



## Financial Reporting Advisory Board Paper

### Treasury Review of Discount Rates Policy

<b>Issue:</b>	The Treasury is reviewing options for changing its financial reporting policy on discount rates for certain non-financial liabilities. The paper considers three alternative approaches; i) a conceptual shift which focuses more on the ability to fund the obligation ii) no discounting for the real time value of money, and iii) a presentational change in the primary statements (gross and net presentation). In addition, the paper asks if the Board supports the principle of harmonising the rates currently set by the Treasury for liabilities measured under IAS 37 (provisions) and IAS 19 (post-employment benefits).
<b>Impact on guidance:</b>	Yes
<b>IAS/IFRS adaptation?</b>	Yes
<b>Impact on WGA?</b>	Yes - discount rate methodology changes would impact on WGA.
<b>IPSAS compliant?</b>	Option 1 and 2 would result in non-compliance with IPSAS.
<b>Interpretation for the public sector context?</b>	Yes
<b>Impact on budgetary regime?</b>	Budgets would continue to show changes in balances derived from discount rate changes
<b>Alignment with National Accounts</b>	No - national accounts exclude provisions and unfunded defined benefit public sector pension obligations. However the latter will be reported in a supplementary table under ESA 10. We understand all Member States will be required to use the same discount rate of 3% real, 5% nominal.
<b>Impact on Estimates?</b>	Estimates would continue to show changes in balances derived from discount rate changes
<b>Recommendation:</b>	That the FRAB respond to the questions raised in the paper, and confirm support for the principle of harmonising the rates for provisions (under IAS 37) and unfunded post-employment benefits (under IAS 19).
<b>Timing:</b>	The Treasury would seek to implement the proposed changes in time for the 2015-16 financial year.

## Introduction and Background

1. In April 2014 the Treasury presented a reflective paper to the Board that considered from first principles its objectives in the use of discount rates in financial and other reporting. The aim was to assess whether the current approach is fit for purpose, including whether the financial information reported can be made more useful for decision making. This reflection was prompted in part from feedback from users of the accounts obtained through the consultation exercise in the Simplifying and Streamlining accounts project. Users felt that the use of different types of discount rates and frequent updating of those rates (to reflect changes in market conditions) was confusing.
2. The Treasury's conclusion were, based on its provisional analysis, that where the FReM currently permits discounting of non-financial liabilities (i.e. those outside of the scope of the financial instrument standards) to adjust for the **time value of money** (as is the case for provisions and post-employment benefits), that future cash flows expressed in current prices should be discounted based upon OBR forecasts of long term real GDP growth.
3. The Board provided valuable feedback on the proposals, including, but not limited to; concern that this would constitute a departure from IFRS, that any such changes should be more clearly articulated by reference to the measurement objectives within accounting standards, and some concern that the proposal would not achieve the desired level of stability. Several members of the Board emphasised that improved disclosures on the effected balances could help users understand more clearly the impact of discount rates.
4. In this paper the Treasury expands further on the detail of the lead option outlined in the Treasury's paper of April 2014. It addresses in more specific terms the Treasury's proposed adaptations in respect of IAS 37 and IAS 19, and why they would be appropriate in the public sector context. The paper refers to this as option 1.
5. The paper also considers two further options, in light of the feedback from Board members:
  - i) An adaption to the FReM to set the real discount rate at zero (for the time value of money), where the rate is already set by the Treasury under existing interpretations of IAS 37 and IAS 19 (option 2).
  - ii) A presentational change to a gross and net (of discounting) presentation of these non-financial liabilities on the face of the statement of financial position. (option 3)
6. More general improvements in accessibility and understandability of accounting disclosures (including in respect of discounting) have been considered through the Simplifying and Streamlining accounts project, which includes moving toward an account that more closely mirrors the presentation in WGA.

## IASB Review of discount rate in IFRS

7. In June 2014 the IASB published a staff paper on its research project on discount rates, which examines the discount rate requirements in IFRS, and assesses whether there any inconsistencies that the IASB should address. The research on discount rates will focus on reviewing measurements that already require the use of present value techniques and for which the objective of measurement is not fair value. The project plan was reviewed by the IASB Board in June, though no decisions were made, and the project is provisionally expected to be considered by the Board in quarter 1 of 2015.
8. The staff paper outlined a number of areas they planned to consider during the research project. This included the measurement objectives, discount rate components, measurement methodologies, disclosure requirements and definitions and terms.
9. While the Treasury believes the research project may provide valuable clarity and consistency in the way rates are used in the standards, it does not consider it necessary to wait for the conclusions of this project before proceeding with the changes it is considering. This is because the project will not address the public sector contextual issues which are one of the principal drivers for a proposed change.

## **Option 1: Discounting by real GDP growth**

### **Scope and Reason for Change**

1. All discount rates as referred to in the IFRS standards have a component that is referred to as the time value of money. The term is used in both IAS 37 and IAS 19 but is not defined in those standards. In IFRS 9 Financial Instruments, IFRS 13 Fair Value and IAS 36 Impairment of Assets the term is defined as the risk free rate on monetary assets.
2. The Treasury does not currently propose to adapt or interpret the time value of money component of discount rates where it is defined in the above standards (IFRS 9, IFRS 13 and IAS 36), nor the discounts rates used in IAS 39, nor the measurement of liabilities under IAS 17, nor any other liability or asset where the measurement objective is fair value. The Treasury, likewise, does not propose to adapt that component of the time value of money that relates to changes in prices or any other component of the discount rate.
3. The Treasury proposal is, narrowly, to apply an adaptation to the real discount rates disseminated by HM Treasury each year in respect of provisions as measured under IAS 37, and unfunded pension scheme liabilities measured under IAS 19.

4. A single real rate will be used (to cover all maturities for which discounting is applied) that reflects expectations of long term economic growth – specifically the mean of the central scenario real GDP growth projections over the next 50 years, as published around June each year by the OBR in their Fiscal Sustainability Report (FSR). The table summarising this projection from the June 2014 FSR is reproduced below:

Table 3.6: Real GDP growth projections

	Annual GDP growth, per cent				
	2013-14 to 2023-24	2023-24 to 2033-34	2033-34 to 2043-44	2043-44 to 2053-54	2053-54 to 2063-64
OBR central <sup>1</sup>	2.4	2.4	2.4	2.4	2.4
High migration	2.5	2.6	2.7	2.6	2.6
Long-term balanced	2.5	2.3	2.2	2.1	2.0
High tens of thousands	2.4	2.4	2.4	2.3	2.4
Young age structure	2.5	2.6	2.7	2.7	2.7
Old age structure	2.4	2.6	2.4	2.3	2.3

<sup>1</sup> Equivalent to the ONS's 'low migration' population variant.

5. The case for the conceptual change proposed reflects the expectation that in the majority of cases the liabilities recognised by the public sector under IAS 37 and in respect of unfunded pension obligations under IAS 19 will be settled when they fall due. The Treasury believes that one of the primary interests of users of the accounts, in respect of these liabilities (beyond assessing the financial performance of the public sector), is in the capacity of the public sector to meet these liabilities when they mature i.e. there is an interest in what the liabilities tell users about the public sector's financial position.
6. As it stands, it is anomalous that IAS 19 and 37 use different measures of the market risk free rate. But beyond this, it could be argued that changes to general real risk free rates are not central to assessing management's financial performance in the public sector. Nor are they necessarily central to understanding the performance of management in managing risk over time (it is a measure of the risk free component).
7. The real time value of money component, therefore, could be replaced with a rate that reflects a general measure of the public sector's capacity to fund these obligations as they fall due. The impact of changes in such a rate would arguably be more relevant (than the risk free rate on monetary assets) to understanding the public sector's overall financial position.
8. The Board will be aware that liabilities recognised under IAS 37 and unfunded pension obligations recognised under IAS 19 are not recognised as liabilities in the national accounts, which are the basis of measuring fiscal policy objectives. The recognition of such liabilities does not give rise to expenditure in the national accounts system. The claims are typically recognised at the point at which they become payable. They are, in effect, pressures on a future public spending envelope.

9. One widely used measure of fiscal sustainability is the 'inter-temporal budget gap'. An extract from the OBR's Fiscal Sustainability Report briefly explaining the measure is included at appendix 1. The Treasury's proposal to use a real discount rate of expected real GDP growth, for liabilities under IAS 37 and unfunded pension obligations recognised under IAS 19, acknowledges that within the assessment of fiscal sustainability these costs will reduce future primary surpluses (used to service and repay debt), and therefore their present value may be better measured by reference to GDP growth.
10. The Treasury's motivation for the change is also driven by a desire to reduce complexity in financial reporting, where that reduction does not significantly diminish the qualitative characteristics of the financial information. By setting a single rate to cover all maturities for these non-financial liabilities which are not pre-funded (by acquiring assets) the Treasury hopes to make reporting of these liabilities more accessible to users of the accounts.

#### **Measurement objective of IAS 37**

11. This section considers the extent to which the proposed change presents a departure from the measurement objectives of the affected standards, IAS 37 and IAS 19.
12. IAS 37 requires that a provision is measured as:

**'the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.'**

And in effect clarifies that this best estimate is an exit value.

**'The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the end of the reporting period. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.'**

13. In respect of determining the present value of this best estimate. The standard states:

**'Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.'**

And in respect of the discount rate used to determine present value

**'The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.'**

14. The Treasury considers that in the case of these obligations an exit value is not appropriate in the public sector context. IAS 37 acknowledges that even in the private sector the settlement or transfer of the obligation at the reporting date may be impossible, but in effect concludes that an exit price remains appropriate. That the ownership of private sector entities can and frequently do change hands, which infers a valuation of that entity (including its provisions), makes the use of an exit price appropriate. It is a measurement approach in keeping with a focus on the investor perspective, but arguably not appropriate in the case of the public sector where such indirect transfers (to the private sector) of material provisions are unlikely.
15. In determining the best estimate (in present value terms) of the expenditure required by the public sector to fulfil the obligation as it falls due it is reasonable to measure that present value by reference to the changing capacity of the public sector to meet that obligation over time.
16. **The Treasury seeks the Board's view on whether a further narrowing of the scope of option 1 is appropriate, in light of the public sector arguments made. For example, whether onerous contracts and financial guarantee obligations measured under IAS 37 should continue to be discounted by reference to the risk free rate on monetary assets.**

#### **Measurement objective of IAS 19**

17. IAS 19 requires that for post-employment defined benefit obligations

**'The amount recognised as a defined benefit liability shall be the net total of the following amounts:**

- (a) the present value of the defined benefit obligation at the end of the reporting period (see paragraph 64);**
- (b) plus any actuarial gains (less any actuarial losses) not recognised because of the treatment set out in paragraphs 92 and 93;**
- (c) minus any past service cost not yet recognised (see paragraph 96);**
- (d) minus the fair value at the end of the reporting period of plan assets (if any) out of which the obligations are to be settled directly (see paragraphs 102–104).**

The present value of the defined benefit obligation is the gross obligation, before deducting the fair value of any plan assets.'

And further that:

**'An entity shall use the Projected Unit Credit Method to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.'**

18. In respect of actuarial financial assumptions to be used the standard states:

**‘Actuarial assumptions are an entity’s best estimate of the variables that will determine the ultimate cost of providing post-employment benefits.’**

And that;

**‘Financial assumptions shall be based on market expectations, at the end of the reporting period, for the period over which the obligations are to be settled.’**

And beyond this it specifies the rate as follows;

**‘The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.’**

19. The Treasury believes that the market yield on high quality corporate bonds does not constitute a variable that is relevant to a ‘best estimate’ of the ‘ultimate cost of providing post-employment benefits’ for unfunded schemes. The Treasury concludes, therefore, that the same approach to that considered above for IAS 37 provisions would be more appropriate.

### **Public sector context of unfunded post-employment defined benefit schemes**

20. The Government, in response to a recommendation in the interim report from Independent Public Services Pension Commission, undertook a review in 2010-11 of the Superannuation Contributions Adjusted for Past Experience (SCAPE) rate, used to determine contributions to unfunded public service pension schemes. The Government outlined five overall objectives in determining the rate:

- a) Be a fair reflection of costs [of public service pensions],
- b) Reflect future risks to Government income
- c) Support plurality of the provision of public services
- d) Be transparent and simple
- e) Be stable

21. After public consultation the Government concluded that the SCAPE discount rate should be set with reference to the future costs of public service pension provision, in order to support a long term financial appraisal of affordability. The Government also concluded that a rate based on expected long-term GDP growth best meets the purposes and objectives identified, and provides both a theoretically sound and practical methodology for setting the SCAPE rate.

22. The Treasury concludes therefore when accounting for unfunded schemes under IAS 19, a rate based on forecast long term real GDP growth, is in keeping with the objective of measuring the ‘ultimate cost of providing post-employment benefits’.

### **Governance arrangements for setting the rate**

23. The Treasury will continue, as now, to set the rate to be applied, both for provisions applied under IAS 37 and unfunded pension obligation accounted under IAS 19. The rates (which will be identical) will continue to be disseminated each year at the same time (in advance of the Supplementary Estimates) in a Public Expenditure System paper. The rate will be calculated (as outlined above) using the OBR's central real GDP growth projection as already published in the Fiscal Sustainability Report of the previous summer. The source of the rate therefore will be very transparent. The independence of the projection (or forecast) will be underpinned by the governance arrangements that support the OBR's independence.

### **Option 2: No discounting for the real time value of money**

24. The scope of this adaptation would in practice be the same as option 1 (applying to those liabilities recognised under IAS 37 and IAS 19 which apply the rate disseminated by the Treasury each year in a Public Expenditure System paper). HM Treasury would set the real discount rate at zero. This would not be the same as no discounting, because future cash flows would still be adjusted for inflation. As the rate would be constant this change could be introduced through an amendment to the FReM using the following adaptations:

In respect of IAS 19:

**The real rate used to discount unfunded central government post-employment benefit obligations shall be zero.**

In respect of IAS 37:

**Where the cash flows to be discounted are expressed in current prices, entities should use a real discount rate of zero.**

25. These adaptations would also be a departure from IFRS, as the present values of the liabilities presented would not be adjusted for market expectations of the risk free rate of return on monetary assets. The public sector justification for such an adaptation would principally be similar to those made for option 1; that these are liabilities which are unlikely to be transferred before maturity, either directly or indirectly (through disposal of a reporting entity that carries these unfunded liabilities). It may also assist users of the accounts in tracking the underlying trends in these liabilities, without the additional variability caused by frequent variations in the real discount rate.

### **Option 3: Gross and net presentation of the liabilities on the face of the accounts.**

26. This option focuses on more clearly presenting the effect of discounting on the face of relevant primary statements. The gross (undiscounted) and net (discounted) liabilities would be presented on the face of the statement of financial position. This option could be applied to any approach that retains a level of discounting to the measurement of the liability.

### **Questions for the Board**



1. **Does the Board support the principle of aligning the rates set by HM Treasury for provisions (IAS 37) and for unfunded post-employment benefits (IAS 19)?**
2. **Which of option 1 and option 2 does the Board consider to be the more appropriate public sector adaption of IFRS?**
3. **Does the Board believe a gross and net presentation of liabilities enhances users understanding of the financial information?**

## APPENDIX 1

### Indicators of sustainability

#### The inter-temporal budget gap

- 5.3 Most definitions of fiscal sustainability are built on the concept of solvency – the ability of the government to meet its future obligations. In formal terms, this solvency condition is given by the government's inter-temporal budget constraint. Satisfying this condition requires that, over an infinite time horizon, the government raises enough revenue to cover all its non-interest spending and also to service and eventually pay off its outstanding debt. This requirement is normally expressed in stock rather than flow terms, namely that the present value of future government receipts should be equal to or greater than the sum of its existing debt plus the present value of all its future spending.
- 5.4 In the event that a government is not on course to satisfy the inter-temporal budget constraint, the 'inter-temporal budget gap' is a measure of the immediate and permanent increase in taxes and/or cut in public spending as a share of GDP that would put the government back on course.
- 5.5 The primary balance required to satisfy the inter-temporal budget constraint depends crucially on the size of the gap between the real interest rate that the government has to pay on its debt and the long-run growth rate of the economy. The higher the interest rate, the quicker debt will accumulate; the higher the growth rate, the easier it is to service and pay it off. If the interest rate paid on government debt remains below the rate of growth, then net

debt would still fall as a share of GDP even if the government were to run a primary budget deficit.

- 5.6 Conversely, if the interest rate exceeds the economic growth rate (as it is normally assumed to do) then in the long run the government will need to raise more in revenue than it spends on things other than debt interest (i.e. to run a primary budget surplus) in order to service and pay off the debt it has already accumulated. The greater the amount by which the interest rate exceeds the growth rate, the bigger the primary surplus required.

Source: Office of Budget Responsibility, Fiscal Sustainability Report, July 2014, p.131-2.