Financial Reporting Advisory Board Paper

Discount rates update

Issue:	This paper provides an update on provisions discounting, particularly how to manage inflation, following consultation with departments.
Impact on guidance:	No impact on the FReM. Any updated rates will continue to be published in the Public Expenditure System paper in December. We intend to issue separate inflation guidance to departments in the autumn.
IAS/IFRS adaptation?	No, this is a methodology paper on how to apply the discount rate requirements in the existing accounting standards.
Impact on WGA?	No impact at this stage, any changes to the methodology will be reflected in 2018-19 WGA.
IPSAS compliant?	Yes. IPSASB have an active Public Sector Measurement Project, which will consider the issue of discount rates.
Interpretation for the public sector context?	No
Impact on budgetary and Estimates regimes?	As per existing policy. Estimates would continue to reflect balances derived from the discount rate applicable.
Alignment with National Accounts	No - National Accounts exclude provisions and unfunded defined benefit public sector pension obligations.
Recommendation:	The Treasury welcome the Board's comments on the paper, specifically: (1) The options available for applying inflation rates to future cash flows and to what extent this is mandated; and (2) Whether the move from nominal to real rates is an accounting policy or estimate change.
Timing:	The Treasury will use the steers from the Board to inform the next steps discussed in the paper and the issuance of the final guidance in the Autumn.

Introduction

1. At the November 2017 FRAB meeting, the Board discussed seven discount rate methodology options that could be applied to improve the clarity and accuracy of discounting for general provisions across the public sector. The Board decided that the application of nominal rates, instead of real rates, was the best methodology to adopt and that they would still be determined using the yield curves on Bank of England (BOE) gilts.

2. The Board recommended that the Treasury issue additional guidance on the application of nominal rates, particularly in relation to the inflation of future cash flows. This paper discusses the progress made.

Consultation work carried out

3. Discussions were held with departments holding the provisions laid out in the table below and make up over 80% of general provisions across government (per draft 16-17 WGA accounts). Follow up discussions have also been held with the NAO.

Department/ALB	Provision description	Value (£bn)
Nuclear Decommissioning Authority (NDA) - BEIS	Provision for costs incurred on the decommissioning of plant and equipment on nuclear sites	174.4
Department of Health and Social Care (DHSC)	The vast majority of this provision relates to clinical negligence claims	68.7
HMRC	Legal and other disputes on tax issues	7.8
HMRC	Held for the repayment of tax receipts resulting from oil and gas field decommissioning	6.4
DWP	The Financial Assistance Scheme provision, relating to top ups on failed pension funds, prior to the establishment of the Pension Protection Fund and levy	7.3
		264.4

4. Specifically, we discussed: a) nominal rate application; b) methods to determine inflation rates; c) whether the new nominal rate methodology was an estimate or policy change; and, d) whether there were any other issues in applying the new methodologies. The results of these discussions are laid out in the sections below.

Nominal rate application

5. Departments agreed with the Treasury's proposal to obtain nominal rates from yield curves on BOE gilts and for these to then be mandated by the Treasury, in line with the FRAB's recommendation from the November 2017 meeting. Departments believed that this would minimise inconsistency between government accounts, be practically expedient and is the best methodology for applying a risk free discount rate.

6. Currently discount rates issued by the Treasury are split between short term, for provisions of 0-5 years with the discount rate taken at 2.5 years along the yield curve, medium term, for provisions of 5-10 years with the discount rate taken at 7.5 years along the yield curve, and long term, for provisions of 10+ years with the discount rate taken at 25 years along the yield curve.

7. Departments were open to changing the timeframes along which discount rates are issued, particularly for long term provisions which extended beyond 50 years and for which the long term rate taken at 25 years along the yield curve was not necessarily appropriate.

8. However, BOE yield curves extend to a maximum of 25 years so there is no obvious alternative in relation to applying long/longer term discount rates. The Treasury will investigate other options, but it may be that the timeframes currently being applied are the most reasonable available.

Methods to determine inflation rates, to apply to future cash flows

9. After further research and investigation, the following methods to determine inflation rates are identified as options to departments:

Method	Pros	Cons
OBR CPI – OBR forecasts CPI inflation in detail up to 2.5 years, and then at a flat rate beyond that. This is recommended by experts as the most appropriate method to determine inflation and is widely used across the Public Sector, for example OBR forecasts are adopted at fiscal events.	• Widely recognised index, from independent 3rd party source (OBR) • The flat rate used by the OBR beyond 2.5 years could be used as a long term inflation assumption into perpetuity (the flat rate is tied into BOE inflation targets)	• The flat rate used by the OBR beyond 2.5 years is not necessarily an accurate forecast into perpetuity as it relies on the BOE being able to meet inflation targets and these inflation targets remaining consistent year on year
OBR RPI – A separate inflation forecast, however this is seen as a less reliable form of inflation forecast, as reported and designated by the ONS	• Obtained from independent 3rd party source • The flat rate used by the OBR beyond 2.5 years could be used as a long term inflation assumption into perpetuity (the flat rate is tied into BOE inflation targets)	• Considered a less reliable measure of inflation
Calculations – Mathematical calculations such as rolling averages, potentially incorporating standard	• Method would allow more flexibility (even if mandated by HMT) to select	• Not from an independent 3rd party source • Difficulties in selecting the most appropriate calculations

deviation or other methods to remove outliers from averages	appropriate inflation assumptions • Long term rates beyond 2.5 years could be more easily determined	for inflation assumptions and whether these can be consistently applied each year
External indices – e.g. LIBOR or SONIA	• Widely agreed benchmarks from 3rd party sources	• Not necessarily equivalent to inflation rates, and not necessarily applied as such • More akin to interest rates • Forecasts are typically short term

10. Departments were also asked which option above they could apply and if they had a preference. They were also asked whether they prefer the Treasury mandate inflation rates or departments were given flexibility to apply their own.

11. The responses can be summarised as follows:

NDA – Currently the provision for Nuclear Decommissioning is calculated using real rates. Were they to apply nominal rates the NDA would seek to apply inflation forecasts that are already verified by a third party entity and incorporated into separate contracts. The NDA is unique in the nature of its provision, relating to decommissioning, as well as in its size and its length (some elements of the provision are over 100 years). As such, applying CPI as an inflation measure is not necessarily as appropriate (compared to a specific NDA inflation index). As such, the NDA would ask that the Treasury do not mandate a methodology.

DHSC – The majority of clinical health provisions already apply nominal rates and already inflate cash flows. Information is pending from DHSC as to how cash flows are inflated.
For remaining DHSC provisions, which apply real rates but are less material, the use of OBR inflation rates was agreed as reasonable.

HMRC – A formal HMRC response is pending from the department. For smaller provisions not included in the table above, the option to apply OBR inflation rates was seen as reasonable.

DWP – The DWP already apply nominal rates to their Financial Assistance Scheme provision. Inflation rates applied to future cash flows are already determined by the Pension Protection Fund. How these inflation rates are determined exactly is pending from the department. As such, the DWP requested flexibility in applying their own inflation rates.

However, given these inflation rates are related to living or pension expenses, CPI could still be reasonable measure to apply. The DWP does not, therefore, have as strong a basis as the NDA for applying their own inflation rates. The department has carried out a review as to why pension discount rates are not applied to this provision, and determined it was a non-pension provision. They are open to a further review of this.

12. The overarching conclusion from these discussions was the OBR CPI inflation forecasts was a reasonable option for determining inflation assumptions to apply to future cash flows. However, it was equally reasonable that some departments could be given flexibility to apply their own inflation rates if the nature of their provision suggested this was a more appropriate approach.

13. The Treasury is currently proposing that:
    a) OBR CPI inflation rates are mandated, but with a rebuttable presumption for flexibility for departments to justify and then apply other inflation indices or methods as necessary
    b) OBR CPI inflation rates are mandated, but specific derogations are issued by the Treasury in the instances where other inflation indices or methods can be justified and applied
    c) OBR CPI inflation rates are proposed for use by departments, but there is flexibility for departments to deviate from the guidance if they require, with no rebuttable presumption or derogation necessary

14. The Treasury's preference at this point is to apply option a) above, but this may be subject to change given further work required, per the next point below.

15. Further work is required to complete the assessment of what methods are applied to determine inflation rates, this includes:

    - Assessing and understanding the outstanding data from departments;
    - Further discussion with departments on the options for issuing guidance as laid out in paragraph 13;
    - Further agreement with the NAO on this point; and
    - Further research into inflation options, for example discussions with the private sector as to how they determine long term inflation rates.

Q. Does the FRAB have any comments on the above and the recommendations set out in paragraph 13?

Accounting policy versus estimate change

16. All departments believed that the change from real to nominal rates would be a change in estimate, except DHSC which was more equivocal. The justification for

this was that the change from real to nominal rates was merely the change in interpretation of a standard, not a change in the standard or the adoption of a new standard itself.

17. Some departments (DHSC and DWP) make reference to real rates in their accounting policies, while others (BEIS and HMRC) do not.

18. Paragraphs 45 to 50 of IAS 37, would imply that the application of inflation to cash flows is an estimate: "The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision". However, the standard is not explicit on this.

19. IAS 8 again does not provide a definitive answer. Paragraph 5 dictates that a change in accounting policy is, 'a change in the bases, rules and practices applied in preparing… financial statements.' The change in discount rate methodology would be a change in the 'bases' of assessing provisions. The change in methodology could still be deemed a change in estimate however, as paragraph 34 (IAS 8) states, 'an estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience.' In this scenario, we have more experience and an updated assessment resulting in an updated estimate.

20. The Treasury would lean towards this being an estimate change, given there is no adaptation of any standard and given the inferences from IAS 37 and IAS 8.

*Q. **Does the FRAB have a view on the above and any opinion as to whether the application of nominal rates from real rates is a policy or estimate change?***

Difficulties in applying nominal rates and inflating cash flows

21. Departments did not believe they would encounter any significant difficulties in the application of nominal rates or in the inflation of cash flows, other than those noted above. Some departments would experience a greater degree of pressure on resource than others, but the application was still possible.

IFRS 16 discount rates

22. Long term discount rates are issued at each spending review. While this is reasonable to only update these rates for the purposes of long term provisions, such as the NDA provision, to reduce volatility, rates could be issued more frequently for the purposes of IFRS 16.

23. As part of our exposure draft, on IFRS 16 (FRAB 133 (03)), the Treasury has proposed that where entities cannot readily obtain the interest rate implicit in the lease, they should use the Treasury discount rate promulgated in PES papers.

24. While IFRS 16 does not specify that discount rates should be updated each year to remeasure lease liabilities, it would seem that this is in line with the Standard's aims of ensuring accounts provide a true and fair view of lease liabilities. The Treasury will continue to discuss this specific issue with the IFRS 16 technical working group.

Next steps

25. Next steps and the timeline are set out below:

- Complete work on inflation rates outlined in paragraph 14 above (June/July)
- Further consultation with departments to cover any smaller provisions held (June/July)
- Draft guidance and circulate this as an out of meeting FRAB paper (August)
- Issue guidance in time for supplementary estimates and FREM updates (September/October)
- Issue updated FReM 2018-19 (December 2018)
- Issue discount rate PES paper (December 2018).

HM Treasury
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