Financial Reporting Advisory Board Paper

Treasury Review of Discount Rates Policy

Issue:	In March 2015 the Board considered the Treasury's proposals for a change in the methodology for discount rates set centrally by the Treasury for provisions and post-employment benefits. This paper outlines the Treasury's proposals in light of feedback from the Board at the March meeting.
Impact on guidance:	No
IAS/IFRS adaptation?	No
Impact on WGA?	No
IPSAS compliant?	Yes
Interpretation for the public sector context?	Yes
Impact on budgetary regime?	As per existing policy
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 Board approve the Treasury's decision to continue with the existing policies on discount rates.
Timing:	Rates will be updated in line with existing policies. The long term rate for provisions will be updated in 2015-16.

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. The Treasury paper to the Board in March 2015 expanded further on the detail of the lead option outlined in the Treasury's paper of April 2014. It addressed in more specific terms the Treasury's proposed adaptions in respect of IAS 37 and IAS 19, and why they would be appropriate in the public sector context. The paper also considered two further options, in light of the feedback from Board members: 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; and 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.

5. The Board's feedback at the meeting of March 2015 was that they were generally supportive of the principle of harmonisation of the two rates, that they did not see a strong case for adapting IFRS as outlined in the Treasury's lead option, nor was the Board supportive of the two further options considered.

Treasury's approach

6. In light the Board being unsupportive of the Treasury's lead option and the further two options outlined, and the general consensus that the existing approach struck the right balance between IFRS compliance and adaptations necessitated by the public sector context, the Treasury has conclude to continue with the existing policy.

7. Specifically, this means that the long-term rate for provisions will be updated in the 2015-16 year; the year for which budgets were set at the 2013 Spending Round. The rate will set based on the methodology agreed with the Board in December 2011, namely; applying the long-term discount rate on the real yield on UK index-linked Gilts as determined by examining Bank of England data for the spot yield curve at 25 years to maturity, with a comparison to the average of the redemption yields of the three longest dated index-linked Gilts according to Debt Management Office data to ensure it remains appropriate for extreme length provisions. This change will be affected through the normal

process, with rates disseminated through the PES paper issued by the Treasury in December.

8. In light of the decision to continue with the existing policy and not undertake further adaptations for the public sector, the Treasury will await further developments in the IASB's project on discount rates before determining whether more can be done to harmonise and improve consistency in the rates used in the financial statements.

Updating other rates

9. The Treasury is also reviewing the real financial instrument discount rate as used in the existing adaptation of IAS 39. This adaptation states that

   Where future cash flows are discounted to measure fair value, entities should use the higher of the rate intrinsic to the financial instrument and the real financial instrument discount rate set by HM Treasury (currently 2.2%) as applied to the flows expressed in current prices.

10. This also currently stands at 2.2% real but is intended to represent the government's long term cost of capital, with the purpose of the adaptation to capture the cost of subsidised loans. The adaption itself will be reviewed as part of the work planning for the implementation of IFRS 9: Financial Instruments. Work is currently being commissioned from the Government Actuary Department to inform the review of the rate.

Recommendation

11. That the Board approve the Treasury's decision to continue with the existing policies on discount rates.