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Financial Reporting Advisory Board Paper

Treasury Review of Discount Rates Policy

Issue:	The Treasury's Simplifying and Streamlining Accounts project revealed users of departmental and Whole of Government Accounts find the current approach to discount rates confusing. This feedback has prompted the Treasury to reflect more broadly on its objectives in using discount rates in financial reporting and to consider whether an alternative approach may better deliver those objectives. This paper updates the Board on the Treasury's provisional conclusions and requests comment.
Impact on guidance:	None at present.
IAS/IFRS adaptation?	None at present but changes to discount rates in accordance with the provisional conclusions would represent an adaptation of IFRS
Impact on WGA?	Yes - discount rate methodology changes would impact on WGA.
IPSAS compliant?	The proposed changes would result in non-compliance with IPSAS.
Interpretation for the public sector context?	None at present but changes to discount rates in accordance with the provisional conclusions would likely require an adaptation of IFRS for the public sector context
Impact on budgetary regime?	Budgets would continue to show changes in balances derived from discount rate changes
Alignment with National Accounts	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.
Impact on Estimates?	Estimates would continue to show changes in balances derived from discount rate changes
Recommendation:	That the FRAB consider the Treasury's provisional conclusions on discount rate policy and discuss the questions raised at the end of this paper.
Timing:	The Treasury would seek to implement the proposed changes in time for the 2015-16 financial year.

Background

1. Consultation feedback from the Treasury's project on Simplifying and Streamlining departmental accounts has indicated that users of the accounts find the use of different types of discount rates and frequent updating of those rates (to reflect changes in market conditions) confusing. The Public Accounts Committee has also made similar comments at hearings on Whole of Government Accounts, indicating that frequent changes in rates obscure underlying trends that are impacting on significant provisions and pension liabilities.

2. This feedback has prompted the Treasury to consider from first principles its objectives in the use of discount rates in financial and other reporting to assess whether the current approach is fit for purpose, including whether the financial information reported can be made more useful for decision making.

3. This paper will focus on non-financial liabilities (i.e. those outside the scope of the financial instruments standards), and a further paper will be provided to the Board at either its June or November 2014 meetings that will present an assessment of discount rates in respect of financial assets and liabilities. The overarching policy objectives and criteria for evaluating the different options will remain common in both papers, but the work on financial assets and liabilities will further consider the context of the IASB development of IFRS 9.

Context of a review of the Treasury's policy on discount rates

4. The Treasury's review of discount rates sits within a broader policy context of established statute and practice, combined with newer developments in public finance management. This context includes, but is not limited to, the areas that are expanded upon below.

5. The Treasury has an ongoing policy objective under the Alignment (Clear Line of Sight) policy to align the 'accounting treatment' in departmental Estimates (used to authorise public expenditure), budgets (used to manage public expenditure) and resource accounts (used to fully account for public expenditure).[1]The Government's vision for the alignment project was *"to create a single, coherent financial regime that is effective, efficient and transparent, enhances accountability to Parliament and the public, and underpins the Government's fiscal framework, incentivises good value for money and supports delivery of excellent public services by allowing managers to manage".*

6. The Treasury's financial reporting obligations under the Government and Resource Accounts 2000 require that the accounts directions issued by the Treasury for both departmental and Whole of Government Accounts conform with generally accepted accounting practice subject to such adaptations as are necessary in the public sector context. GAAP is currently taken to be International Financial Reporting Standards. There are further obligations under the Act to consult a group of persons who appear to the Treasury to be appropriate to advise on financial reporting principles and standards.[2] The Board fulfils the function of the advisory group.

[1] The Government's policy in Alignment (Clear Line of Sight) Cm 7567 in March 2009.
[2] See sections 5, 9 and 24 of the Government and Resource Accounts Act 2000. The

7. The Office of Budget Responsibility (OBR) was created in 2010 and has a statutory duty to examine and report on the sustainability of the public finances[3], including a specific requirement to prepare an annual analysis of the sustainability of the public finances. The Charter of Budget Responsibility requires this annual sustainability report to include long-term projections for the public finances and assessment of the public sector balance sheet.[4]

8. HM Treasury decided, after a public consultation process in 2010/11, to change the discount rate for the Superannuation Contribution Adjusted for Past Experience model used to determine the contribution rate for unfunded public sector pensions. The rate was changes from the Social Time Preference Rate to a rate based on expected GDP growth in line with the Office for Budget Responsibility's long term forecasts.[5]

9. The Treasury recently (December 2013)[6] published a review of financial management in government which reaffirmed the value of good financial reporting information being available to decision makers, but also emphasised the importance of developing improved management (including management accounting) information. The Treasury's publication of April 2012, 'Improving Spending Control' also re-iterated the objective of the budgeting and spending framework in supporting the achievement of macro-economic stability by ensuring that public expenditure is controlled in support of the Government's fiscal framework, and emphasises the importance of relevant, robust and timely data.

10. The IASB has also commenced preliminary work on a research project on discount rates. This project was launch in response to the IASB's 2011 Agenda consultation where constituents commented that the reasons for differences in discount rate requirements under various IFRS was not well understood and could be considered inconsistent. However, to date there is no progress to report on this project.

Current uses of discount rates in financial statements covered by the FReM

11. There are currently 3 main areas in which the Treasury sets discount rates that are applied by entities producing financial statements in accordance with the FReM. This paper will focus primarily on evaluating the appropriate discount rate for the first two, but the third is also mentioned here for completeness:

    i.) Provisions - These rates are set by the Treasury, based on market data, in accordance with the relevant accounting standard (IAS 37) which requires a pre-tax rate that reflects current market assessments of the time value of money. Where departments use this rate they are expected to have already adjusted for other risks through adjustments to estimates of the future cash flows. The rate set by the Treasury, therefore, represents a risk free rate and a market assessment of the time value of money with some adaption for the public sector context. Rates for short (0-5 years) and medium (5-10) term cash flows are based on market data (for index linked gilts) at the time of Supplementary Estimates (as opposed to the financial year end as the standards would require) to fit within the annual processes for authorising public expenditure. The Treasury's policy is to set the

[3] Section 4, Budget Responsibility and National Audit Act 2011.
[4] Section 4 of the Charter of Budget for Budget Responsibility, April 2011.
[5] See 'Consultation on the discount rate used to set unfunded public service pension contributions: Summary of responses', April 2011.
[6] 'Review of financial management in government', December 2013.

rate for longer time periods (over 10 years) at each spending review (to provide budget stability) using market data. In accordance with this policy it is expected that the next update of the long-term rate would be for Spending Round 2013 which covers the 2015-16 financial year.

ii.) Post Employment Benefit Obligations (public sector pensions liabilities) – The FReM complies with IAS 19 Employee Benefits which requires that the rate used to discount post employment benefit obligations (both funded and unfunded) is determined by reference to market yields on high quality corporate bonds. The standard and the basis for conclusion makes clear that the discount rate is intended to reflect the time value of money but not the actuarial or investment risk, nor the entity specific credit risk borne by the entity's creditors or the risk that future experience may differ from actuarial assumptions. The rate for unfunded schemes is set by the Treasury and in accordance with the standard is a market rate, derived from a 15 year spot rate on an AA corporate bond index with adjustments to bring the bond duration up to 15 years by extrapolation based on UK Government bonds, and with appropriate adjustments to reflect that pensions are uprated by CPI and not RPI. This is considered to be an appropriate discount rate for a reasonable range of different profiles of the timing of benefit payments and the methodology was developed with the support of the Government Actuaries Department. The rate for funded schemes is determined by the actuaries for the individual schemes (fully compliant with IAS 19).

iii.) Financial Assets with an intrinsic rate below the Government's cost of borrowing – The main category of assets this applies to, in practice, is student loans. The FReM requires that when discounting future cash flows to measure the fair value of a financial asset the higher of the Treasury discount rate (2.2% real – intended to represent the Government's long-term cost of borrowing) and the rate intrinsic in the instrument should be applied. This is a slight adaption from the accounting standards and ensures that where departments issue loans (for example) that include a subsidy (in national accounts terms) this is recognised upfront in budgets in order to encourage budgetary control of future fiscal costs.

Objectives for deciding financial reporting policy on discount rates

12. The Treasury has identified three primary objectives against which to assess its policy on discount rates.

i) Maintaining the credibility of departmental accounts and WGA (from both a GAAP and fiscal transparency perspective).

ii) Meeting the qualitative characteristics of good financial information (relevance and faithful representation), with an enhanced focus on improving the decision usefulness of financial information to assess affordability in the public sector context.

iii) Meeting the objectives of the Simplifying and Streamlining accounts project.

Issues to consider in evaluating against the objectives

13. Initial work has outlined a non-exhaustive list of more specific issues to consider in evaluating the Treasury's policy in this area.

i.) Level of compliance with international standards

Achieving a high level of compliance with international and/or commercial accounting standards infers credibility and impartiality. It also potentially increases comparability between sectors and countries.

ii.) Market vs non-market rates

Using a market based rate increases credibility and impartiality and is more consistent with the general approach of International Financial Reporting Standards which prioritise the use of market based information. However, market rates tend to be volatile. Impartiality and credibility could be achieved by reference to rates used by independent third parties, like the OBR.

iii.) Private vs public sector context

Using statement of financial position values that are consistent with those that a private sector entity would use helps derive an exit price for the liability. Adapting values for the public sector context (where decisions are driven by value for money rather than profit seeking and affordability is determined by fiscal policy) may make the information more appropriate to the decision-making and accountability needs of users, particularly where an exit price is not the most appropriate measurement objective.

iv.) Homogeneity/Heterogeneity of rates

Using a single rate is simple and aids simple comparison between different balances (especially long term liabilities). However a single rate may not adequately reflect the different cash flow risks and durations associated with those liabilities.

v.) Frequency of updating

Infrequent updating of the rate provides stability for budgetary planning and may make it easier for users of the information to understand the underlying factors leading to changes in values. However, infrequent updating may reduce the credibility of financial reporting and stakeholders may question whether the balances represent a true and fair view.

vi.) Usefulness for financial and fiscal planning purposes

The Government currently forecasts and assesses its fiscal performance based on OBR forecasts. Using rates that are consistent with the assumptions used by the OBR could potentially make the statement of financial position values more useful for public spending decision making.

Options

14. The Treasury has outlined a number of options to be assessed against the objectives and issues outlined above.

i) The status quo

The principle benefit of the status quo is that it achieves a high level of compliance with International Financial Reporting Standards and uses up to date market prices within the confines of the annual Estimates process. This gives credibility to departmental accounts and WGA, achieves GAAP compliance in accordance with the requirements of the Government and Resource Accounts Act 2000, and generally helps remove any concerns around creative accounting. It could also be argued that it achieves greater comparability between the public and private sectors, although feedback from the users of departmental accounts indicates that they do not make such comparisons. Maintaining the status quo also does not address users concerns about the understandability of the financial information, and the statement of financial position values that are subsequently derived have a more limited use in public spending decision making (e.g. in judging fiscal sustainability). The conceptual underpinning of the rates also does not take account of the capacity of government to settle obligations over time through a revenue stream (taxation) not available to private sector market participants.

ii.) Long term average annualised real growth in Government receipts.

This would represent the growth in the Government's future revenue stream (predominantly but not solely taxation) from which obligations will be settled, and therefore has some conceptual strength. No market based measures of this are available and so the rate would either need to be set by the Treasury or could be based on OBR forecasts to enhance credibility. In either case it would have the disadvantage of being based on forecast assumptions including assumptions on future tax policy (though in practice this may be largely assumed to be a continuation of the status quo). The rate should be understandable to users. A long term rate would be stable and better reflects the basis upon which public spending decisions are made, but could still be updated annually to reflect any changes.

iii.) Government's real financing costs

We currently use a measure of the Government's financing costs in the discount rate for provisions, but conceptually this is based on it being a proxy for market assessments of the risk free time value of money, not because it represents Government's own financing costs. If we were to continue to use this rate for provisions the main conceptual justification would be that it is a proxy for a market risk free rate, but there would seem a more limited justification for using Government financing costs to discount pension liabilities – it is neither the IFRS compliant rate (as determined by IAS 19) nor the most relevant public sector specific rate (where growth in the Government's funding streams used to settle the obligation would seem more appropriate). However, the rate in IAS 19 (a high quality corporate bond rate) is referred to as a rate that reflects the time value of money, but a time value of money rate as referred to in IFRS 13 is specified as a risk-free interest rate.

iv.) Real GDP growth

The main conceptual justification for using GDP growth would be as a proxy for growth of Government's potential future revenue base. The advantage of using GDP growth over a forecast of receipts growth is that it does not require an assumption on future tax or other revenue raising policies. It is also far more widely forecast by external parties than a forecast of future receipts and an average basket of external forecasts could be used directly or provide a test of credibility if an OBR forecast were used. Forecast GDP, being more widely forecast because of its market significance, would constitute a closer proxy for market based measures. A discount rate based upon GDP growth would reflect the present value of the obligation for Government and reflect the inter-temporal/generational trade-off between settling an obligation now (through taxation and other revenue) compared to settling it through future taxation. The statement of financial position value

would better reflect the sustainability for Government of present obligations with future settlement dates.

v.) Social time preference rate

This is rate used in cost-benefit analysis (economic appraisal) in the Treasury's Green Book. It represents the social preference for present compared to future consumption. It is composed of an element that reflects society's pure preference for consumption now compared to the future (0.5%), an element of catastrophe risk as future benefits/costs may not materialise (1%) and assumes that as the economy grows and incomes rise the marginal utility of consumption will fall (2%).While there are obvious strengths in using this methodology to assess the public value of projects or programmes it's unclear how discounting using this rate (especially the pure preference and generic catastrophe risk components) would give statement of financial position values that represent the Government's financial position.

Conclusion

15. The Government's financial reporting policy, including in this case the use of discount rates, needs to be seen as credible and transparent. Applying internationally accepted standards and using market based measures can help in this regard. However, acknowledging the uniqueness of the public sector (particularly its funding sources) is especially important in assessing and informing decision making on the sustainability of very long term obligations.

14. Volatility in discount rates (that reflect relevant underlying economic changes) does not lead to less comparable financial information. However, feedback from the key users of departmental and Whole of Government Accounts indicates that even with enhanced disclosure of the component changes in liabilities they find it difficult to determine underlying trends or financial performance. The current policy is therefore neither meeting the accountability or desicion-making aims of financial reporting.

15. The Treasury's provisional conclusion is that financial reporting policy on discount rates could be improved to better reflect the public sector context and to more simply reflect the inter-temporal or time value comparability of different obligations, thus producing financial information that both enhances comparability and the decision usefulness of the Government's statement of financial position. It also concludes that credibility, impartiality and transparency can be achieved by means other than market based rates and that the Treasury's initial preference it to align with other aspects of fiscal policy in using rates drawn from the forecasts of the statutorily independent Office for Budget Responsibility.

16. The Treasury proposes therefore, 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, with the Treasury producing a fixed, and transparent, methodology for determining an appropriate duration to reflect a reasonable range of different profiles of future cash flows (i.e. that there will be single rate). It would be possible to update the rate annually after publication of the OBR July Fiscal Sustainability Report (FSR) and necessary changes in departmental budgets would be reflected in the Supplementary Estimates. As the growth rate would be a long term rate it would be expected to be largely stable from year to year, but would take account of significant changes in long term economic expectations. By way of illustration the OBR's 2025-26 central projection for real GDP growth was 2.1% in

2011, rose to 2.5% in 2012 and remained stable at 2.5% in 2013. Entities covered by the FReM would continue to adjust the valuation of liabilities for other risks (non-time value of money effects) in accordance with the relevant IFRS.

Recommendation

17. The Treasury asks the Board to consider and discuss its emerging policy on discount rates and specifically to consider the following questions:

    i) Does the Board consider there to be a case for changing the Treasury's existing discount rates policy?

    ii) Does the Board consider that, in light of the constituent feedback which prompted the IASB's research project on discount rates and the feedback HM Treasury has received as part of the Simplifying and Streamlining Accounts project, that there is merit is considering conceptually appropriate discount rates for the public sector context?

    iii) What is the Board's view of the Treasury's provisional conclusions?

HM Treasury
3rd April 2014.