

Reporting Update

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Discounting employee benefits: using corporate bond yields

Australia now has a deep market in high quality corporate bonds. KPMG accepts the analysis in the *Discount Rates for Australian Employee Benefit Liability Valuation* Milliman Report in April 2015, which investigated the Australian high quality bond market and found sufficient evidence to support the above conclusion.

When the high quality corporate bond market is deep, entities (except public not-for-profit sector entities) must change to that rate for all employee benefits measured on a discounted basis under AASB 119 *Employee benefits*.

This Reporting Update considers the key financial reporting impacts of this change and provides guidance to assist entities in the transition.

KEY POINTS

- Australia now has a deep high quality corporate bond market
- When discounting employee benefit liabilities, use the high quality corporate bond rate at the reporting date
- Treat as a change in estimate

ACTION POINTS

- Discuss valuation with actuaries prior to year end
- Consider disclosures ahead of period end
- Consider impact on ratios and debt covenants

Discounting using a High Quality Corporate Bond Rate

What is the High Quality Corporate Bond Rate?

When the market for high quality corporate bonds is deep, AASB 119 requires that entities discount post-employment benefits and other long-term employee benefits with reference to market yields at the reporting date [AASB 119.83]. High quality corporate bonds, and the concept of depth, are not defined in AASB 119, causing much discussion around the world. These definitions are important because they form the foundation of assessing two factors:

- whether the market for high quality corporate bonds is deep; and
- if so, the market yield on those high quality corporate bonds.

The Group of 100 (G100) commissioned actuarial firm Milliman to perform an assessment of the depth of Australia's high quality corporate bond market. In their report released in April 2015, Milliman investigated the Australian bond market and compared it to other bond markets around the world. The report highlights that it is generally accepted practice that bonds rated AA or above are high quality. Milliman determined that there is sufficient evidence to support a conclusion that the high quality corporate bond market in Australia is deep.

The G100 has also commissioned Milliman to calculate and publish a blended high quality corporate bond rate that incorporates AA and above rated bonds on a quarterly basis, although additional frequency may take place. KPMG expects that this published rate will be an acceptable source for determining the rate to use to discount defined benefit obligations and other long-term employee benefits, although entities and their auditors will need to consider whether it suits their particular circumstances. An entity that adopts a source for a corporate bond discount rate other than the published Milliman curve may need to engage its advisors and auditors to discuss the implications of such a choice. Similarly, if an entity's reporting period-end does not coincide with the periodic publication of discount rates from Milliman, the entity will need to determine its valuation inputs through other means.

Which liabilities are affected by this change?

All post-employment benefits and other long-term employee benefits that are discounted will be impacted by this change. Examples of such obligations include:

- defined benefit plans;
- long service leave; and
- other long-term employee benefits, such as:
 - long-term disability benefits;
 - profit-sharing and bonuses;
 - deferred remuneration; and
 - annual leave classified as long-term.

We expect that the carrying amounts of the above liabilities will be lower than they would have been if the entity had continued to apply the Australian government bond rate. This view is based on the fact that the high quality corporate bond rate is greater than the Australian government corporate bond rate, resulting in a greater discount factor and smaller liability amount.

The effects of changing to the high quality corporate bond rate are clearly wide-reaching. However, not all discounted liabilities are impacted. The following measurements do not incorporate the high quality corporate bond rates, and are therefore not impacted by this change:

- share-based payments under AASB 2;
- other provisions under AASB 137; and
- impairment calculations under AASB 136.

Clearly, entities will need to ensure that the appropriate rate is being used in the appropriate context.

Does this change impact my statement of profit or loss?

The profit or loss impact of changing to the high quality corporate bond rate will depend on the circumstances of the entity, and the types of long-term employee benefits it offers. Changing to the high quality corporate bond rate will impact profit or loss in future periods for all types of entities.

Other long-term employee benefits

In the year of transition to the high quality corporate rate, the closing balance of an entity's other long-term employee liability (for example, long service leave) will be lower than it would have been if the government bond rate were used. The difference for long service leave and other types of 'other long-term employee benefits' will flow through profit and loss (see below regarding AASB 108 considerations).

Defined benefit plans

Similarly, an entity's closing defined benefit obligation will be lower than it would have been if the government rate were applied. However, as discussed below, this change will be treated as an actuarial gain. Actuarial gains and losses on defined benefit plans are recognised in other comprehensive income (see below regarding AASB 108 considerations).

Future period impacts

The impact on future periods will be difficult to predict. Although entities will be using higher discount rate to determine the interest element of long-term employee benefits, that rate will be applied to a lower liability balance. Whether the interest element will increase or decrease compared to prior periods will depend on the entity's particular circumstances, including time to maturity and funding levels.

When should the valuation of these liabilities change to using the corporate bond rate?

Based on the information and analysis in the Milliman report, KPMG's view is that there is a deep market in high quality corporate bonds in Australia. Accordingly, to remain in compliance with AASBs and IFRSs entities must apply the high quality corporate bond rate at their next reporting date [AASB 108.36]. For example, an Australian entity with a 30 June 2015 year-end will need to apply the new discount rate to their 30 June 2015 financial report. However, for reasons discussed below, comparatives are not restated.

Adopting in interim periods

If the next reporting period for an entity is an interim reporting period, the change to the high quality corporate bond rate is made in that interim reporting period. The overall principle behind an interim financial report is to provide an update on the latest complete set of annual financial statements. Any significant events and transactions that have occurred during the interim period that are material to a

user's understanding of an interim report should be included in the interim financial statements. Accordingly, if changing to the high quality corporate bond discount rate is material the change must be reflected in measuring employee liabilities at that interim reporting date.

For long-term employee benefits other than defined benefit plans, the impact of changing to the corporate bond rate is recognised in full in the first interim or annual period that the entity uses the corporate bond rates.

For entities with defined benefit plans that adopt this change in an interim period, care must be taken such that their obligation to prepare an interim financial report does not affect their annual expense, compared to an entity that does not have interim reporting obligations. As a reminder, an entity's net interest cost for a defined benefit plan is calculated based on the opening net defined benefit liability (asset), multiplied by the opening discount rate – which has been based on government bond rates. This is the amount recognised in profit or loss. An entity that changes to the corporate bond rate in an interim period does not reset the discount rate when they calculate the net interest cost for the remaining part of their year. The net interest cost recognised in profit or loss for the full annual period will continue to be based on the government bond yield determined at the beginning of the year.

However, the defined benefit obligation as at the interim reporting date (and at the end of year) will be determined by applying the high quality corporate bond rate as at that date. The differences between the government bond rate at the beginning of the annual period and the corporate bond rate at both the interim date and at the end of year will result in an actuarial gain or loss that is recognised in other comprehensive income.

AASB 108 considerations

Change in policy or change in estimate?

When adopting the high quality corporate bond discount rate, the question arises as to whether this change should be treated as a change in estimate, or a change in accounting policy. AASB 108.5 provides the following criteria for a change in accounting estimate, stating that such a change is a result of new information or new developments and causes:

- an adjustment to the carrying amount of an asset or liability; or
- a change in the amount of the periodic consumption of an asset.

In our view, the Australian high quality corporate bond market becoming deep satisfies the “new development” criterion. Furthermore, the adoption of the high quality corporate bond rate as the discount rate for defined benefit obligations and other long-term employee benefit liabilities adjusts the carrying amounts of those liabilities. The measurement basis remains the projected unit credit method, however, entities must now apply the high quality corporate bond discount rate. Accordingly, we consider this is a change in estimate.

DB obligations vs other long-term benefits

By virtue of paragraph 128(d) in AASB 119, changes in the discount rate are treated as actuarial gains or losses. AASB 119 contains different recognition requirements depending on whether the liability being measured is a defined benefit obligation or other long-term employee benefit. These requirements are:

- actuarial gains and losses for defined benefit obligations are recognised in other comprehensive income [AASB 119.120(c)]; and
- actuarial gains and losses for other long-term employee benefits are recognised directly in profit or loss [AASB 119.156(c)].

Based on the discussion above, the gains or losses arising from changing to a high quality corporate bond discount rate are treated as a change in accounting estimate and are recognised in the period in which the change occurs. Accordingly, entities do not restate prior periods for the change in the discount rate applied.

As an example, for entities with only long-service leave and long-term annual leave obligations, all gains or losses arising from the application of the high quality corporate bond discount rate must be recognised directly in profit or loss in the period the change is applied.

Disclosure impacts

What is the impact on accounting policy disclosures?

Entities will need to review their accounting policy disclosures to ensure they are consistent with the change to the high quality corporate bond rate. Some entities make specific mention to the use of Australian government bond discount rates in their employee benefit policy disclosures. Those entities will either change the reference to high quality corporate bond rates or simplify their policy disclosures as illustrated in the extracts below of KPMG's *Example Public Limited: Guide to annual reports – Illustrative disclosures 2014-15*:

iii. Defined benefit plans

The Group's net obligation in respect of defined benefit plans is calculated separately for each plan by estimating the amount of future benefit that employees have earned in the current and prior periods, discounting that amount and deducting the fair value of any plan assets.

v. Other long-term employee benefits

The Group's net obligation in respect of long-term employee benefits is the amount of future benefit that employees have earned in return for their service in the current and prior periods. That benefit is discounted to determine its present value.

What should be disclosed in the notes when changing to the corporate bond rate?

The disclosure below is an extract from *Example Public Company Limited: Illustrative Disclosures 2014-2015* that satisfies the disclosure requirement of AASB 119 paragraph 141. For defined benefit obligations the change to the high quality corporate bond discount rate will be captured in current-year actuarial gains or losses arising from changed financial assumptions (highlighted).

B. Movement in net defined benefit (asset) liability

The following table shows a reconciliation from the opening balances to the closing balances for net defined benefit (asset) liability and its components.^a

<i>In thousands of euro</i>	Defined benefit obligation		Fair value of plan assets		Net defined benefit (asset) liability	
	2014	2013	2014	2013	2014	2013
Balance at 1 January	7,057	6,718	(7,508)	(7,162)	(451)	(444)
Included in profit or loss^b						
Current service cost	497	456	-	-	497	456
Past service credit	(100)	-	-	-	(100)	-
Interest cost (income)	360	322	(383)	(344)	(23)	(22)
	757	778	(383)	(344)	374	434
Included in OCI^b						
Remeasurements loss (gain):						
– Actuarial loss (gain) arising from:						
– demographic assumptions	(31)	4	-	-	(31)	4
– financial assumptions	(21)	8	-	-	(21)	8
– experience adjustment	(30)	6	-	-	(30)	6
– Return on plan assets excluding interest income	-	-	10	(3)	10	(3)
Effect of movements in exchange rates ^c	21	(1)	76	(1)	97	(2)
	(61)	17	86	(4)	25	13

Paragraph 144 of AASB 119 also requires the disclosure of the significant actuarial assumptions used to determine the present value of the defined benefit obligation.

D. Defined benefit obligation

i. Actuarial assumptions

The following were the principal actuarial assumptions at the reporting date (expressed as weighted averages).

	2014	2013
Discount rate	5.1%	4.8%
Future salary growth	2.5%	2.5%
Future pension growth	3.0%	2.0%
Medical cost trend rate	4.5%	4.0%

In the period of change to the high quality corporate bond discount rate, under AASB 108 paragraphs 39 and 40, an entity will disclose the nature of the change in estimate and its impact on the current and future periods, unless impracticable. Entities should consult with their actuaries to quantify this impact. An example of such a disclosure is included on the next page.

Change in discount rate

During the reporting period the Group changed the discount rate used in its AUD-denominated defined benefit calculation from the Australian government bond rate to the high quality corporate bond rate and applied this change as a change in accounting estimate. This change is the result of new developments in the Australian economy that caused the Australian high quality corporate bond market to be considered deep.

Actuarial gains or losses directly attributable to this change of \$x are included in the financial assumptions actuarial gains disclosed above. Interest cost was unaffected in the current period as the change in discount rate occurred after the start of the annual reporting period. However, on applying the high quality corporate bond discount rate to the opening net defined benefit asset in the next reporting period, the Group estimates the impact on interest cost in the next reporting period to be \$x.

The Group also decreased the carrying amounts of annual leave and long-service leave by \$x and \$x, respectively, in the current year upon application of this change in estimate.

Due to the inherent uncertainty in measuring net defined benefit assets/liabilities, the Group is unable to predict the impact of the change to a high quality corporate bond discount rate in periods beyond the next reporting period.

In respect of other long-term employee benefits, such as long-service leave and the long-term annual leave, AASB 119 does not contain any specific disclosure requirements. However, the example disclosure in the last two paragraphs above provides the impact of the change in estimate in the current year for other long-term employee benefits to satisfy the requirements of AASB 108.39-40.

Does this impact remuneration report disclosures?

Disclosures in the remuneration report are based on the expense measured under accounting standards. Entities will need to use the new measurements incorporating discount rates based on high quality corporate bonds when calculating KMP (key management personnel) remuneration amounts.

In some cases, the expense for an individual KMP's other long-term employee benefits, such as long-service leave and long-term annual leave, could be a credit amount due to the impact of discounting at the higher corporate bond rate. If that is the case, the correct amount to disclose is the credit amount. Entities may want to provide an explanation in the remuneration report that the credit is due to the changing from using the government bond rate to high quality corporate bond rates in measuring the liability.

An entity's policy for allocating defined benefit expenses to KMP could affect the remuneration amounts. As an example, some acceptable allocation policies include:

- an allocation of all elements, including service cost, net interest on the net defined benefit liability or asset, and re-measurements of the net defined benefit liability or asset;
- an allocation of service cost only; or
- an allocation of the change in the defined benefit obligation before benefit payments, and excluding plan assets.