcome;

Mercer Response

In theory this is a reasonable requirement, but in practice there will be little benefit gained from these disclosures. The wording is likely to be similar for all defined benefit funds. For most funds, employer contributions are set at a level to meet obligations and there is therefore an inherent exposure to credit risk relating to the employer. However the fund is restricted in its ability to measure or manage the employer's credit risk, so that any disclosure would most likely to limited to a general comment that the fund's trustee acknowledges the risk, regularly reviews the payment of contributions by the employer and, where appropriate, monitors the employer's credit risk rating provided by independent agencies.

(iii) liquidity risks relating to any non-financial liabilities other than tax liabilities held by the entity [as proposed in paragraphs 41 and 42 of this Exposure Draft]? If so, please describe the nature of these difficulties and how they might be overcome;

Mercer Response

We do not have any comment on this requirement.

(iv) disaggregated financial information based on the principles and requirements of AASB 8 *Operating Segments* [as proposed in paragraphs 43, 44 and AG31 of this Exposure Draft]? If so, please describe the nature of these difficulties and how they might be overcome.

Mercer Response

Whilst ED223 removes some of the confusion surrounding the ED179 requirements to disclose disaggregated financial information for segregated groups of assets, we believe some uncertainty remains in relation to the application to "operating segments". In particular, how do the requirements apply to a master trust with a number of sub-plans?

It is not completely clear whether a sub-plan meets the definition of operating segment in AASB 8. The trustee of the master trust will review the financial position of each sub-plan from time to time and make decisions accordingly, but we do not believe that this is sufficient to classify a sub-plan as an operating segment.

If sub-plans are deemed to be operating segments, paragraph 44 of ED223 requires that information be disclosed in respect of plans with liabilities that are at least 10% of the total fund liabilities, and additional segments are identified until at least 75% of the total fund liabilities are disclosed (even if they do not meet the 10% threshold).

Any requirement to disclose information in respect of sub-plans will potentially add considerable cost to the production of the financial statements, without providing significant benefits to readers of the statements. For example, some master trusts have hundreds of sub-plans and whilst no plan would meet the 10% requirement, the 75% requirement would generate an enormous amount of work.

We also note that more detailed information in respect of a defined benefit sub-plan is often available in other communications produced by the plan. For example, additional information for

each sub-plan is usually provided with the annual report for the fund as a whole, a copy of which is made available to each sub-plan member. This document will generally contain information on the investments of the sub-plan, movement in assets and the funding position at the sub-plan's most recent administration review. We therefore do not believe that disaggregated information need be disclosed in the fund's financial statements, particularly given the costs involved.

We recommend that the circumstances in which disaggregated financial information should be disclosed be clarified and modified so that unnecessary and unhelpful disclosure requirements are removed.

(c) Would it be reasonable to require retrospective application of the replacement Standard for AAS 25 to annual reporting periods beginning two years from the date of issuing that Standard?

Mercer Response

We have no concerns with this suggestion.

(d) Overall, would the proposals result in general purpose financial statements that would be useful to users?

Mercer Response

For the majority of defined benefit funds, the measure of accrued benefits (the AASB 119 liability) will exceed the fund's assets, leading to negative total equity in the financial statements. We are unsure if this has any legal implications for the fund, for example whether it implies that the fund is continuing to operate while insolvent.

Reporting a negative equity amount may also lead to inappropriate behaviour by members or unnecessary concern over the security of members' benefits. For example, at the extreme, members could convert out of the defined benefit section of the fund based on a perceived fear for the security of their benefit, even though the fund's vested benefits and funding accrued benefits may be adequately covered by assets.

We are also concerned with the principle of recognising a net liability (or asset) in the financial statements of a defined benefit superannuation fund. A net superannuation liability (or asset) is already recognised in the financial statements of the sponsoring employer. It seems inappropriate to recognise the superannuation liability (or asset) in two different sets of financial statements.

The liability for a deficit of assets relative to accrued liabilities lies with the employer – the fund itself has no obligation to make good a deficit. A defined benefit fund can only pay out a maximum of the assets that it holds. It has no recourse to any other funds.

To reflect the reality of the situation, the employer's liability to the deficit could be shown as a receivable in the fund's financial statements. Such an approach would mean that the accrued liabilities less the employer receivable would matched by the fund assets, with no resulting negative equity.

(e) Are the proposals in the best interest of the Australian economy?

Mercer Response

We are concerned that some of the changes proposed by ED223 add little useful information while presenting a high risk of being misleading to members.

We believe that the most appropriate measure for reporting the benefit obligations of a defined benefit fund in its financial statements is the total of vested benefits (ie the benefit entitlements were all members to leave service at the date of calculation). From the point of view of the main users of the financial statements, the members of the fund, this is the measure of liabilities that is the easiest for them to understand and the most relevant. A comparison of the total value of assets in the fund with the total of vested benefits gives members an idea of the security of their immediate benefit entitlements, which is likely to be their main concern when reading the financial statements.

By recognising vested benefits as liabilities in a defined benefit fund, there is also consistency with defined contribution funds, for which vested benefits is the most appropriate and only feasible measure. From a member's perspective, defined benefit and defined contribution funds have much in common and therefore the measurement of liabilities should be the same. Indeed, many individuals are members of both the defined benefit and defined contribution sections within the same fund. Using different approaches for the same member would lead to even less understanding.

The advantages of using vested benefits as the measure of a defined benefit fund's liabilities include:

- It is generally a simple calculation that does not require actuarial input, thus reducing costs and time spent and thereby improving the timeliness of the reporting;

- The total of vested benefits is already used as a solvency measure, compared with assets to determine if a fund is in an unsatisfactory financial position for the purposes of the Superannuation Industry (Supervision) Act;
- The concept of vested benefits is familiar to members and is currently disclosed in the financial statements of superannuation funds;
- Members and other readers of the financial statements are likely to better understand the concept of vested benefits rather than an actuarial value of accrued benefits.

We also note that the Australian Prudential Regulation Authority has issued a draft Prudential Standard on Defined Benefit Matters which focuses on the full funding of the vested benefits of beneficiaries of a defined benefit superannuation fund. Where an actuarial investigation finds that a fund's assets are less than the total of vested benefits, the actuary must recommend a contribution program to restore the fund to full funding within a reasonable period of time (not exceeding 3 years). With this focus on vested benefits by APRA, it seems appropriate for a defined benefit superannuation fund to report its liabilities on a consistent basis.

Requiring defined benefit members' Accrued Benefits to be calculated in accordance with AASB 119 would present a number of challenges:

- Timing of calculations – A defined benefit obligation will be calculated in accordance with AASB 119 for inclusion in the employer sponsor's financial statements. However, this will generally be calculated well before the Fund's financial statements need to be prepared. Even if the employer and the Fund have the same reporting date, to meet the employer's reporting deadlines the figure calculated for inclusion in the employer's financial statements will usually have been based on data at a date prior to the Fund's reporting date and projected forward to the reporting date. If the defined benefit obligation calculated for the employer's financial statements is used for the Fund's financial statements, it will not always be based on final data at the reporting date, and could be inconsistent with the value of assets reported. On the other hand, if the intention is that an updated AASB 119 defined benefit obligation will be calculated as at the Fund's reporting date, this will involve significant additional costs that will need to be borne by the Fund. It may also be difficult to determine a final defined benefit obligation in time to meet the deadline for preparing the Fund's financial statements. Often final membership data is not available until close to the end of the 4-month period from the reporting date for preparation of financial statements. This would leave minimal time to then calculate the required defined benefit obligation.

- Assumptions for Accrued Benefits – The defined benefit obligation calculated for the employer's financial statements is based on assumptions determined (or approved) by the employer. We imagine that the Trustee would need to determine (or agree) to the assumptions

used to calculate the Accrued Benefits shown in the Fund's financial statements. If these differ from those used to calculate the figure for the employer's financial statements, this will also require a recalculation and associated additional costs.

(f) In quantitative or qualitative terms, unless already provided in response to specific matters for comment (a)-(e) above, what are the costs and benefits associated with the proposals?

Mercer Response

There will be significant costs associated with the proposals outlined in ED223, in particular relating to the calculation of accrued benefits for defined benefit funds.

The direct costs of calculating the ED223 measure of the benefit obligation will include:

- Additional valuation fees. Requiring actuarial input to generate a valuation figure will incur annual actuarial fees, which will vary considerably depending on the level of complexity and level of assistance needed in completing the required disclosure notes.

- Additional consultation time between auditors, actuaries and Trustees to agree on assumptions used.

The indirect costs will include:

- Time spent responding to Defined Benefit members' questions about the conflicting measures of the Defined Benefit liability, when comparing the ED223 measure against their Vested Benefit and Accrued Benefit measure for funding purposes.

- Poor decisions being made by individual defined benefit members, who may be misled about the security of their benefits by the Accrued Benefit measure proposed under ED223.

We do not believe that the liability measure proposed will add useful information to that already in existence, but instead could cause confusion for members.

Other Issues

Paragraph 22 of ED223 states that the defined contributions members' vested benefits shall be measured as the amount "payable on demand". This may be misleading, as the member's vested benefit is not like a bank deposit which can be withdrawn at any time. No superannuation benefits

are payable on demand as the member needs to either utilise the portability provisions or satisfy a condition of release to trigger the payment of a benefit in cash; eg retirement. We recommend that the wording of paragraph 22 be amended to simply refer to the defined contributions members' vested benefits.

We believe that further clarification is required in relation to the recognition of liabilities arising from insurance arrangements. We understand the intention of the standard is that where a fund self-insures its death and disability benefits, a liability will need to be recognised in its financial statements. This liability would be limited to claims that are outstanding at the balance sheet date, and an estimate of claims that have been incurred but are yet to be reported. We recommend that the wording of the standard reflects these requirements.

If a fund insures the liability for its death and disability benefits with an external insurer, we understand that no additional liability need be recognised in its financial statements. However, there are likely to be situations where the fund is inadvertently self insuring some of the liability (generally a small portion) even if there is an external insurance arrangement in place, due to the interaction of the insurance formula and the financial position of the fund. We recommend that the standard be clear that a fund is not required to recognise a liability in these situations.