18 May 2011

GOVERNMENT FINANCIAL REPORTING MANUAL (FReM) EXPOSURE DRAFT No:

(11)01

EXPOSURE DRAFT OF PROPOSED

AMENDMENTS TO THE FReM

PROPOSALS TO IMPROVE THE METHODOLOGY FOR SETTING THE GENERAL PROVISIONS DISCOUNT RATE

Comments to be received by 13 July 2011

HM TREASURY

FINANCIAL MANAGEMENT AND REPORTING GROUP
HM TREASURY

This exposure draft of proposed amendments to the Government Financial Reporting Manual (FReM) is published by HM Treasury for comment only. The proposals may be modified in the light of comments received in this consultation process before being presented to the Financial Reporting Advisory Board for its agreement. Final proposals approved by the Financial Reporting Advisory Board will be published as amendments to the FReM from the proposed effective date.

Comments on this exposure draft should be submitted in writing so as to be received by 13 July 2011. Respondents are asked to send their comments electronically to FReM.consultation@hmtreasury.gsi.gov.uk.

All responses may be published on the FReM website unless the respondent requests confidentiality.

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Proposed amendments to the FReM

Introduction

Financial Management and Reporting Group, HM Treasury, has published this exposure draft of proposed amendments to the Government Financial Reporting Manual (FReM) as part of its ongoing work in ensuring that the Manual reflects the latest developments in government financial reporting.

Structure of exposure draft

The exposure draft includes a section for each FReM chapter for which an amendment is proposed. Each section includes:

(a) An explanation of why the amendment is proposed;

(b) When necessary any specific additional questions unique to that proposed amendment;

(c) The paragraphs of the FReM chapter that are affected by the proposed amendment;

(d) The proposed effective date of each proposed amendment.

Invitation to comment

HM Treasury invites comments on the proposed amendments. It would particularly welcome answers to the questions set out below. Comments are most helpful if they:

(a) Answer the question as stated;

(b) Indicate the specific paragraph or paragraphs to which they relate;

(c) Contain a clear rationale; and

(d) Describe any alternative HM Treasury should consider.

HM Treasury will consider all comments received in writing by 13 July 2011. In considering the comments, HM Treasury will base its conclusions on the merits of the arguments for and against each alternative, not on the number of responses supporting each alternative.

Amend the FReM interpretation of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	
Why the amendment is proposed	The review is necessary because while the current methodology for determining the discount rate for general provisions is based on the requirements of International Accounting Standard 37 *Provisions, Contingent Liabilities and Contingent Assets* (IAS 37), fuller compliance is proposed with the standard.
Paragraphs affected by the amendment	10.2.13
Proposed date	1 April 2011

Background: IAS 37 requirements and the current methodology

1. IAS 37 requires that 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. The discount rate (or rates) used to calculate the present value 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 (IAS 37 para 43).

2. The FReM requires the application of IAS 37 in full, subject to interpretations for the public sector context. A current interpretation relates to the discount rate, where it is noted that "where the cash flows to be discounted are expressed in current prices, entities should use the real discount rate set by HM Treasury as promulgated in PES papers available on the Treasury website." (FReM 10.2.13). At present, therefore, where reporting entities express cash flows related to provisions in current prices, they use a discount rate set by HM Treasury.

3. The methodology which is utilised for determining the discount rate to be applied to general provisions is as follows:

- HM Treasury sets one real discount rate;
- the discount rate is determined with reference to the real return of index-linked Gilts; and
- the discount rate is set before each Spending Review period, in order to allow for a degree of certainty in resource budgeting.

4. In each aspect of this methodology there are, however, elements which moved practice away from full compliance with IAS 37 and the requirement for discount rates to reflect current market assessments of the time value of money.

5. The first issue is that HM Treasury sets only one real discount rate. It is debatable whether the setting of one real discount rate to be applied by all entities to

all provisions is appropriate. There are examples of liabilities which have extreme durations (e.g. nuclear decommissioning liabilities which have crystallisation periods that extend over a century in the future) and it is questionable whether a single discount rate adequately reflects the current market assessments of the time value of money for all liabilities.

6. The second issue is that HM Treasury practice has been to set a real discount rate; as cash flows to be discounted tend to be expressed in current prices. However, when setting the discount rate in the past the inflation rate used to ascertain the real rate has been the government's target rate of inflation and not the rate of inflation derived from market expectations. Again the methodology does not, therefore, reflect current market assessments of the time value of money.

7. Thirdly and finally, the current methodology is to set discount rates ahead of each Spending Review period. This has been seen in the past as a compromise between meeting the requirements of financial reporting standards which require the use of a discount rate based on current yields, and allowing for a degree of certainty in resource budgeting over a Spending Review period. Reviewing the rate on an annual basis would ensure fuller compliance with IAS 37.

Proposals and Questions

8. There are several options being considered by HM Treasury that would ensure that the discount rate(s) adequately reflects the current market assessments of the time value of money, as required by IAS 37. We are mindful of the possible significant consequences these changes could have for some reporting entities, so we request responses to the questions noted below which follow each aspect of the proposals. Please note that any change to the methodology would result in a change in accounting estimate and not a change in accounting policy.

HM Treasury to continue to set discount rate(s)

9. HM Treasury considers that it should continue to set the discount rate(s) to be applied by all entities coming under the remit of the FReM. We believe this is necessary in order to ensure consistency and efficiency in determining accounting measurements across government. By setting the discount rate, HM Treasury is able to ensure that Parliament can be certain that there is a correct and consistent approach adopted by entities in reporting their provisions. It also eliminates the costs which individual entities would face in devising their own methodologies to calculate discount rate(s).

Q1. Do you agree that HM Treasury should continue to set the discount rate(s) to be applied by all entities coming under the remit of the FReM? If not, please provide you reasons.

Annual review

10. Current practice is for the discount rate to be set ahead of each Spending Review period. This practice was introduced as a compromise between the

requirements of financial reporting standards and a view that policy decisions should not be based on short-term views.

11. Reviewing the rate on an annual basis would ensure fuller compliance with IAS 37, as the discount rate(s) provided would better reflect market assessments of the time value of money at each statement of financial position date. Recent budgeting developments have resulted in movements in provisions being classified as AME, with the subsequent crystallisation of provisions being charged against DEL. This has made annual changes in discount rates more manageable within budgets. However, under Clear Line of Sight changes to the Estimates process, AME is now voted and included as a distinct line in the Statement of Parliamentary Supply. This could lead to difficulties for entities if a change in the discount rate were to lead to an unexpected score in AME.

12. Should an annual review of the discount rate be adopted, it is expected that the review and setting of the discount rate, to be applied on the statement of financial position date, would occur on 30 November, similar to the Pension discount rate. This would permit entities the necessary time to gain additional AME cover as necessary through the supplementary estimate process, helping mitigate against a breach of voted limits. However, as for the Pension discount rate, there would have to be a validation at 31 March to ensure that there had not been a significant deviation between the 30 November rate(s) and the rate(s) that would apply if set at 31 March. In the event of a significant deviation the 31 March rate(s) would have to be applied to ensure that the discount rate(s) accurately reflected current market assessments of the time value of money.[1]

Q2. Do you agree that HM Treasury should set the discount rate(s) annually or maintain the current practice of setting rates ahead of each Spending Review period? Please provide reasons for your answer.

Q3. If the discount rate(s) were to be set annually, what would be the possible impacts of this for your entity from the perspective of both accounting processes and financial impact?

Use of market-based data

13. The discount rate(s) will continue to be based on index-linked Gilt rates, as we believe these provide the most reliable and relevant proxy for risk-free rates. We consider, however, that the continued use of a target rate of inflation is undesirable for the reasons provided in paragraph 6. Consequently, we propose that a revised methodology should be introduced to ensure discount rate(s) reflect rates of inflation derived from market expectations.

Q4. Do you consider that there are any valid reasons for continuing to use a target rate of inflation measure as opposed to market-based data? If so please explain why.

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[1] For the Pension discount rate a deviation of up to and including 0.25% in the real rate between 30 November and 31 March was considered to be acceptable. It is likely that a similar measure will apply for the general provision discount rate, although if multiple rates are provided this methodology will need to be refined.

The number of discount rates to be provided

14. HM Treasury currently promulgates only one real discount rate to be applied to all general provisions where the cash flows to be discounted are expressed in current prices. We believe that it is questionable whether a single discount rate adequately reflects the current market assessments of the time value of money for all liabilities, as required by IAS 37.

15. There are several options available which could ensure fuller compliance with IAS 37. These include:

- provide a full range of nominal and real discount rates along with market expectations of future inflation. Entities would then be able to choose the rate(s) which most closely corresponds to a specific provision or liability; or
- continue to provide a single real discount rate that would be applied to most provisions, but provide additional rates to those entities that have, for example, provisions of extreme durations or significant materiality.

16. Annex A to this document provides examples of the application of these options to enable comparison to be made.

Q5. Would you prefer a change from the promulgation of a single real discount rate? If yes, please answer question 6. If no, please provide reasons as to why you believe a single rate is appropriate.

Q6. If you would prefer a change from the current practice, could you indicate which of the following you would recommend?

(i) Entities are provided with a full range of real and nominal discount rates;

(ii) Most entities will continue to apply a single discount rate, but some are provided with additional rates for provisions of extreme duration or materiality;

(iii) If you believe another option would be more appropriate, please provide details and the reasons for it.

FReM chapters addressed

The following table shows the topics addressed by these proposed amendments.

FReM Chapter	**Subject of amendments**
Chapter 10, *Other Assets and Liabilities*	To amend the interpretation of IAS 37 for the public sector context relating to the discount rate set by HM Treasury

Proposed amendment to Government Financial Reporting Manual Chapter 10, *Other Assets and Liabilities*

Introduction

An amendment to Chapter 10, *Other Assets and Liabilities*

Why the amendments are proposed

The amendments proposed in this Exposure Draft seek to amend the FReM to remove reference to the previous methodology of promulgating only one real discount rate by HM Treasury.

Proposed amendments

Paragraph 10.2.13 is amended (new text is underlined and deleted text is struck through)

10.2.13 Where cash flows are to be discounted ~~are expressed in current prices,~~ entities should use the ~~real~~ discount rates set by HM Treasury as promulgated in PES papers available on the Treasury website

Effective date of amendment

The effective date for the proposed amendment is 1 April 2011.

Annex: Examples of proposed methodologies

1. Single Discount Rate

The retention of a single discount rate would see HM Treasury promulgate one real discount rate in December of each financial year based on the real yield of index-linked Gilts as at 30 November. This real yield of index-linked Gilts would be checked on the statement of financial position date to ensure that there had not been a significant variation from the 30 November rate. The discount rate would be applied to provisions on 31 March.

Accounting treatment would follow current arrangements, although entities would see increased volatility in the value of provisions as they adjusted the provisions at each statement of financial position date using the new discount rate.

Practical Example:

Department Yellow raises a provision on 1st April 2011 for £1m related to a legal claim. The claim is expected to be heard in court and a decision as to whether it will need to pay costs by 31 March 2015. The Department has deemed that the time value of money is material and will, therefore, discount the provision. As the provision is expressed in current prices, the Department will use the real discount rate promulgated by HM Treasury. The real discount rate at 1st April; 2011 is 2.2%.

(i) Initial recognition at 1st April 2011

Cash flows excluding inflation	NPV	1	2	3	4
NPV (real discount rate of 2.2%)	914,8620	0	0	1,000,000	

Dr SOCNE (create provision) 914k (AME)
Cr Provisions 914k

During the year, HM Treasury indicates that the real discount rate which will be applicable on the statement of financial position date has fallen to 1.5% real. As the new discount rate applies only from 31 March, the Department must first unwind the discount using the original rate of 2.2%. It will then, if necessary, uplift the provision for inflation before applying the new discount rate of 1.5% real to calculate the present value.

(ii) Unwinding the discount at 31 March 2012

Cash flows excluding inflation	NPV	1	2	3
NPV (real discount rate of 2.2%)	935,441	0	0	1,000,000

Dr SOCNE (borrowing costs) 19k (AME)
Cr Provisions 19k

(iii) Uplift the provision for inflation and revalue by applying the new discount rate

1,000,000 uplifted by inflation of 5% gives an expected cash flow at current prices of 1,050,000 when the provision is to be paid. This, and the application of a new real discount rate of 1.5%, requires an increase in the value of the provision at 31 March 2012.

Cash flows excluding inflation	NPV	1	2	3
NPV (real discount rate of 1.5%)	1,003,455	0	0	1,050,000

Dr SOCNE (increase in value of provision) 78k (AME)
Cr Provisions 78k

2. Single Discount Rate with additional rates for certain liabilities

This would see the promulgation of a single discount rate as above that would be used by most entities. There would, however, be additional rates provided for certain liabilities that were of a unique nature. This would include, for example, rates to be used for nuclear decommissioning liabilities that are of a very long-term nature and where it may not be appropriate for discount rates to be changed on a yearly basis.

As noted above, accounting treatment would follow current arrangements, although some entities would not have to adjust certain provisions on a yearly basis for changes in the discount rate.

Practical Example:

In addition to the provision noted above, Department Yellow has a nuclear decommissioning liability of £1billion at current prices with cash flows covering the next 100 years. HM Treasury has indicated that for nuclear decommissioning liabilities, the need for long-term certainty requires a set discount rate which will not be adjusted on a yearly basis.

For this specific provision, therefore, the Department will merely unwind the discount and uplift for inflation. There will be no requirement to adjust the provision as the general provision discount rate changes.

3. Full range of discount rates

The provision of a full range of discount rates would see HM Treasury promulgate a complete set of nominal discount rates, real discount rates, and related implied inflation figures. Both forward rates and spot rates will be provided, with forward rates to be used unless models require or can only cope with one rate in which case the relevant spot rate is to be applied.

Practical accounting treatment under this option may vary considerably from the current practices of most entities, but it would give entities greater freedom in deciding whether to express cash flows related to provisions in current or future prices.

Shown below is a table of compounded rates derived from Bank of England market data in March 2011. Due to the current status of the Gilt markets as the economy recovers from

the uncertainty caused by the global recession, rates for periods close to the balance sheet date are subject to considerable volatility at present.

Duration in years from SoFP date	RPI implied forward	RPI implied spot	Real yield forward rate	Real yield spot rate	Nominal yield forward rate	Nominal yield spot rate
1	2.53%	4.08%	-0.20%	-2.47%	2.32%	1.51%
2	2.31%	3.34%	-0.14%	-1.93%	2.17%	1.35%
3	2.46%	3.09%	0.88%	-1.16%	3.36%	1.89%
4	2.77%	2.96%	1.32%	-0.60%	4.13%	2.34%
5	3.13%	2.96%	1.51%	-0.20%	4.69%	2.75%
6	3.44%	3.01%	1.61%	0.10%	5.11%	3.11%
7	3.70%	3.10%	1.64%	0.32%	5.40%	3.43%
8	3.89%	3.18%	1.63%	0.48%	5.58%	3.68%
9	4.03%	3.27%	1.58%	0.60%	5.67%	3.89%
10	4.12%	3.36%	1.51%	0.70%	5.69%	4.08%
11	4.20%	3.43%	1.42%	0.77%	5.68%	4.23%
12	4.24%	3.49%	1.33%	0.82%	5.63%	4.34%
13	4.28%	3.55%	1.23%	0.85%	5.56%	4.43%
14	4.30%	3.60%	1.14%	0.87%	5.49%	4.50%
15	4.33%	3.64%	1.05%	0.89%	5.43%	4.56%
16	4.35%	3.69%	0.96%	0.89%	5.35%	4.61%
17	4.36%	3.73%	0.89%	0.90%	5.29%	4.66%
18	4.36%	3.77%	0.83%	0.89%	5.23%	4.69%
19	4.35%	3.80%	0.78%	0.89%	5.16%	4.72%
20	4.33%	3.82%	0.74%	0.88%	5.10%	4.73%
21	4.29%	3.84%	0.70%	0.88%	5.02%	4.75%
22	4.26%	3.86%	0.68%	0.87%	4.97%	4.76%
23	4.21%	3.88%	0.66%	0.86%	4.90%	4.77%
24	4.15%	3.89%	0.64%	0.85%	4.82%	4.77%
25+	4.10%	3.90%	0.62%	0.84%	4.75%	4.77%

Practical Examples:

Real forward rates

Imagine again that Department Yellow raises a provision on 1st April 2011 for £1m related to a legal claim. The claim is expected to be heard in court and a decision as to whether it will need to pay costs by 31 March 2015. The Department has deemed that the time value of money is material and will, therefore, discount the provision.

Department Yellow wishes to express the provision in current prices and so will use real discount rates from the table above. It is able to utilise forward rates in its models and so selects the real forward rates related to years 1, 2, 3 and 4 from the table above.

Cash flows excluding inflation	NPV	1	2	3	4
NPV based on real forward rates	981,4440	0	0	1,000,000	

(NPV = 1,000,000*1.0020*1.0014*0.9912*0.9868 = 981,444)

Dr SOCNE 981k (AME)
Cr Provisions 981k

Nominal spot rates

Department Purple also raises a provision on 1st April 2011 for £1m related to a legal claim. The claim is expected to be heard in court and a decision as to whether it will need to pay costs by 31 March 2015. The Department has deemed that the time value of money is material and will, therefore, discount the provision.

Department Purple wishes to express the provision in future prices and so will use nominal discount rates from the table above. It cannot use forward rates in its models so utilises the nominal spot rate related to year 4.

Cash flows including inflation	NPV	1	2	3	4
NPV based on nominal forward rates	1,038,045	0	0	0	1,141,168

(Cash flow at year 4 = 1,000,000*1.0408*1.0334*1.0309*1.0296 = 1,141,168)

(NPV = 1,141,168*0.9766*0.9766*0.9766*0.9766 = 1,038,045)

Dr SOCNE 1,038k (AME)

Cr Provisions 1,038k