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Submission

AASB Exposure Draft 179: Superannuation Plans and Approved Deposit Funds

Presented by

Australian Institute of Superannuation Trustees

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Background

In May 2009, the Australian Accounting Standards Board (AASB) released Exposure Draft 179, containing proposals for a new accounting standard to replace Australian Accounting Standard 25 (AAS 25), *Financial Reporting by Superannuation Plans.*

AIST welcomes the opportunity to comment on the new Exposure Draft.

AIST

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose mission is to promote and protect the interests of Australia's $450 billion not-for-profit superannuation sector. AIST's membership includes the trustee directors and staff of industry, corporate and public-sector funds, who manage the superannuation accounts of nearly two-thirds of the Australian workforce.

As the principal advocate and peak representative body for the not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST provides professional training, consulting services and support for trustees and fund staff to help them meet the challenges of managing superannuation funds and advancing the interests of their fund members. Each year, AIST hosts the Conference of Major Superannuation Funds (CMSF), in addition to numerous other industry conferences and events.

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Introduction

Exposure Draft 179 contains proposals for a new Australian Accounting Standard to replace AAS 25 Financial Reporting by Superannuation Plans.

The new proposed superannuation standards adopt a principles-based approach and, in essence, seek to incorporate the principles from other Australian Accounting Standards such as:

- AASB 119 Employee Benefits,
- AASB 1038 Life Insurance Contracts,
- AASB 7 Financial Instruments: Disclosures,
- AASB 3 Business Combinations, and
- AASB 8 Operating Segments.

If adopted as a replacement standard for AAS 25, the proposals in ED 179 would bring about significant change to financial reporting for superannuation plans.

Key recommendations

AIST's key recommendations are;

- Vested benefits are the preferred measure for calculating member liabilities as they represent the actual liability as at the balance date.
- If vested benefits are rejected as the appropriate liability measure, then AASB 119 should be applied without the risk-free rate exemption.
- AASB 1038 requirements should be removed from the draft, with self insured funds required to disclose the risks via the note disclosures.
- Funds which reinsure, should provision against the risk that an insurer elects to reject a claim which leaves the fund liable via the funds contingency reserve, with an appropriate note disclosure.
- The requirement for superannuation funds to judge the credit risk of a defined benefit employer at any level should be removed.
- Consolidation is only warranted in instances where real control exists and can be documented.
- The board undertakes to revert to investment accounting as per the US, Canada and the UK with increased disclosures instead of consolidation.
- Support segmented reporting, however further guidance is required to ensure sector reporting is focussed on liabilities.
- That the board defines segments and aligns the segments with APRA's concept of 'sub-fund', in the interests of system efficiency.
- Support the changes with regards to the cash flow statement and the statement of changes in members benefit.
- Do not support the statement of changes in equity, preferring note disclosure.
- The board work closely with APRA to align their definition of a fund segment with APRA's definition of a sub fund.

Discussion

AIST undertook to run two roundtable discussions regarding ED179, on 22 July 2009 and 25 August 2009. This document has been prepared based on the arguments made during these consultations.

The most important question to consider when discussing the financial statements of superannuation funds is: who are the users? Although the answer appears obvious, it is essential to contemplate this point, as it is central to the debate: the users of these statements must be catered for if we are to successfully adopt a principles-based approach to financial reporting of superannuation assets and liabilities.

Evidence suggests that, to date, common practice for the majority of funds is to operate a two-tiered approach:

- General purpose financial statements are the statutory requirement and are normally used by regulators, financial intermediaries, employer sponsors, creditors, and finance professionals. While these are required to be made available to members under law, they are usually not circulated to all members, but only on request, and the number of requests is negligible; and
- Special purpose financial statements are an abridged simplified set of financial statements (usually one page) for member reporting and are circulated to all members, as required under law.

Furthermore, several studies of member behaviour to date have revealed that the level of member engagement within the superannuation sector is quite low. As members are relatively unengaged, the conclusion that members will be better informed as to the risks impacting a fund's ability to pay benefits through the proposed changes is difficult to digest. If you were to put a set of general purpose financial statements in the hands of a typical member the reaction would be confusion. Many superannuation professionals without an accounting background might react in a similar manner. Our research indicates that members are mainly concerned with a fund's current earning rate, its historical earning rate, and the costs associated with earning the return.

It is difficult to argue against the broad principles of the proposed changes. However, members of the accounting and finance profession are likely to be the only people equipped to decipher the capacity of an entity to meet its members' benefits. Typical superannuation fund members are likely to end up feeling further alienated by highly complex financial statements.

While outside the scope of this consultation, we support a review of the Corporations Act disclosure rules to make the abridged financial information more useful to members.

Analysis

This section takes each of the more controversial proposed changes and considers the pros and cons of each as discussed during our roundtable discussions with key stakeholders.

AASB 119 Employee Benefits

ED179 proposes two significant changes affecting defined benefit liabilities. The first change is that defined benefit liabilities will be based on accrued benefits rather than vested benefits; the second, that the measurement of the accrued benefits is to be determined using the projected unit cost method as prescribed by AASB119, with the key exception that the discount rate used will be a risk-free discount rate.

Arguments against

We believe the proposal adds confusion to what are already difficult financial disclosures. Presently there are already three different measures being used to measure a defined benefit plan's liabilities:

1. The popular vested benefits measure (preferred by AIST), which is extensively used by APRA and fund trustees.
2. The accrued benefit as actuarially calculated and commonly used to determine an employer's contribution rate. This is a detailed measure that considers a fund's projected liability, the projected growth of a fund's assets, and is the basis for deriving a fund's status, whether it is in a surplus or deficit position.
3. The liability reflected on the corporate sponsor's balance sheet. This is commonly known as the AASB119 liability and is calculated using a projected unit cost method.

The proposal in ED179 requires funds to calculate and present a fourth measure. Whilst the method may be consistent with AASB119, the measure will result in a different number due to the risk-free rate exception in ED179. Under the proposal, it is clear that the fourth measure will lead to increased confusion amongst members, as there are likely to be significant discrepancies between the amounts disclosed in funds' and sponsors' accounts.

We believe the AASB 119 use of a risk-free rate will increase volatility in the liability numbers. Market-determined rates are likely to lead to a suboptimal outcome as they are prone to considerable volatility, and reflect the short-term nature of market participants. Superannuation and liability matching is a long term prospect, therefore a more appropriate rate would be a rolling ten year rate of monthly bond rates. Such a rate would exhibit an element of variability but at the same time, given the long-term nature of the rate, it would be reflective of the liabilities being measured. Also, a lower discount rate will lead to a higher liability, which is likely to create higher instability when funds are already under considerable pressures. Some have suggested that a one per cent move in the risk-free rate will translate to a ten per cent movement in the liability.

Public-offer hybrid funds will be disadvantaged – the proposals require a fund to document liabilities on the balance sheet and, in situations where a fund is in deficit, this presents the fund to potential investors as technically insolvent. Disregarding the argument over who is responsible for such a liability, one must ask: who will want to invest in a hybrid scheme when a portion of that scheme is technically insolvent, and there exists a perceived risk, that the insolvency may call on the assets of all members?

We also believe that including the accrued benefit figure (which incorporates some element of future benefit accruals) as a liability is inconsistent with the assets side of the balance sheet including present assets only. By using vested benefits as the liability measure, the balance sheet would provide a more transparent picture of the fund's position, and would be more consistent with APRA's focus on vested benefit index as an immediate measure of a fund's financial position.

<u>Preferred position</u>

AIST's preferred position is to use vested benefits as the measure for calculating member liabilities - as vested benefits represent the liability at the balance date and are the key measure used by APRA. If the Board elects not to accept vested benefits then the next preferred position is that the board uses AASB 119 in its current form, and removes the requirement for a separate discount rate in the draft standard.

We also note that for many funds vested and accrued benefits will eventually converge as the remaining members of closed defined benefit schemes approach retirement. This is particularly so as the majority of defined benefit schemes have been closed for ten to fifteen years.

AASB 1038 Life Insurance Contracts

ED179 proposes that life insurance be accounted for as in AASB 1038. The implication of this requirement is that funds will be required to recognise the net value of all future receipts from, and payments to, members under insurance contracts in existence at the reporting date. This obligation is triggered irrespective of whether the fund has fully reinsured those contracts. The exception is if the fund is acting as an agent for the insurer.

<u>Arguments for</u>

Reinsurance risk - in the case of the fund reinsuring its risk under a traditional group life policy, there remains the potential for the insurer to reject a claim and the fund may then be liable for the claim under the trust deed. Under the proposals such risks need to be quantified.

Self insurance – where funds elect to self insure, the argument is that the fund should account for the risks as in AASB 1038.

Arguments against

There is no insurance contract between a member and the trustee– the standards are based on the presumption that a contract exists between the "insurer" and the "insured". The nature of the contract gives rise to a contingent liability. Within the superannuation environment, the key feature that is missing is the insurance contract. This provokes debate over whether a contingent liability exists, given that the trustee retains the ability to decide if a claim is valid.

Disability clauses in trust deeds – following from the first argument, most trust deeds contain a definition of disability that defaults to the policy definition. In most cases this means that the fund is not liable if the insurer refuses a claim.

The net effect will be zero – this argument is more holistic in nature and is as follows: when self insuring, a fund's actuary will assess the future liability and discount this to a present value. The fund's assets, set aside for meeting the claims, will be subject to a similar analysis involving projected returns and future premiums, and will then be discounted to a present value. The end result should theoretically net to zero and therefore, the exercise will result in an unnecessary increase in costs.

Reinsurance risk is immaterial – this argument states that the reinsurance risk is not deemed material and is addressed through the fund's operational contingency reserve. Provided the reinsurance contract matches the terms of the agreement between the fund's trust deed and the member, the risk is considered to be a low probability event.

Preferred position

AIST recommends that the AASB 1038 requirements be removed from the draft. Funds that self insure should be required to disclose the risks as per the existing note disclosures. Funds that reinsure through a Group Life Policy, but have the potential to be held liable for claims not covered under the policy, should also provide note disclosure and provision through the contingency reserve.

AASB 7 Financial Instruments: Disclosures

ED179 proposes increased disclosure as per the principles embedded in AASB 7 Financial Instruments: Disclosures. The standard will require increased disclosure with regard to liquidity risk, market risk, credit risk, investment strategy, and script lending. Furthermore, strategies to mitigate such risks will be also required. Likewise, an assessment of the credit risk associated with a defined-benefit employer will be required under this standard.

Arguments for

Greater transparency – we encourage risk disclosure and welcome the proposals in ED179.

Arguments against

Funds reporting credit risk – it is unusual to expect a superannuation trustee or the executive team of a superannuation fund to ascertain the credit risk associated with a corporate sponsor. The recent financial crisis demonstrates that even the most highly regarded credit experts find it difficult, or even impossible, to predict and/or ascertain the credit risks of highly-rated securities. Furthermore, the information requirements to adequately quantify credit risk are beyond the normal business practices of a fund. Finally, what are the legal ramifications for a fund that misquotes the credit risk associated with a corporate sponsor? We do not believe that ascertaining the credit risk associated with a defined benefit employer is a task for funds.

Preferred position

The requirement for superannuation funds to judge the credit risk of a defined-benefit employer at any level should be removed.

AASB 3 Business Combinations

ED179 proposes that superannuation funds be required to prepare consolidated financial statements in accordance with AASB 3 Business Combinations.

Arguments against

We believe that defining control as 51 per cent ownership is a crude measure. In many scenarios it is possible for a fund's investments to exceed the 51 per cent threshold, which theoretically gives them control. However, the true test should be the fund's ability to govern the entity invested in. For example, several scenarios were raised during AIST's discussions in which funds had met the 51 per cent control definition but had been unable to obtain financial information to prepare consolidated reports. In an extreme case, a fund with a majority stake in an investment trust was powerless when the investment manager decided to wind-up the trust and was unable to control the timing of this event, meaning that the redemption was at the manager's discretion.

Situations of inadvertent control can arise for a number of reasons. The most common reason is where other investors in a vehicle divest, leaving one of the remaining shareholders with theoretical control. The other less-common example is where funds seed an investment in a private equity type vehicle and, for reasons beyond their control other investors fail to take up their allocations, which leaves the original investor in a position of theoretical control.

In some instances, member investment choice can lead to a majority holding where the trustee makes additional investments to reflect members' choices. Whilst this scenario is unlikely, it could arise when investment options are predominately unlisted investments.

Equity in a company versus benefits – equity in a company gives an investor a share of all assets, whereas equity in a fund will generally only give a member a share of a proportion of the assets. The argument then follows that consolidated reporting is essentially irrelevant, as members rarely have a claim on all the assets of a fund.

APRA will continue to require the unconsolidated statements. The consolidated position may be considered the true position of the fund; however, while the fund may have control in some circumstances, it is rare. Even under these rare circumstances, whether we should be recognising goodwill is questionable. Given that super funds invest for the long term, the probability of goodwill being recognised is highly unlikely. For example, where funds collectively have an ownership in an administrator or an asset consultant, they have made the investments on the basis of achieving cost efficiencies, and the assets in question are operational assets and not investments.

Preferred position

AIST has two preferred positions: firstly, consolidation only in instances where real control exists and can be documented. Secondly, revert to investment accounting with increased disclosures.

Where real control exists - three of the five arguments against consolidation share a common thread: theoretical control. It is imperative that if the Board elects to retain consolidation within the standard that it then commits to clarify control. We understand there is a proposal to rewrite the AASB 127 *Consolidate and Separate Financial Statements* standards. Consideration should be given to accelerate this process and align it with the release of ED179. Furthermore, the Board should consult with industry regarding when control actually exists. The majority of trust deeds and investment management agreements for investment vehicles are structured so that practical control remains with the manager or trustee in almost all circumstances. This is necessary for investment managers to have full control of their investment strategy. Outside influence as to when or how to trade contradicts the argument that investors employ a manager for his or her expertise, and is akin to micromanagement. In all discussions that AIST held, the argument of whether control exists dominated; this is by far the most controversial aspect of the present draft.

Investment accounting – throughout AIST's discussions, reference was made to investment accounting standards in the US, Canada and the UK. The participants in our discussions believe that these accounting standards provide good models for Australia to work from. Investment accounting recognises that investment is not driven by a desire to control an entity; rather, the desire to invest in an opportunity. Superannuation funds are generally not in the business of controlling entities. The requirement to consolidate may, in fact, have an adverse impact on investment in emerging technologies through private equity. The worst case scenario is where the investment decision is driven by the accounting implications; that is, the 'tail ends up wagging the dog', so to speak. The second preferred position is investment accounting with increased disclosure. Disclosure of critical items such as net tangible assets, combined with increased explanations around debt levels, interest coverage, debt structure, and debt maturity, essentially exploring refinancing risks and serviceability of debt.

AASB 8 Operating Segments

ED179 proposes that superannuation plans report on the logical segments that their business decisions are based on, in accordance with AASB 8.

Arguments for

Logical segments do exist – segments are especially important in the case of a hybrid fund, where defined benefit and defined contribution options share a liquidity pool. In such scenarios, it is possible that one of the plan's needs places the other plan's members at a disadvantage. Likewise, another logical segment exists with pension assets, which are treated differently for taxation purposes. Arguably, the move to operating segments will enhance the management of the fund.

Increased transparency - operating segments increase investor transparency, facilitate easier reconciliation of performance calculations and may, over time, increase the comparability of funds.

Management efficiency – management expense ratios enable management and investors to ascertain the investment efficiencies that the fund is able to achieve. Operating segments increase the ability to cross check these calculations, thereby focusing investor attention and aiding fund comparability. As the industry matures, efficiency becomes critical and segmented reporting will facilitate such an analysis.

Arguments against

Under the draft, segment reporting is based on management decisions and, where the assets of a fund are managed as a pool, it can be argued that segments do not exist. However, the view expressed consistently during our consultation is that while the assets are managed as a pool, the management of the assets focuses on matching of the liabilities, and it is here that the real segments exist. Asset pooling is used for cost and operating efficiency; to use this argument as a reason for not segregating is inappropriate.

Preferred position

AIST is favourable towards segment reporting as it fosters transparency and facilitates unit pricing. Segmented reporting forces cost allocations to be documented and scrutinised. Over time, segmented reporting will reduce the ability for trustees to cross-subsidise costs within funds. However, we believe further guidance is required in the draft to ensure sector reporting is focussed on liabilities, and also to ensure that segments align with the APRA concept of 'sub-fund'.

Format of financial statements

ED179 proposes a total of five financial statements: a balance sheet, income statement, cash flow statement, a statement of changes in equity, and a statement of changes in member benefits. The key change is that contributions, rollovers and benefits that are normally presented in an income statement, are now presented in a statement of changes in member benefits.

Arguments for

The separation of contributions and rollovers from the income statement increases the transparency of the income statement, which is a logical and desirable outcome. Counting rollovers and contributions as income, as has been the process in the past, is inappropriate, and AIST welcomes the proposed changes.

Arguments against

The proposed changes will increase the costs to funds of producing such statements; however, any increase will be marginal.

Preferred position

AIST welcomes the changes with regard to the cash flow statement and the statement of changes in member benefits. With regard to the statement of changes in equity, AIST believes that given superannuation is essentially about the matching of assets and liabilities a statement of changes in equity offers little value. In most instances the equity component of a fund is predominately made up of fund reserves, be they contingency provisions, insurance reserves, or investment fluctuation reserves. An interesting question to ask in the case of a defined benefit scheme is: who does the equity belong to? Does it belong to the employers or fund members? Equally, should a scheme really have equity at all? Our preferred position is to remove the requirement for a statement of equity in preference for a comprehensive note disclosure.

Should the Board choose to persist with a statement of equity, we believe characterising this as a 'statement of reserves' would be more in keeping with the trust structure of super funds

Other implications (with respect to efficiencies)

APRA Alignment

Following the aftermath of the worst financial crisis since the Great Depression, APRA identified a shortfall within its existing superannuation data collections. With the objective of increasing regulatory oversight and risk mitigation, APRA released a discussion paper titled *Enhanced APRA superannuation statistics collections* on 25 May 2009. The paper clearly details the regulator's desire to delve deeper into the operations of superannuation funds by dissecting them into logical sub-funds.

The most important aspect of the APRA paper is that we are able to get high level information for each of the fund's logical sub-funds. One of the interesting elements of the APRA paper is that it proposes a series of requirements for sub-funds, with the definition of a sub-fund based on the fund's liabilities.

The assumption is that ED179 proposes that funds report on segments with the distinction being an asset-based distinction, given superannuation is about liability management it follows that the appropriate distinction be liability based. The focus on segments enables users to foster a better understanding of how the fund manages the assets attributable to different member groups. The dominant view that emerged from AIST's roundtable discussions was that if a fund can demonstrate that it manages assets as a pool, there is no logical sub-fund for ED179 purposes.

This argument, that assets are pooled and managed as a whole, is not a legitimate reason to avoid segmented reporting. Asset pooling has evolved over time for efficiency and cost minimisation purposes and it should therefore be ignored as an argument against segmented reporting. To support this argument indicates that segmented reporting is only valid if a fund has a segmented structure. In fact, pooling achieves economies of scale for the management of all assets, the returns of which are then apportioned appropriately. Sub-funds do exist and they are defined by their products, the products' members, and their associated assets.

Both the Accounting Standards Board and APRA appear to be working with the same focus: risk mitigation and reporting. It seems logical that the APRA definitions for sub-funds and ED179's proposed segmentation definitions align, thereby eliminating the possibility for conflicting definitions which result in funds operating two levels of segmenting reporting: one for APRA and one for AASB requirements. We have made a submission to APRA suggesting that they provide further guidance on the definition of 'sub-fund'.

Irrespective of whether it is from an asset or liability perspective, it is imperative that the definitions align for efficiency and, more importantly, to limit confusion. Once this is achieved, reporting systems and risk management systems will align and lead to a sophisticated reporting system that is monitored from two angles: reporting under the Accounting Standards, and reporting to APRA through returns.

The proposed changes and the cost benefit argument

The Cooper Review will focus on efficiencies in the superannuation industry and therefore changes that increase costs for little benefit are to be highly discouraged. This is evident in our arguments against consolidation, insurance accounting, and the potential for a fourth measurement for accrued benefits.