



G100 VIEWS

ON

**DISCOUNT RATE FOR
EMPLOYEE BENEFITS**

January 2013

Is there a deep market for high quality corporate bonds in Australia?

Members have raised concerns about the requirement to use a government bond rate as the discount rate to measure employee benefit liabilities because it is inappropriate for corporate reporting purposes. Although a government bond rate may be used to provide a benchmark it in no way represents a rate at which corporates are able to borrow and, as such, does not represent the time value of money for a corporate. The use of the government bond rate in these circumstances does not reflect the commercial environment in which a company is operating. While a government bond rate may be used to provide a benchmark for purposes of estimating the discount rate, the rate at which companies can borrow is determined by their commercial and business risk which is normally reflected in their credit rating. A consequence of using the government bond rate as the discount rate is that the amount at which employee benefit liabilities are included in financial reports are likely to be misleading to users.

Discount rates are required to be used in a broad range of accounting measurements including insurance liabilities (AASB 4), rehabilitation costs and self-insurance (AASB 137), leases (AASB 117), asset impairments (AASB 136), financial instruments (AASB 139) pensions and long service leave liabilities (AASB 119). This note is concerned with the determination of the discount rate in applying the requirements of AASB 119 "Employee Benefits".

Position Paper

The views of the major accounting firms are set out in a position paper provided to the G100.

While the position paper identifies a range of factors relating to determining whether a deep market in high quality corporate bonds exists the G100 disagrees with the views expressed in this paper because it seeks to set an unreasonably high hurdle for determining whether such a market exists in Australia both now and in the future.

In the G100's view the factors which should also be considered when assessing the statements made and issues raised in the position paper are outlined below.

Background

AASB 119 'Employee Benefits' (2011) which applies to annual reporting periods beginning on or after 1 January 2013, requires 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." (paragraph, 80).

"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.” (paragraph, 83).

AASB 119/IAS 19 (2011) contains the following commentary:

“One actuarial assumption that has a material effect is the discount rate. The discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity’s creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions” (paragraph 84).

“The discount rate reflects the estimated timing of benefit payments. In practice, an entity often achieves this by applying a single weighted average discount rate that reflects the estimated timing and amount of the benefit payments and the currency in which the benefits are paid” (paragraph 85).

“In some cases, there may be no deep market in bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments. In such cases, an entity uses current market rates of the appropriate term to discount shorter-term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve. The total present value of a defined benefit obligation is unlikely to be particularly sensitive to the discount rate applied to the portion of the benefit that is payable beyond the final maturity of the available corporate or government bonds” (paragraph 86).

{Note: AASB 119 (September 2011) contains the same requirements}.

Discussion

AASB 119/IAS 19 does not address what is meant by:

- ‘high quality’
- ‘government’
- ‘deep market’

High quality

The IASB does not clarify what constitutes a high quality corporate bond in IAS 19 and presumably was comfortable about stating a principle and leaving it to companies/preparers to exercise their judgment. It is noted that the IASB took this position notwithstanding precedence in the requirements in the United Kingdom and the USA. For example, in 2000 the UK, which has since adopted IFRSs, the Accounting Standards Board specified that a high quality corporate bond is one having an AA rating or better (AAA) and in 1993 the USA SEC staff specified an AA rating or better for US GAAP purposes. Past practice and precedent has been to consider corporate bonds to be high quality if they receive one of the two highest ratings given by a recognised rating agency.

It would seem that the position taken by the accounting firms is heavily influenced by these requirements and that if ASIC or the AASB were to make a determination the UK and US precedent would be persuasive.

However, this does take account of the changed investment and credit environment. Following the global financial crisis (GFC) there are now very few companies and governments with credit ratings of this order. Pre GFC notions are now demonstrably out of date and accounting practices and requirements have not changed in response to these developments. The G100 believes that it is necessary to revisit what constitutes a high quality corporate bond. For example, the primary rating scales for S & P and Fitch Ratings can be interpreted to suggest that securities that are A rated or better are high quality.

[It is notable that the UK ASB (FRS 17 paragraph 33) commented that in the absence of a liquid market of AA rated bonds or duration then a reasonable proxy should be used, for example, government bonds plus a margin for assumed credit risk spreads derived from global bond markets.]

Government

AASB 119 does not mandate the use of market yields on Commonwealth Government bonds as the basis for determining the discount rate.

Accounting Standards define Government broadly as follows:

“Government refers to government, government agencies and similar bodies, whether local, national or international.” (AASB 120, paragraph 3 and AASB 124, paragraph 9).

Given this definition of ‘government’ and the reference to market yields on government bonds IAS 19 (paragraph 83) the yield on government securities and semi-government securities other than Commonwealth Government bonds could be used as the basis for determining the discount rate. Further, issues by corporatized government entities, for example, Australia Post, should be included in this analysis. We see no reason for excluding such securities from consideration as proposed by the accounting firms. We consider that these securities constitute an important part of the market.

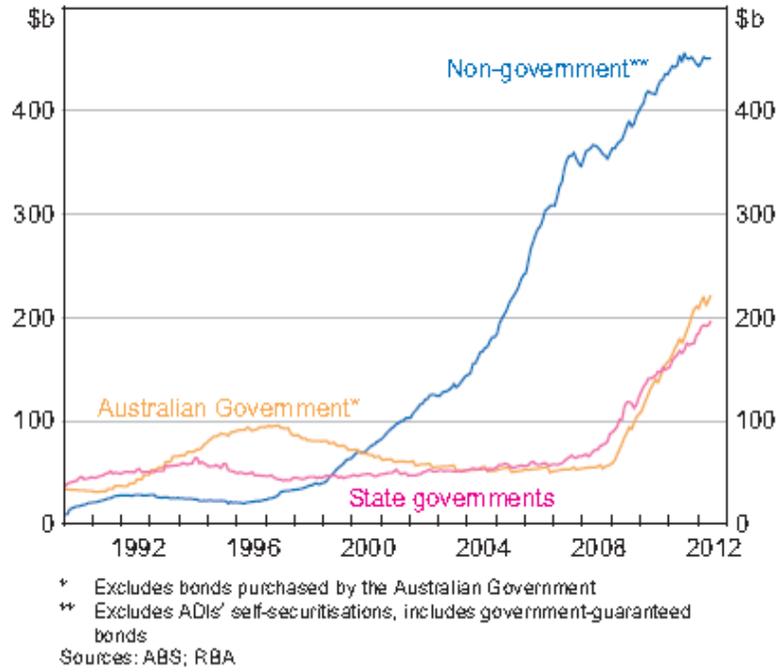
Deep market

A key stumbling block in previous discussions about whether the market for high quality bonds in Australia is sufficiently deep has been the need for an observable market rate or index on high quality bonds, to be determined at each measurement date.

The G100 believes that the approach, by the accounting firms, to determining the extent of the market is too narrow and that a wider range of issues such as asset backed bonds, covered bonds, floating rate notes and subordinated bonds denominated in Australian dollars (or the reporting currency) should be included in the scope of the market.

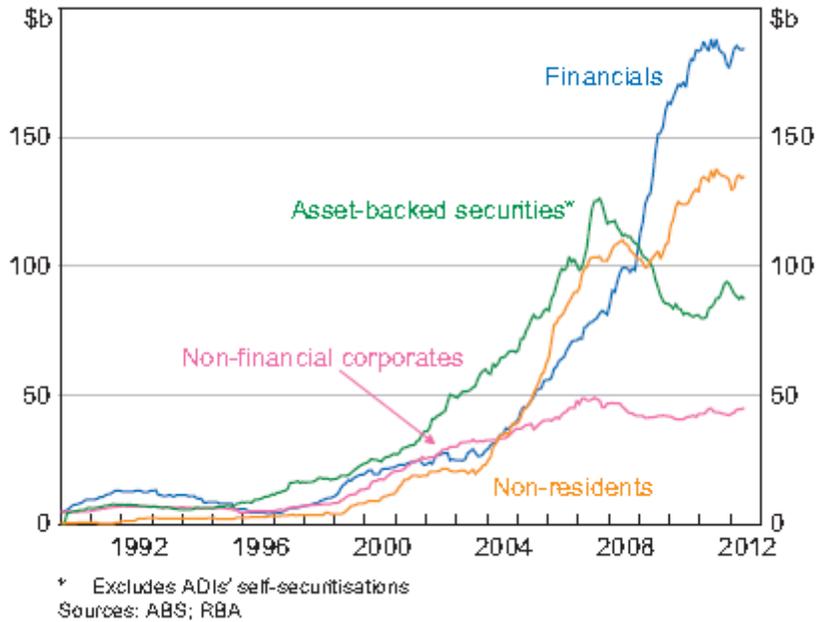
There is a range of market and market related data available that can be used to determine a discount rate. Market depth analysis for Non-government bonds on issue in Australia is provided from the Reserve Bank of Australia and Australian Bureau of Statistics. The following graphs from the Reserve Bank of Australia August 2012 chart pack show the Non-government bond market to be more liquid than the Government bond market.

Bonds on Issue in Australia



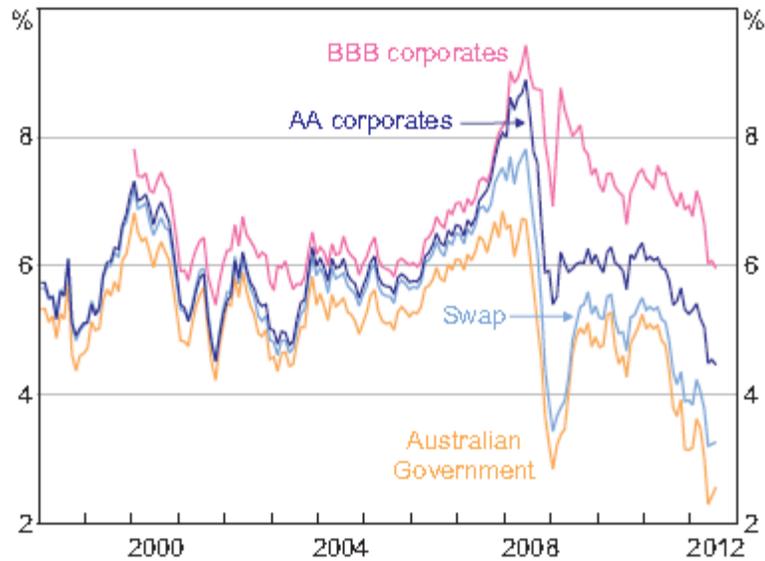
Further detail on the types of Bonds on issue by Non-government entities is shown below:

Non-government Bonds on Issue in Australia



Finally spreads/discount rates for differing quality Non-government entities can be extracted from Blombergs and independent brokers as shown below are sourced from the Reserve Bank of Australia chart pack.

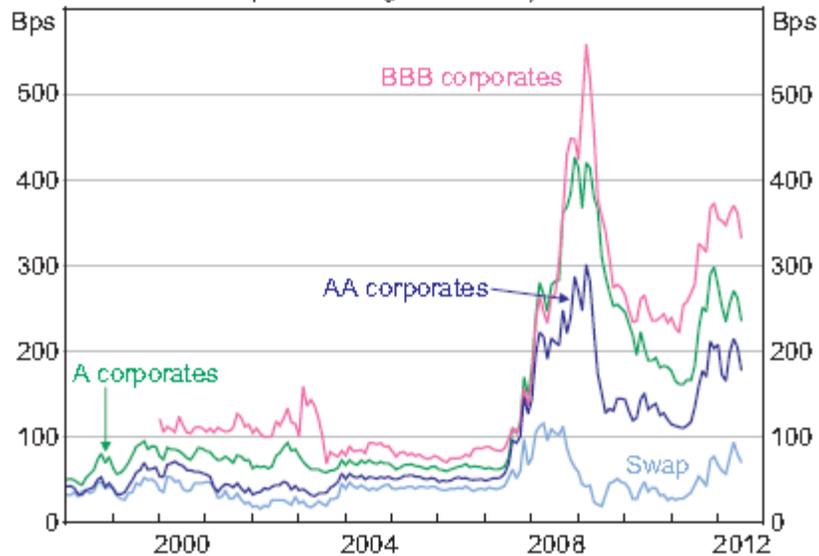
Australian Bond Yields*



* Australian Government yields and swap rates are for 3-year maturity. Corporate bond yields are a weighted average of senior bonds with remaining maturities of 1 to 5 years; they include financial and non-financial corporates.
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Australian Bond Spreads*

Spread over government yields



* Swap spreads are for 3-year maturity. Corporate bond spreads are a weighted average of senior bonds with remaining maturities of 1 to 5 years; they include financial and non-financial corporates.
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Further examples of derivable corporate bond discount rates can be extracted from the Australian *iTraxx* indices (a family of credit default swap index products constructed with the overriding criterion being the liquidity of underlying credit default swaps) which comprise 25 Australian entities including the Big 4 banks and other major companies provide evidence of depth and liquidity of the market by:

- publishing a new series every six months to filter out instruments which either do not exist or whose trading is illiquid. Further validation of *iTraxx* can be achieved by referring to Bloomberg's 'fair market value curves'; and
- the increasing volume and frequency of bond issues in Australian bond markets, particularly in the last twelve months (A\$53.6 billion issued between 1 June 2011 and 25 June 2012).

The information available on both market depth and pricing indicates that the view that the Australian corporate bond market is illiquid needs to be revisited.

The G100 does not consider the lack of market yields at longer maturities of corporate debt is an impediment to determining an appropriate discount rate because the extrapolation of yield curves is common practice in other circumstances including the measurement of rehabilitation costs and insurance liabilities.

Summing Up

The G100 considers that in view of recent developments in investment and credit markets the methodology previously used to determine discount rates for applying AASB 119 is questionable and should be addressed/modified by standard-setters as a matter of priority.

At this stage there is no general agreement that a deep and liquid market in high quality corporate bonds presently exists in Australia. The G100 considers that the universe of bonds considered for the purpose of applying AASB 119 should be extended to include:

- bonds issued by state governments and semi-government entities including corporatized entities whether or not those bonds are guaranteed by a government;
- debt securities issued by corporates including covered bonds, asset backed bonds and subordinated bonds. We do not consider that the existence of a government guarantee in respect of bank paper precludes its inclusion in the bond universe as it can be traded and contributes to the liquidity of the market; and
- bonds regarded as satisfying criteria for being of high credit quality as applied by ratings agencies.

Recent Developments

At its November 2012 meeting the International Financial Reporting Interpretations Committee (IFRIC) considered an agenda proposal seeking guidance on the determination of the rate used to discount post-employment benefit obligations, in particular, the interpretation of high quality. In its discussions IFRIC noted that under IAS 19, paragraphs 84 and 85, the discount rate:

- reflects the time value of money but not actuarial or investment risk
- does not reflect the entity-specific credit risk

- does not reflect the risk that future experience may differ from actuarial assumptions
- reflects the estimated timing of benefit payments; and
- that because IAS 19 does not specify the grade of bonds which are designated as high quality or how to determine the market yields on high quality corporate bonds an entity shall apply judgement in applying IAS 19 paragraphs 84 and 85 in determining the current market yields on such bonds.

At its January 2013 meeting IFRIC further discussed approaches to determining the discount rate and agreed that as a live issue it would be taken to the Board for it to determine a course of action. The G100 will continue to monitor the IASB's discussions on this issue.

Current practice

We are aware of different practices in determining the discount rate for AASB 119 purposes. For example, the following practices have been applied in 2012 financial reports:

- the use of Commonwealth bond rates;
- the use of a blended rate based on State Government yields;
- the weighted average rate of return on Commonwealth and State Government securities on issue with a duration similar to that of the pension plan liabilities.

These approaches are justified on the basis that:

- government is defined broadly in Accounting Standards;
- AASB 119 does not mandate the use of the Commonwealth bond rate and provides scope for exercising judgment in determining the discount rate; and
- market yields on the broader population of government securities more closely approximates the borrowing costs of corporates and as such provide a more relevant basis for determining the discount rate.

Further Action

The G100 is taking the following actions to achieve some resolution of the issue so far as the Australian environment is concerned because the present requirement does not reflect the realities in the commercial marketplace and results in presenting potentially misleading information:

- engaging with the IASB and IFRIC (and AASB) to seek amendments to IAS 19 and (AASB 119)
- monitoring the IFRIC project regarding the use of a government bond rate as a default rate in the absence of a liquid market in high quality corporate bonds including explanation of applying the criterion 'high quality' in a post-GFC environment
- engaging with the major accounting firms to obtain clarity as to the underlying reasons for their restrictive interpretation of what would constitute a market for high quality corporate bonds in Australia.