

STAFF PAPER

19 June 2014

[REG IASB Meeting]

Project	Research project on discount rates – review of existing requirements		
Paper topic	Approach to the research		
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Introduction

1. Financial decisions often involve comparing different sets of cash flows occurring at different points in time. Expressing these various cash flows as a value at a point in time enables us to compare them. The process by which we do this is referred to as the present value measurement technique. The technique is often used in the measurement of assets and liabilities for financial reporting purposes. It requires two main inputs: future cash flows and a discount rate.
2. A present value technique is merely a method, not a measurement objective, and can be applied when the objective is to measure the fair value, value in use or other current value of an asset or a liability, as a method for initial or subsequent measurement.
3. Depending on the measurement objective, IFRSs require different discount rates to be used in different Standards where a present value technique is required or permitted. Views received during the 2011 Agenda Consultation suggest that the reasons for using different discount rates are not well understood, with some respondents suggesting that such differences cause IFRS requirements to be inconsistent.
4. The IASB has decided to conduct a research project to examine discount rate requirements in IFRS, explaining why those differences exist and assessing whether there are any inconsistencies that the IASB should consider addressing. If the analysis undertaken in this research project identifies inconsistencies, it may lead to

recommendations to address them. The recommendations could range from proposing a fundamental review of discount rates, to suggesting minor wording changes as narrow scope improvements, to concluding that no further actions are necessary. Paragraph 50 sets these possibilities in more detail.

5. This paper presents the proposed approach to make this assessment.
6. It includes the following sections:
 - (a) Summary of proposed approach;
 - (b) Scope of discount rates research;
 - (c) Discount rate aspects to consider in the research;
 - (d) Research methodology;
 - (e) Research output;
 - (f) Resources and timing; and
 - (g) Appendix A: Summary of comment letters on 2011 Agenda Consultation discussing discount rates.
7. This paper does not ask any specific questions, instead it is looking for comments or suggestions on the proposed approach.

Summary of the proposed approach

8. The objective of this research project is to review discount rate requirements and identify any inconsistencies that the Board should consider addressing. The main output of the project will be a report, which will consider whether there are any inconsistencies that the IASB should consider addressing and how this could be done.
9. To appropriately communicate the limited scope of the current project, we propose to elaborate the project description to say ‘Discount rates – review of existing requirements’.
10. We propose that the research on discount rates should focus on reviewing measurements that already require use of present value technique and for which the

objective of measurement is not fair value. This will include review of current guidance as well as of guidance in development.

11. This review would include:
 - (a) Present value measurement objectives set in individual standards;
 - (b) Discount rate components included in the present value measurement;
 - (c) Measurement methodology;
 - (d) Disclosure requirements; and
 - (e) Definitions and terms used.

12. In conducting the research, we would mostly rely on a desktop study of requirements and related literature, supplemented by interviews with a small selection of stakeholders.

Scope of the discount rates research

Research objective

13. The objective of this project, as stated in the Feedback Statement on the 2011 Agenda Consultation, is to examine existing discount rate requirements. We propose to also review relevant requirements in development, either by the IFRS IC or the IASB. The objective of the review of current projects would be not only to identify potential inconsistencies but at the same time work with the teams to resolve them before the guidance is finalised. On this basis, the proposed scope of the research is outlined below.

Existing discount rate requirements

14. We propose to focus our research on measurements that already require use of present value techniques and for which the objective of measurement is not fair value.

15. IFRS 13 *Fair Value Measurement* is a recent standard and will be subject to a separate review in due course. We do not envisage carrying out research to identify whether the IASB should consider making any changes to IFRS 13.

16. Some IFRS measurements rely on past or future cash flows but prohibit discounting, such as net realisable value of inventories, or prepaid expenses. Whilst we will mention those we do not propose to do any significant work on them. We see the purpose of this project as being to assess current discount rate requirements and not whether to extend the use of discounting.
17. Some IFRSs require discounting for purposes other than measurement, for example when assessing whether an exchange transaction has commercial substance, in accordance with IAS 16 *Property, Plant and Equipment*. Again, we propose only to mention those, as we see the project being primarily concerned with the discount rates used for measurement.
18. Based on the above approach, the main standards that we would review are:
 - (a) IAS 19 *Employee Benefits*;
 - (b) IAS 36 *Impairment of Assets*;
 - (c) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*;
 - (d) IFRS 9 *Financial Instruments* (for amortised cost measurements only).
19. As the projects revising requirements in IFRS 4 *Insurance Contracts* and IAS 17 *Leases* are currently in progress, we have focussed on reviewing the proposals and not the current requirements in detail. We are also reviewing changes to IFRS 9.

Ongoing IASB projects

20. Discount rate requirements are currently being revised in two major projects; Leases and Insurance Contracts, and requirements are being clarified in the project on IFRS 9 *Classification and Measurement*. Discount rates are also discussed in IFRS 9 *Financial Instruments - Impairment* project. We will continue to liaise with the teams to ensure any differences are explained and the guidance provided is consistent, even when rates used are different.
21. The project *Financial Instruments: Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* also discusses discount rates – we are also liaising with that team.

22. We have also liaised with the Revenue team on discount rate drafting in the new Standard on Revenue.
23. Some other research projects also consider discount rates, in particular rate regulation and employee benefits research and we are keeping in contact with the project staff.
24. The *Conceptual Framework* project considers measurement and we are liaising with the team on anything relevant to discount rates in the forthcoming Exposure Draft.
25. We will also liaise with the team working on the Comprehensive Review of the IFRS for SMEs on any discount rate related issues.
26. We will keep the teams informed of the progress on the project and discuss any issues relevant to their work. This includes reviewing papers or drafting relevant to discount rates prepared by respective teams and helping them ensure consistency.
27. In working with the teams, we will seek to resolve any identified issues immediately and will document this work in the research report.

Work by the IFRS Interpretations Committee

28. The IFRS Interpretations Committee (IFRS IC) regularly receives requests for interpretations relating to discount rates. We have identified about a dozen issues related to discount rates discussed by the IFRS IC so far – the same number as the standard with highest number of issues referred to the IFRS IC (see IFRS IC paper 17B for September 2013). However, most of these have resulted in agenda decisions (a decision that the IFRS IC is not going to address an issue), and there are a few outstanding issues, some of them being put on hold. We will continue to liaise with the team on their current issues relating to discount rates to help address any inconsistencies.

Discount rate aspects to consider during the research

29. In performing the research, we propose to look at several aspects of discount rate requirements:
 - (a) Measurement objective: the measurement objective for a particular Standard guides the discount rate to be used in measurement. Different

measurement objectives may require different rates. We will look at whether the measurement objectives in individual standards are clear and whether they are consistently reflected in the discount rate used for measurement.

- (b) Discount rate components: time value of money, currently represented in the IFRS guidance¹ by a risk-free rate on monetary assets (IFRS 9 *Financial Instruments* B13 (c), IFRS 13 *Fair Value Measurement* B13(c), IAS 36 *Impairment of Assets*, 30(c)), is a component used in all present value measurements that rely on discount rates. Some present value measurements also include other components, reflecting various risks; we will look at which components are included in determining the discount rate to use and how they are described.
- (c) Measurement methodology: this considers the level of detail included in describing present value methodology and its consistency; for example whether risks can or should be considered either in the rate or in the cash flows, whether they are considered from an entity perspective or a market perspective etc. We will also look at how inflation and tax are considered in the rate.
- (d) Disclosure requirements related to discount rates: Investors and analysts are often interested in disclosures surrounding present value measurements and thus we think these should be reviewed. We propose to review them with a particular focus on consistency across standards. We expect the results of this aspect of the research to feed into the Disclosure Initiative work and not be a part of any work on discount rates.
- (e) Definitions and terms: Some requirements refer to risk-free rates, others refer to time value of money; we will research which terms are used in describing present value methodology, whether they are defined or explained, and whether they are used consistently across standards.

¹ IAS 19 and IAS 37 also mention time value of money, but are not as explicit in saying what it is represented by.

Research Methodology

30. Most of the research work will be performed as a desktop study of IFRS requirements and proposals on active projects discussed in the Scope section. This includes:
 - (a) Review of requirements as set out in the guidance and the related Bases for Conclusions;
 - (b) Review of a selection of relevant staff papers and the related board discussion.
 - (c) Review of more recent comment letters that discuss discount rates.
31. In addition to researching IFRS requirements, we will look at relevant books and academic work published as well as guidance published by major accounting firms and guidance in other GAAP.
32. We propose to complement the desktop study with a selection of interviews with internal and external stakeholders. This input will help us understand whether there is a problem with inconsistent discount rate requirements that the IASB needs to consider. Key project stakeholders are discussed in the next section.
33. We do not propose to form an advisory group for the project at this moment but will instead liaise with key stakeholders as set out below.

Who are the key stakeholders?

34. As discussed above, we propose, as a part of this stage of research, to do limited and informal outreach with the stakeholders. In the following paragraphs we discuss the key stakeholders.
35. Investors and analysts are primary users of financial statements. We propose to reach out to them to find out whether they have problems related to discount rates, whether it is a problem with the rate used, a problem with arriving at a rate or a problem with related disclosures. We would reach out to investors through our investor advisory group members, Capital Markets Advisory Committee.
36. Discount rates are at the core of work of actuaries and valuation professionals. They are represented by two global organisations, the International Actuarial Association (IAA) and the International Valuation Standards Council. We will be liaising with

both and also reviewing the work they have done on discount rates, such as IAA's Discount Rate Monograph.

37. Preparers and audit professionals would be familiar with any practical issues and inconsistencies in applying discount rate requirements. We propose to reach out to preparers through members of our preparer advisory group, the Global Preparers Forum. We propose to reach out to auditors individually via informal discussions.
38. We also propose to consider whether discount rate guidance and disclosures give rise to any issues with enforcement. This can be achieved by reviewing regulatory documents.
39. National standard-setters are natural stakeholders in all standard-setting work. Some of national standard-setters are also working on discount-rate related issues and we will liaise with them.
40. Many academics have researched discount rates with respect to inconsistencies in IFRS requirements. We will review this work and also consider whether there are any specific topics we want to ask the academic community to help us with.
41. Whilst liaising with key stakeholders, we will ensure to have appropriate geographic coverage.
42. In addition to external stakeholders, the project has a number of internal stakeholders – these are project teams that work on discount rate requirements in their projects and their advisers which we discussed in the section Ongoing Projects.

What evidence of inconsistency in discount rate requirements will we look for?

43. Once potential inconsistencies are identified, we would look for evidence on whether these inconsistencies lead to problems in financial reporting, such as:
 - (a) Differences in interpretation lead to significant divergence in practice, or lack of guidance leads to significant divergence in practice; or
 - (b) Existing guidance, or the lack of it, creates opportunities for earnings management; or

- (c) Users make adjustments to discount rates or ask questions on what is being reported (information asymmetry) – this could also be indicative of a wider measurement issue and not just an inconsistency.
44. The financial reporting problem not only needs to exist but it has to be significant in order to be addressed by the IASB. We would assess the significance of any identified inconsistencies, using the following indicators:
- (a) Is the issue limited to certain jurisdictions or global?
 - (b) What types of entities or industries are affected by it?
 - (c) How pervasive or acute is a particular issue likely to be for entities?
45. We would also consider whether any significant problems identified are solvable by the IASB. We would do this by researching the possible approaches to solving the problem and by doing a preliminary analysis of their effects.

The research output

46. The Due Process Handbook identifies two main outputs from research projects, Discussion papers and Research papers. Whilst they are described similarly, a Discussion paper is a more formal document, requiring balloting and including a formal request for comments with a comment letter deadline and a comment letter summary to be presented to the IASB.
47. We think a Research paper, and not a Discussion paper, might be a more appropriate output from the discount rate research project. The discount rate research is intended to identify any potential issues with discount rate requirements, and it might find that there are no issues. As producing a research paper is less resource intensive (for staff, and the IASB as well as external stakeholders) than producing a discussion paper, it might make sense to only commit to preparing a research paper which will discuss whether there is a problem that the IASB needs to consider addressing. Although a research paper would not have a formal request for comments it would be a public document and interested parties would not be prevented from providing feedback.

48. We envisage that the paper will describe the findings of the research work described in previous sections and discuss some possible ways forward. We will keep an eye on the question of the best form of publication as the project progresses.
49. Other, more informal output is input provided to other project teams who work on discount rates on their respective projects, via discussions or written comments on their papers and draft documents. We can also document this work in the research paper.
50. We propose to consider the following possible ways forward in the research paper:
- (a) No further action after issuing the research paper;
 - (b) Follow-up research in specific areas to gather more evidence about inconsistencies;
 - (c) Proposal to prepare guidance on discount rates and:
 - (i) include it in the *Conceptual Framework*; or
 - (ii) include it in a non-authoritative staff paper posted on the IASB website; or
 - (iii) publish it as a stand-alone standard; or
 - (iv) use it as an internal guide for standard-setting.
 - (d) Define narrow-scope improvement project(s) to deal with any issues identified on a level of individual standards.
51. We do not propose to discuss these alternatives until we have made more progress with the research, as the recommended approach will depend on the issues identified. Different ways forward are not mutually exclusive and could be combined.

Resources and timing

52. We have one staff member working approximately half – time on the project. At this point, we do not envisage allocating further internal resources to the research.
53. Several national standard-setters have expressed interest in working with us on this research and we are exploring the best way to work together. It may make sense to get them more involved with specific issues, once those are identified.

54. In addition, we will explore getting help from the academic community with conducting an academic literature review. Academic literature on discount rates is quite broad and any review will have to be focussed.
55. We expect to report to the Board periodically on the progress and main findings, giving the Board the opportunity to discuss the analysis in public. We expect to prepare a draft research paper in November 2014.

Question for the Board

Does the Board agree with the suggested approach to the research on discount rates – review of existing requirements? Do you think any changes are needed and why?

Appendix A: Summary of comment letters on 2011 Agenda Consultation discussing discount rates

- A1. From 247 comment letters received on the 2011 Agenda Consultation, 47 discussed a potential project on discount rates.
- A2. Most of those respondents thought the IASB should do a limited-scope project on discount rates. A few respondents suggested a comprehensive review, but a few thought no work was needed.
- A3. Many of those respondents who thought no work on discount rates was needed justified this by IFRS 13 having been issued, which provides guidance on discount rates in determining fair value. Other respondents were concerned that any project on discount rates might result in a rules-based approach.
- A4. Some respondents suggested that the purpose and role of discounting should be addressed in the Conceptual Framework project before any Standards-level work was started. Others thought that it is best dealt with at Standards level, because each Standard has different measurement objectives, meaning that cross-cutting examination would not be meaningful.

Suggestions for a limited-scope project

- A5. The respondents who thought the IASB should carry out a limited-scope project on discount rates mainly focused on improving the consistency of guidance in different Standards that do not rely on the guidance in IFRS 13. For example:
- discount rates can have significant impact on key figures included in financial statements. It would be a useful improvement if more consistent guidance could be given as to how to determine discount rates. This would assist preparers and auditors and would improve the confidence with which users rely on key figures that are a function of discount rates.
(CL 82)
- A6. Some respondents provided specific suggestions on how to improve consistency, for example by asking for guidance on the use of pre-tax vs post-tax rates. Those respondents thought that only post-tax rates should be used.

- A7. Several respondents asked for more guidance including:
- a. detailed guidance on the determination of the risk-free rate used in IAS 19 *Employee Benefits*. For example:

Further, the recent significant surge in some or rather many European countries government bonds yields offers a new challenge of how to define the risk free rate. CL 150
 - b. Some respondents focused on the requirements in IAS 19, commenting on the volatility that results from switching from the discount rates on corporate bonds to those on government bonds. Others also remarked that the IAS 19 requirements were rule-based.

Comprehensive project suggestions

- A8. Most respondents who were in favour of a comprehensive review of discount rates suggested a project that would define and describe how to determine discount rates. Such a project would be similar to the project on fair value, which produced IFRS 13 *Fair Value Measurement*. Some of those respondents went a step further, also requesting that guidance on how to account for interest should be included as a part of the project. For example:

There are many standards that require the use of a "discount rate" (e.g., IAS 2, IAS 16, IAS 37, IAS 38 and IAS 39), but the Conceptual Framework and those standards are weak on providing guidance on determining the discount rate and on how to account for the interest (difference between the future value and the present value). We believe that this subject would merit a comprehensive project, similar to the Fair Value (IFRS 13).

- A9. Some of those respondents commented on perceived unexplained inconsistency in the guidance on discount rates in existing IFRSs; for example:

There is currently no guidance on the use of discount rates, and different standards have different discount rate requirements without the appropriate justification to explain the

difference. For example, IAS 19 and IAS 37 Provisions, Contingent Liabilities and Contingent Assets both aim to give a present value figure of the liability by using a discount rate. However, the discount rates required by each standard are different, and the justification for this difference is not apparent.

Other suggestions

- A10. Some of the user respondents asked for more disclosure about key assumptions used in discounting and when using discounted cash flows in general.
- A11. A respondent from an emerging market asked for uniform treatment of the financing components included in a forward price, commenting that different treatments are required in IAS 2, IAS 16, IAS 38, IAS 39, IAS 37.