International Financial Reporting Standards

Present value measurements – discount rates

Research findings and the need for change

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The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

Objectives of the session

- Present research findings;
- Obtain feedback on the findings and explore the need for change;
- Preliminary discussion of the ways forward.

Previous discussion with ASAF

- Discussion of project scope in September 2014, the main advice being:
  - Consider whether to expand use of present value measurement
  - Consider effect on performance reporting
  - Consider cash flows together with discount rate

Research objective

- Review discount rate requirements in IFRS and:
  - Identify any inconsistencies
  - Consider whether the IASB should address those inconsistencies.
- The research considers the following aspects:
  - Use of present value measurement
  - Impact on performance reporting
  - Measurement objectives
  - Discount rate components
  - Measurement methodology
  - Terms and definitions

Use of present value measurement

- Present value measurement is widely used in IFRS

Discount rate	PV as the only measurement technique	PV as a threshold measurement	PV as one of measurement techniques
Historical discount rate	Leases, financial instruments measured at amortised cost		
Current discount rate	Provisions, Insurance Contracts, Defined benefit liabilities	Value in use for non-financial assets	Assets and Liabilities measured at Fair Value
No discounting (measuremend includes cash flows only)	Deferred tax, Prepayments	Net realisable value for inventories	

- Also used for financing component in IFRS 15, discounting of the expected costs to sell in IFRS 5, assessing substance of exchange transaction in IFRS 9

When is PVM not used?

- the measurement of inventories at net realisable value in accordance with IAS 2 *Inventories* does not take into account the time it would take to sell inventories or put inventories into use;
- requirements for accounting for deferred taxes do not permit discounting (but some automatically discounted);
- prepaid expenses, which are generally measured as the aggregation of past cash flows (some being addressed by IFRS IC);
- property, plant and equipment and intangible assets carried at cost in accordance with IAS 16 *Property, Plants and Equipment* and IAS 38 *Intangible Assets*;
- when not material.

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Use of PVM – is there a need for change?

- Calls from some to extend use of PVM, especially:
  - Prepayments made, very common in emerging economies and in some industries (eg mining)
  - Deferred taxes, some analysts make adjustments to reflect time value of money, some local GAAP require discounting at the moment
- Consider interaction with work of IFRS IC on prepayments and research project on income taxes

Question 1 for ASAF

Do you have any comments on where is present value measurement used in IFRS?

In your opinion, is there a need for change (ie should the IASB require present value to be used for any of the areas on slide 7) and if so why?

Subsequent measurement and performance reporting

- Unwinding of discount recognised as interest cost, but:
  - Different terms used (finance charge, finance cost etc)
  - Not always presented as interest cost on the face of profit or loss, eg IAS 19
- Reassessment arises when PVM used as only measurement method

Remeasurement effect

	Pensions	Provisions	Insurance Contracts
Discount rate	Other comprehensive income	Profit or loss	Accounting policy choice
Cash flows	Other comprehensive income	Profit or loss	Profit or loss

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Effect on performance reporting – is there a need for change?

- Calls from some for consistent presentation of interest cost on the face of profit or loss
- Calls from some for consistency in the presentation of effects of reassessment
  - Preparers prefer OCI to avoid volatility
  - Some others prefer profit or loss
- Consider interaction with the Conceptual Framework and Performance Reporting Research

Question 2 for ASAF

Do you have any comments on the impact of present value measurement on performance reporting in IFRS?

In your opinion, is there a need for change in this area?

Measurement objectives

- Individual objectives in Standards identified, or inferred where not explicit
- Mapped to measurement objectives included in the Conceptual Framework Exposure Draft

Conceptual Framework ED – proposed measurement bases

Measurement bases

Historical cost	Current value
Measures based on historical cost provide monetary information about assets, liabilities, income and expenses using information derived from the transaction or event that created them.	Measures based on current value provide monetary information about assets, liabilities, income and expenses using information that is updated to reflect conditions at the measurement date.

Measurement based on:

Market participant's assumptions	Entity-specific assumptions
Fair Value	• Value in use (assets) • Fulfilment value (liabilities)

Objectives in individual Standards

- Objective often not explicit

Item measured	Objective explicit	Measurement objective (as described or inferred)	Proposed *Conceptual Framework*
Defined benefit obligation (IAS 19)	✗	Present value of ultimate cost	Fulfilment value
Impaired non-financial asset (IAS 36)	✓	Value in use	Value in use
Provisions (IAS 37)	✓	Amount required to settle or to transfer the obligation	Fulfilment value
Insurance contracts (2013 ED)	✗	Present value of net cash flows expected to fulfil	Fulfilment value
Lease liability (2013 ED)	✗	Cost	Historical cost
Financial instruments at amortised cost (IFRS 9)	✗	Amortised cost	Historical cost

Notes

1. Although fulfilment value is the closest matching measurement basis for the IAS 19 measurement, the IAS 19 measurement is quite different.
2. Value in use is not a measurement basis per se, but a part of a threshold measurement that an asset cannot exceed.

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Measurement objectives – is there a need for change?

- Calls from many for an explicit and clear objective in IAS 19:
  - Hard to interpret rules-based guidance, eg what is high quality, when is a market deep
  - Some jurisdictions have no corporate bonds and their governments do not issue bonds either (eg oil-rich countries)
- Is IAS 19 information comparable to <u>information required by other standards</u> for similar liabilities?
- Consider interaction with IAS 19 research project

Measurement objectives – is there a need for change? (continued)

- Some ask for an explicit single measurement objective in IAS 37 – current objective perceived as dual, possibly conflicting:
  - – Possible inconsistencies in application
- Consider interaction with IAS 37 research project
- Calls from some to scrap value in use altogether and just use fair value for impairment in IAS 36– value in use creates unnecessary complexity
- Consider interaction with IAS 36 research project

Question 3 for ASAF

Do you have any comments on the present value measurement objectives?

In your opinion, is there a need for change in this area?

Components of present value measurement

- All present value measurements include:
  - Future cash flows;
  - Time value of money ('risk-free rate');
- Some present value measurements also reflect:
  - Possibility that cash flows may be different (risk premium);
  - Possibility of default (non-performance risk);
  - Market illiquidity risk (liquidity premium);
  - Profit margin
  - Other items, such as transaction costs.
- Same components can be measured differently depending on whose perspective is considered

Entity vs market perspective

Standard / Project	Item measured	Measurement atribute	Cash flow perspective	Rate perspective
IFRS 13	Assets and liabilities at fair value	Fair value	market	market
IAS 36	Non-financial assets (impairment)	Value in use	entity	market
Insurance Contracts	Insurance liability (or an asset)	Present value of amount to fulfil	entity (consistent with market)	entity for risk, market for the rest
IAS 37	Provisions	The amount to settle or transfer	entity (implicit)	market
IAS 19	Defined benefit plan obligation	Present value of ultimate cost	entity	market

- Is there a difference between an entity-specific measurement and entity's perspective in a measurement
- Question whether market participant perspective is different from entity perspective

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Components of PVM in IFRS

IFRS / Project	Item measured	Measurement description	Central estimate of cash flows	Time value of money	Risk premium	Liquidity premium	Own non-performance risk
IFRS 13	Assets and liabilities at fair value	Fair value	Yes	Yes	Yes	Yes	Yes
IAS 36	Non-financial assets (impairment)	Value in use	Yes	Yes	Yes	Yes	n/a
Insurance Contracts	Insurance contract*	Present value of net cash flows expected to fulfil	Yes**	Yes	Yes (separate)	Yes	**No**
IAS 37	Provisions	The amount to settle or transfer	Yes	Yes	Implicit	**Not explicit**	**Not explicit (in practice no)**
IAS 19	Defined benefit plan obligation	Present value of ultimate cost	Yes	Yes	**No**	**Some*** **	**Some*** **

* Insurance contract can be a liability or an asset
** Includes both a cash flow component and a contractual service margin (CSM). The table does not mention the CSM.
*** Included to the extent that these are included in the rate of bonds used; the components are not entity-specific.

Components of PVM – is there a need for change?

- Calls from some for more clarity on which components of discount rates are included in which measurements and which perspective they consider – linked to clearer measurement objectives.

Question 4 for ASAF

Do you have any comments on the components of present value measurement?

In your opinion, is there a need for change in this area?

Measurement methodology

- Main principles identified
  - Do not double-count
  - Use internally consistent assumptions
  - Include everything
- Main aspects considered
  - How are risk adjustments reflected?
  - How is impact of tax reflected?
  - How is impact of inflation reflected?

Measurement methodology in IFRS

Standard/ Project	Item measured	Measurement attribute	Adjustment in rate or cash flows	Rate pre-tax/ post-tax or either	Rate real/nominal or either
IFRS 13	Assets and liabilities at fair value	Fair value	either	either	either
IAS 36	Non-financial assets (impairment)	Value in use	either	pre-tax	either
Insurance Contracts	Insurance liability/asset	Present value of amount to fulfil	either	pre-tax (implicit)	either
IAS 37	Provisions	The amount to settle or transfer	either	pre-tax	either (implicit)
IAS 19	Defined benefit plan obligation	Present value of ultimate cost	n/a	pre-tax	nominal (unless real more reliable)

Measurement methodology – is there a need for change?

- Calls from many to eliminate requirement to use pre-tax rates in IAS 36 = post-tax rates used in practice and conversion to pre-tax not straight-forward and considered unnecessary
- Calls from some to explain measurement interaction with tax in general, terms post-tax and pre-tax and their relationship often misunderstood
- Perceived need for more methodology guidance in general, for example via education materials, in particular for emerging economies.
- Consider interaction with valuation community and IASB experience with developing education materials in past

Question 5 for ASAF

Do you have any comments on the present value methodology?

In your opinion, is there a need for change in this area?

PVM and alternative performance measures

- Pro-forma earnings (preparers) and street earnings (investors)
- Few adjustments to IAS 19 since revised IAS 19 in effect since 2013
- Adjustments to IAS 37:
  - Some equity investors ignore decommissioning liabilities, different approaches between various credit analysts
  - Pro-forma earnings often exclude litigation expenses, also some street earnings
- Adjustments to IAS 36
  - Impairment losses excluded from pro-forma and from street earnings

The way forward

- Research Paper or an education document explaining differences in discount rates
- Then, a number of options:
  - No further action;
  - Discussion papers in specific areas where need for change identified;
  - Prepare guidance and embed in the Conceptual Framework;
  - Discussion paper for stand-alone Standard on discounting.
- Options not mutually exclusive

Question 6 for ASAF

Overall, what opportunities and risks do you see arising from discount rates research?

How do they affect the next steps on the project?