New South Wales
TREASURY

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Our Reference:
Your Reference:

Dear Sir David

<u>IASB Discussion Paper *Preliminary Views on Amendments to IAS 19 'Employee Benefits'*</u>

Thank you for the opportunity to comment on the International Accounting Standards Board's (IASB) Discussion Paper *Preliminary Views on Amendments to IAS 19 'Employee Benefits'*. New South Wales Treasury's detailed comments are attached.

NSW Treasury does not support the IASB proposals regarding the 'contribution based promises', as we believe that accounting for contributions based *and* defined benefit promises should be addressed at the same time in conjunction with the IASB's fair value measurement and conceptual framework projects.

In regard to the other IASB proposals, NSW Treasury's main comments include:

- <u>Expected return on plan assets</u> – Strongly disagree with the proposal to omit the expected return on plan assets as a component of the superannuation expense, as this will result in the loss of valuable decision useful information.
- <u>Presentation approaches</u> - Support the immediate recognition of changes in plan assets in the period they occur in profit and loss (Approach 1), but with further disaggregation.
- <u>Promises vs Plans</u> - Disagree with the proposal to focus on 'promises' rather than 'plans', as this may not reflect the substance of the total arrangement and will increase the complexity of accounting.
- <u>Discount rate</u> – Although not addressed in the Discussion Paper, strongly support a discount rate for measuring the gross defined benefit obligation based on the expected rate of return on superannuation fund assets, as this reflects the reality of the defined benefit superannuation obligation.

Please contact Dianne McHugh (612 9228 5340) or myself (612 9228 3019) if you wish to discuss these matters further.

Yours faithfully

Robert Williams
for Secretary

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ATTACHMENT 1

**IASB DISCUSSION PAPER –
PRELIMINARY VIEWS ON AMENDMENTS TO
IAS 19 EMPLOYEE BENEFITS**

Scope of the project

Question 1- Given the objective of the IASB project to address specific issues in a limited time frame, are there additional issues which you think should be addressed by the Board as part of this project? If so, why do you regard these issues as a matter of priority?

No. Rather, NSW Treasury believes that the proposals regarding the fair value measurement of 'contribution based promises' are premature and pre-empt the IASB's fair value measurement and conceptual framework projects. We believe that the accounting for both contribution based and defined benefit promises should be examined at the same time.

Recognition and presentation of defined benefit promises

Question 2 - Are there factors that the Board has not considered in arriving at its preliminary views? If so, what are those factors? Do those factors provide sufficient reason for the Board to reconsider its preliminary views? If so, why?

Yes. NSW Treasury supports recognising all changes in plan assets in the period they occur (PV2), in profit and loss (Approach 1), but not the omission of the expected return on plan assets (PV3). NSW Treasury strongly supports retaining the concepts of expected return on plan assets and actuarial gains and losses, as currently defined. In making the proposal (PV3) to omit the concept of the expected return on plan assets, we do not believe that the Board has adequately considered the following important issues.

Interrelationship with Approach 1 (i.e. recognition through profit or loss)

If Approach 1 were adopted (para 3.11), the concern regarding profit manipulation would dissipate, as all components of the superannuation expense would be recognised as part of profit or loss.

The relationship with the discount rate

Although the discount rate for the defined benefit obligation has not yet been considered in the Discussion Paper, any proposal to omit the expected return on plan assets concept in the recognition of the superannuation expense presupposes that the current IAS 19 discount rate will remain unchanged in the future, which is not supported (refer Attachment 2). As discussed, NSW Treasury's official view is that the discount rate should be based on the expected return on plan assets.

Loss of valuable information

Omitting the expected return on plan assets will result in the loss of valuable information for forecasting future investment returns and potential employer funding; i.e. cash contributions to the defined benefit fund.

The relationship with interest cost will be lost

In Australia, the expected return on plan assets and its relationship with interest cost is an important concept under Australian Accounting Standard AASB 1049 *Whole of Government and General Government Sector Financial Reporting*, which harmonises Government Finance Statistics and GAAP reporting. Under AASB 1049, the expected return on plan assets is offset against the interest cost and recognised as a 'transaction' in profit or loss, while the difference between the actual and expected return is recognised as an 'other economic flow' (i.e. change in value or remeasurement) as part of 'actuarial gains and losses'. This is further discussed in response to question 4.

Fundamentally changes the concept of actuarial gains and losses

By excluding the difference between expected and actual return on plan assets from actuarial gains and losses, a significant component of actuarial gains and losses is removed, and the concept of actuarial gains and losses in IAS 19 is changed, without explanation.

Arguments for change are weak and inconsistent

The reasons for the Board's proposal to omit the expected return on plan assets are weak and inconsistent. That is, the Board expresses concern about the 'subjectivity inherent in determining the expected rate of return' (para 2.15) yet, for contribution based promises, adjusts for risks such as asset and credit risk, which may equally be difficult or subjective to measure. There are many assumptions used across many Accounting Standards that have an equal degree of subjectivity. That is why IAS 1 requires disclosure of key sources of estimation uncertainty.

If the choice of an expected long term earnings rate is subject to perceptions of unfair influence (2.15) (even with the adoption of Approach 1) this could be overcome through a process of actuarial certification of the chosen rate. However, in NSW Treasury's view, we believe that the expected return on assets can be based on very objective criteria, such as asset class sharemarket indexes over the long term. Equity risk premium is very consistent over the long term and an objective basis for determining the expected return on plan assets.

Also, any alternative suggestion, raised by some actuarial commentators, that the expected return on plan assets should be linked to the discount rate used to measured the gross defined benefit obligation (IAS 19, para 78) is not supported. This is because, in Australia, the discount rate for many for-profit entities (in the absence of a deep market in corporate bonds) and for all not-for-profit entities is based on the government bond rate. The government bond rate is substantially lower than the expected return on superannuation plan assets and would therefore not faithfully represent the economic reality of the plan assets.

Question 3(a) - Which approach to the presentation of changes in defined benefit costs provides the most useful information to users of financial statements? Why?

NSW Treasury supports Approach 1 (immediate recognition through profit or loss), consistent with the *Framework*. We also support the disaggregation of the superannuation expense, within profit or loss (refer response to question 4 below).

Question 3(b)(i) - In assessing the usefulness of information to users, what importance do you attach to presentation of some components of defined benefit cost in other comprehensive income, and why?

Conceptually, NSW Treasury does not believe that there is any basis to split the superannuation expense between components recognised in profit and loss and components recognised in 'other comprehensive income'. We believe Approach 1 is the only approach consistent with the *Framework*, which requires all items of income and expense to be presented in the income statement.

Question 3(b)(ii) - In assessing the usefulness of information to users, what importance do you attach to disaggregation of information about fair value, and why?

NSW Treasury agrees that disaggregated information is likely to be helpful, but believe that any disaggregation should also include the concept of expected return on assets. NSW Treasury supports Approach 1, as well as the disaggregation of the superannuation expense within profit and loss (also refer response to question 4 below).

Question 3(c)- What would be the difficulties in applying each of the presentation approaches?

As discussed, Approaches 2 and 3 are not supported as there is no basis for splitting certain parts of the superannuation expense as 'other comprehensive income'. Therefore, it is not a matter of what approach is 'difficult' or 'easy'; rather it is a matter of adopting the approach that is the most appropriate and relevant.

Question 4

(a) How could the Board improve the approaches discussed in this paper to provide more useful information to users of financial statements?

(b) Please explain any alternative approach to presentation that provides more useful information to users of financial statements. In what way does your approach provide more useful information to users of financial statements?

NSW Treasury supports Approach 1. However, to improve this approach, it is suggested that, contrary to PV3, the superannuation expense be disaggregated (including the presentation of sub-totals and the expected return on plan assets) within profit or loss. This would alleviate many of the concerns raised regarding Approach 1.

In particular, NSW Treasury supports separating income/expense between 'transactions' and 'other economic flows' (i.e. changes in value), within profit or loss, consistent with Australian Bureau of Statistics' Government Finance Statistics (GFS) (which is based on the International Monetary Fund GFS) and Australian Accounting Standard AASB 1049.

Under this approach, actuarial gains and losses would separately be recognised (as 'other economic flows') and most other components of the defined benefit superannuation expense would be recognised as a 'transaction' (i.e. including the expected return on plan assets and interest cost). A sub-total above 'profit or loss', called 'net operating balance', is included for the difference between revenue and expenses from 'transactions'. This retains the advantages of Approach 3, by separating 'remeasurements' (that have different predictive implications), while retaining the strength of Approach 1, that is recognition through profit or loss.

Definition of contribution-based promises

Question 5 - Do you agree that the Board has identified the appropriate promises to be addressed in the scope of this project? If not, which promises should be included or excluded from the scope of the project, and why?

No, because no problems have been identified for defined contribution plans. As discussed, NSW Treasury believes that accounting for ‘contribution based promises’ should be considered at the same time as ‘defined benefit promises’ to ensure consistent treatment. We believe that changing the treatment of contribution based promises in such a fundamental way, without considering the existing accounting for defined benefit promises, is premature and pre-empts the other long term IASB projects.

Although the Board asserts that there should be no significant change in the measurement of defined contribution plans, this is not immediately obvious and may require additional costs to demonstrate that any differences are immaterial. The benefits of such an exercise will be limited and will result in an unnecessary increase in complexity. This is particularly so, given that the proposed changes seem to be directed at plans which provide for specified returns on actual or notional employer contributions, which would appear to be more common in the United States of America than in Australia.

In addition, NSW Treasury is significantly concerned about the change in focus from a ‘plan’ to a ‘promise’. This will mean that a plan must be disaggregated between defined benefit and contribution based promises, which will be measured differently and may or may not reflect the substance of the entire arrangement. This will significantly increase the complexity of reporting of superannuation plans for limited benefits. This is also problematic, given that the overall substance of the arrangement may often be clear (e.g. as a defined benefit plan), although it may comprise a component (which may be minor in relation to the total plan), in a different form (e.g. a contribution based promise). This change is also not consistent with the superannuation legislation in Australia which is usually on a plan basis rather than based on specific promises.

Finally, the reason for this proposed change from ‘plan’ to ‘promise’ is not made clear in the Discussion Paper. Therefore, given that the types of plans that we are aware of are not causing any difficulties, NSW Treasury cannot see any benefit in disaggregating plans into promises, as it will result in an unnecessary increase in complexity and potentially excessive disclosure.

Question 6 - Would many promises be reclassified from defined benefit to contribution-based under the Board’s proposals? What are the practical difficulties, if any, facing entities affected by these proposals?

There is a potential for significant reclassifications from defined benefit to contribution based promises.

Practical difficulties may arise, including:

- Allocating plan assets between those funding career average promises and final salary promises. The basis of any allocation is likely to be arbitrary, but significant as it will impact on the calculation of the superannuation expense.
- Determining the dividing line between career average promises (treated as contribution based promises) and final salary promises (treated as defined benefit promises). At some point this distinction will be arbitrary and may result in structuring of arrangements to ensure a particular measurement approach.

Question 7 - Do the proposals achieve that goal (of not leading to significant changes in accounting for most promises that meet the definition of defined contribution plans in IAS 19)? If not, why not?

No. Refer response to question 5 and 6 above.

Recognition issues related to contribution based promises

Question 8 - Do you have any comments on those preliminary views? If so, what are they?

Refer question 5 and 6 above.

Measurement of contribution based promises

Question 9(a)- Are there alternative measurement approaches that better meet the measurement objectives described in this paper? Please describe the approaches and explain how they better meet the measurement objectives.

NSW Treasury does not support the proposal to measure contribution based promises at fair value, as this treatment is significantly different to the treatment of defined benefit promises, even though the nature of the obligation may be the same.

The introduction of fair value concepts is a major change compared to the language, terminology and approach used for defined benefit accounting and should therefore not be introduced before similar changes are considered for defined benefit accounting. Notwithstanding this, we believe that such fundamental changes are premature and should only be considered as part of the long term projects on employee benefits, the conceptual framework and fair value measurement.

NSW Treasury's concerns regarding the adoption of 'fair value' are summarised below:

- The measurement approach for contribution based promises may not necessarily equate to 'fair value', as the Board acknowledges (para 7.40).
- How this proposal fits within the proposed fair value hierarchy and the concept of current exit price is unclear. For example, one view is that the fair value of a 'pension' is the cost of buying an annuity from an insurance company, which may be priced based on different assumptions.

- About the increase in complexity, confusion, mixed measurement and inconsistencies that will result from proceeding with this proposal i.e. as the same obligation could be accounted for differently.
- That the proposed measurement approach and the concept of 'fair value' introduces increased subjectivity in measurement.

Question 9(b) To what extent should the effect of risk be included as a component of the measurement approach at this stage of the Board's post employment benefit promises project? How should this be done?

NSW Treasury believes that the treatment of risk needs to be more fully considered by the Board as part of the fair value measurement project. For example, by incorporating credit risk in the measurement of contribution based promises there could be wide variations in the 'fair value' of identical benefit promises by different employers.

Question 10

(a) Do you agree that the liability for benefits in the payout and deferment phases should be measured in the same way as they are in the accumulation phase? If not, why?

(b) What are the practical difficulties, if any, of measuring the liability for a contribution based promise during the payout phase at fair value assuming the terms of the benefit promise do not change?

Yes. However, we believe that the same obligation should be accounted for in the same way, whether or not it is a defined benefit or contribution based.

Disaggregation, presentation and disclosure of contribution based promises

Question 11

(a) What level of disaggregation of information about changes in the liability for contribution based promises is useful to users of financial statements? Why?

(b) Do you agree that it is difficult to disaggregate changes in the contribution based promise liability into components similar to those required for defined benefit promises? If not, why not?

To the extent that contribution based promises satisfy the existing definition of defined contribution plans, we believe that there is no need to disaggregate the expense (as the liability is limited to unpaid contributions). Disaggregation would only appear to be relevant and appropriate in relation to defined return promises. For these types of promises, in principle, we can see no reason why the level of disaggregation should be any different to defined benefit promises and we do not envisage any additional difficulties.

Question 12

Should changes in the liability for contribution based promises:
(a) be presented in profit or loss, along with all changes in the value of any plan assets; or
(b) mirror the presentation of changes in the liability for defined benefit promises?
Why?

NSW Treasury believes that changes in the liability for contribution based promises should:

- be presented in profit or loss, along with all changes in the value of any plan assets; *and*
- mirror the presentation of changes in the liability for defined benefit promises.

We believe that movements in the liability for either contribution based or defined benefit based promises should all be recognised in profit and loss (i.e. Approach 1). However, as discussed in question 3, we believe that disaggregation of the income/expense should be permitted.

Benefit promises with a 'higher of' option

Question 13
(a) What are the practical difficulties, if any, in identifying and measuring the 'higher of' option that an entity recognises separately from a host defined benefit promise?
(b) Do you have any other comments on the proposals for benefit promises with a 'higher of' option? If so, what are they?

We believe that the Board should only review the treatment of 'higher of' options, where this is considered in relation to both contribution based and defined benefit promises. Therefore, the Board's proposal is not supported as it does not consider how to account for the higher of two defined benefit promises.

Other matters

Question 14 - What disclosures should the Board consider as part of that review?

NSW Treasury believes that the current IAS 19 disclosure requirements for defined benefit plans are excessive in comparison to other Standards. The disclosures are complex and difficult for users to digest. The proposal to change from 'plans' to 'promises' exacerbates this issue by potentially further increasing disclosures at a disaggregated promise level. Therefore, we would support a simplification of the requirements and the adoption of a more high level principled based approach to the disclosures.

Question 15 - Do you have any other comments on this paper? If so, what are they?

Terminology

We do not support the use of the term ‘promise’. We believe that the term ‘promise’ can be misinterpreted and may not have the strength of the terms ‘obligation’ or ‘liability’. In common usage, a ‘promise’ can be broken, while an obligation or liability is binding.

Additional guidance

If the IASB proposals regarding contribution based promises do proceed, NSW Treasury believes that additional guidance is required regarding the treatment of ‘plan assets’ in relation to contribution based promises.

In particular, we believe that the Board needs to clarify whether the reference to plan assets includes *both* the paid and unpaid contributions (i.e. considering the plan assets and liabilities separately). In the July 2007 IASB meeting, the IASB staff proposed that the contribution requirement should include both paid and unpaid contributions, with any payments recognised as plan assets. The Board’s conclusion on this issue is not clear.

ATTACHMENT 2

DISCOUNT RATE FOR CALCULATING THE GROSS DEFINED BENEFIT OBLIGATION

NSW Treasury believes that the discount rate should be based on the expected return on assets rather than the high quality bond rate.

Treasury is of the view that a strong argument exists for a discount rate to be based on the expected rate of return on assets. These matters are discussed further below.

Bond related discount rates vs Expected investment returns

NSW Treasury believes that the discount rate should be based on the expected return on assets, consistent with the approach taken in current Australian Accounting Standard AAS 25 *Financial Reporting by Superannuation Plans.*

A number of reasons have been put forward for using a bond related yield as the discount rate (rather than a rate based on expected investment returns), including:

- The rate used to discount liabilities should not be dependent on the assets supporting those liabilities.
- The use of bond related yields may make it easier to compare the financial reports of different entities.

However, Treasury is of the view that there is a strong case for using the expected rate of return on assets (rather than a bond related yield) as the discount rate to value liabilities, including:

- This will reflect the current amount of assets that, if invested today, will provide future cash flows that will match the cash outflows for a particular liability.
- The expected return on plan assets faithfully represents the expected ultimate cash outflow.
- It is consistent with the requirements of AAS 25 and the valuation of accrued benefits for including in the financial statements of superannuation funds.
- It would produce an estimate of the unfunded superannuation liability that is the same as that determined for actuarial funding purposes.
- It eliminates any confusion for users of financial reports that would result from different assets / liability amounts being reported as part of an actuarial assessment of the financial position of the fund under AAS 25.

Also, a liability measured using the current IAS 19 discount rate has the potential to make a fully funded scheme, unfunded, and if the discount rate applied is lower than the superannuation plan's investment earnings rate, there is a potential for the plan to produce large surpluses as it winds down.

Public sector entities

Some arguments for the adoption of the corporate bond rate as the discount rate, rather than the expected return on assets, may not be applicable in the public sector.

In the private sector, the use of a return on assets (including a risk premium for growth assets such as equities and property) may not be appropriate, as it is not possible to predict the longevity of private sector entities. For private sector entities, it may be reasonable to allow the risk premium to emerge on a year by year basis, as it is earned, rather than being capitalised in the discount rate.

These arguments, however, do not apply in the public sector. As public sector entities can be regarded as having an unlimited life span, long term best estimates can be used with confidence and the long term best estimate is the return on assets.