GPF meeting, 5 March 2015
Agenda paper 7

Discount rates research

Input from GPF members

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

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Objectives of the session

- Introduce research project, key areas under review as well as some initial findings;
- Obtain input from GPF members on most challenging areas of present value measurement requirements in IAS 19 *Employee Benefits*, IAS 36 *Impairment of Assets* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Research objective

- Review discount rate requirements in IFRS and:
  - Identify any inconsistencies
  - Consider if the IASB should address those inconsistencies.
- The research considers the following aspects:
  - Measurement objective
  - Discount rate components
  - Measurement methodology
  - Impact on performance reporting
  - Disclosure requirements
  - Terms and definitions.

Aspect: Measurement objective

- Is the measurement objective in a Standard clear?
- Are present value techniques applied in that Standard in a way that is consistent with the stated measurement objective:
  - In drafting?
  - In practice?

Aspect: 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.

* Uncertainties in amount or timing of future cash flows are dealt with using techniques including central estimates (such as expected value, mode or median) and maximum or minimum

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Initial findings: Components of PVM

IFRS / Project	Item measured	Measurement description	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
IAS 36	Non-financial assets (impairment)	Value in use	Yes	Yes	Yes	n/a
Insurance contracts	Insurance contract*,**	Present value of net cash flows expected to fulfil	Yes	Yes (separate)	Yes	No
IAS 37	Provisions	The amount to settle or transfer	Yes	Implicit	Not explicit	Not explicit (in practice no)
IAS 19	Defined benefit plan obligation	Present value of ultimate cost	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 these are included in the rate of bonds used; the components are not entity-specific.

Aspect: Measurement methodology

- Rate observed or built (bottom-up or top-bottom);
- Pre-tax or post-tax and real vs nominal;
- Entity vs market perspective; in cash flows and in the rate;
- Adjustments to the cash flows or the rate;
- Detail of guidance included in the Standard.

Initial findings: Measurement methodology

Standard / Project	Item measured	Measurement attribute	Bottom-up or top-down	Rate pre-tax/post-tax or either	Rate real/nominal or either	Cash flow perspective	Rate perspective	Adjust rate or cash flows
IFRS 13	Assets and liabilities at fair value	Fair value	either	either	either	market	market	either
IAS 36	Non-financial assets (impairment)	Value in use	either	pre-tax	either	entity	market	either
Insurance contracts	Insurance liability	Present value of amount to fulfil	either	pre-tax (implicit)	either	entity	entity for risk, market for the rest	either*
IAS 37	Provisions	The amount to settle or transfer	not explicit	pre-tax	either (implicit)	entity (implicit)	market	either (implicit)
IAS 19	Defined benefit plan obligation	Present value of ultimate cost	n/a	pre-tax	nominal (unless real more reliable)	entity	market	n/a

*risk adjustment is a separate measurement

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Initial findings: Measurement methodology – continued

Tax

- Pre-tax inputs predominantly required but this can create issues, one reason is that pre-tax rates are not always observable;

Inflation

- Mostly nominal inputs used; real rates (and corresponding, real CFs) are used for long-term liabilities per IAS 37;
- More instances of negative rates in practice (Japan, more recently Germany, Switzerland); even for nominal rates.

Risk adjustments

- Required in IAS 36 and IAS 37*, either as adjustments to the rate or cash flows. In practice adjustments to cash flows encouraged because of better accuracy (in theory should give same results).

*risk adjustment also proposed for insurance contracts, but as a separate measurement

Aspect: Performance reporting

- Analyse:
  - differences in performance reporting due to differing requirements relating to discount rates;
  - differences in performance reporting due to different methodologies used;
  - how investors use performance reporting information related to discount rates.

Initial findings: Discount rate impact on performance reporting

- Amount of interest recognised will depend on the rate applied as well as on the base to which the rate is applied. These can be different due to different components included in the measurement, eg whether risk adjustment is reflected or not.
- Differences in methodology will not impact total P&L but will affect allocation between interest and other P&L items, eg whether risk adjustment is reflected in the rate or in the cash flows.
- Differences in use of OCI also impact P&L:
  - reassessment of IAS 19 rate goes through OCI;
  - reassessment of IAS 37 rate goes through P&L;
  - in proposed Standard, insurance entities can use OCI for changes in discount rate (accounting policy choice).

Aspect: Disclosures

- IAS 36 requires rate disclosure, IAS 19 too, no explicit requirement in IAS 37 (but disclosure of charge due to effect of time value of money required).
- IAS 36 disclosure does not apply at every level (eg no disclosure by CGU, also no disclosure of rate required if assets not impaired).
- IAS 36 pre-tax rate requirements can be a practical challenge.

Preliminary feedback from investors

- Like IAS 19 rate because it is market-based
- Lack trust in IAS 37 rate because it is not perceived as truly current
- Some do not value IAS 36 information, think companies have too much room for manoeuvre and the impairment happens too late =>rate therefore irrelevant

Preliminary feedback from investors – continued

- Differing approaches to IAS 37 long-term liabilities
  - Some equity analysts ignore completely
  - Some credit analysts include interest expense in financing costs (and treat liability as debt)
  - Other credit analysts treat interest as an operating item
- Like better disclosures, eg disclosure of cash flow assumptions and reference used for the rate in IAS 19 (eg IBOX), disclosure of rates by CGUs for IAS 36
- Some investors adjust deferred tax assets to discount them

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Questions for GPF members

- What are the most common issues you have come across in applying discount rate requirements:
  - in arriving at the rate to use?
  - in providing disclosures?
  - in explaining the rate used to the investors?
- Do you think there are inconsistencies with discount rate requirements in IFRS?
- Do you think there are any issues with discount rates that the IASB should address?

Thank you

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