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UK Shareholders' Association

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International Accounting Standards Board

7 Westferry Circus, Canary Wharf,

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Dear Sirs

Third Agenda consultation

I write as Policy Director of the UK Shareholders' Association, in response to your consultation on which financial reporting issues might be given priority in the Board's work plan

In my view, discount rates are an area that should be revisited as an matter of the utmost priority. This is because

- arbitrary manipulation of discount rates can easily be used to create reported capital, which can then be used to distribute income, or inflate the book value in a way that misleads prospective investors, creditors or policyholders;
- the use of discount rates in excess of riskfree is rejected by all financial economists.
- stakeholders have raised highly public concerns that the determination of discount rates will lead to excessive subjectivity in accounting, and about the the use of discount rates that are too high because they are in excess of risk-free rates;
- discounting is a pervasive issue that affects all firms with medium to long term debt, often with a material impact on the accounts;
- use of rates in excess of risk-free has been discussed in parliamentary debate;[1]

1 Baroness Bowles, Lords Grand Committee, 27 April 2021, https://parliamentlive.tv/event/index/a6c10479-6486-451f-8f48-ac25f9930589?in=16:36:58: "With the

- users of accounts such as UK shareholders consider this an area of potential concern due to the subjectivity and the scope for variation in rates applied
- many of the concerns raised above have even been expressed by the UK Endorsement Board itself.[2]
- the logic of BC 193 (the original basis for conclusion on discount rates) is flawed (see appendix) and should be reviewed.

As well as ensuring that the interests of all stakeholders are represented (for example shareholders and (for life insurance) policyholders, the review process should reflect the currently accepted science on discounting, recognised by all academic economists.

Yours sincerely

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proposed new insurance standard, IFRS 17, the issues go further than unrealised profits, and credit is given to reduce liabilities, not merely for unrealised gains, but for anticipated future income, giving the appearance of capital. *This cannot be proper accounting*. These unrealised gains and anticipated income can neither be used to service debt, pay down debt or invest in other assets, nor have any value as collateral. No way is it true and fair, and anyone endorsing it would surely have to be nobbled, which seems to aptly describe the UK endorsement board." Our emphasis.

[2] "Tentative IFRS 17 technical issues for assessment against endorsement criteria in SI 2019/685, https://assets-eu-01.kc-usercontent.com/99102f2b-dbd8-0186-f681-303b06237bb2/b1558b77-8ae6-40ea-96f0-59fee2cadea7/4.1%20IFRS%2017%20Insurance%20Contracts%20Technical%20Issues.pdf

Appendix: "IFRS Standards, Basis for Conclusions on IFRS 17 Insurance Contracts" May 2017, BC 193

Financial economics

Financial economics holds that we always discount riskless liabilities at the risk free rate, for the following reason.

Consider a 'matched pair', where a liquid and riskless asset is cashflow-matched with a liability which while riskless, and can be transferred readily between issuers, cannot be transferred between creditors, so is completely illiquid from creditor's point of view. (Hint: pension).

Assume the liquid asset is priced at 100. Since the cashflow from the matched pair has cashflows of zero in every possible state of the world through to maturity, every cashflow received on the asset side is cancelled by a cashflow paid on the liability side. Every coupon paid by the asset goes to pay a coupon required on the liability side, and the principal repaid on the asset side goes to the creditor on the liability side.

Thus the matched pair produces no income, nor any payment at maturity, therefore has no value. It follows that the value of the liability is equal and opposite to the value of the asset, i.e. 100, and if so, that this value is the same as the value given by discounting all the liability cashflows at the risk free rate. This is true, *regardless of the liquidity characteristics of the liability*.

This is why we always discount riskless liabilities at the risk free rate.

IASB Basis for Conclusions

Against financial economics, the IASB has argued[3] that a liquid riskfree bond has two components

> (a) a holding in an underlying non-tradable investment, paying a higher return than the observed return on the traded bond; and
>
> (b) an embedded option to sell the investment to a market participant, for which the holder pays an implicit premium through a reduction in the overall return;

and that the discount rate on the liability should equal the return on the non-tradable investment, because the entity cannot sell or put the contract liability without significant cost.

It follows from this assumption that the matched pair has a value of greater than zero. Assume that the price (100) of the liquid asset includes the price X of the embedded option to sell at market. Then (on that assumption) the illiquid liability has a value of 100-X, and the matched pair has a value of X.

[3] "Basis for Conclusions on IFRS 17 Insurance Contracts", May 2017, paras BC 193ff.

This reasoning is fallacious.

Suppose, first, that the issuer will hold the matched pair to maturity. Then the option can never be exercised, for the asset must be sold at par to redeem the liability. But an unexercisable option has no value. If the issuer firm represents the value of the matched pair at X, it is representing to prospective shareholders that the option has a value that it can never have, thus misrepresenting the value of the firm in a way that verges on fraudulent.

Or suppose the firm sells off the asset to realise the value of the embedded option at market, but holds the liability to maturity. But then it must still hedge the liability with a liquid asset, thus tying up another embedded option to maturity. Whatever gain X the firm realises by the sale is offset by the loss X on an option which can never be exercised.

Finally, suppose the firm sells off the matched pair before maturity. But what is the fair value of the pair? No market participant will pay more than zero, for the reasons outlined above. The pair will never produce an income, so has no market value. Perhaps the firm can dupe a buyer into paying more than the fair value. Possibly, but accounting rules do not allow firms to represent instruments at more than fair value, which is the whole principle behind IFRS. QED.