EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG BOARD MEETING

Discounting with Current Interest Rates

Project status and ways forward

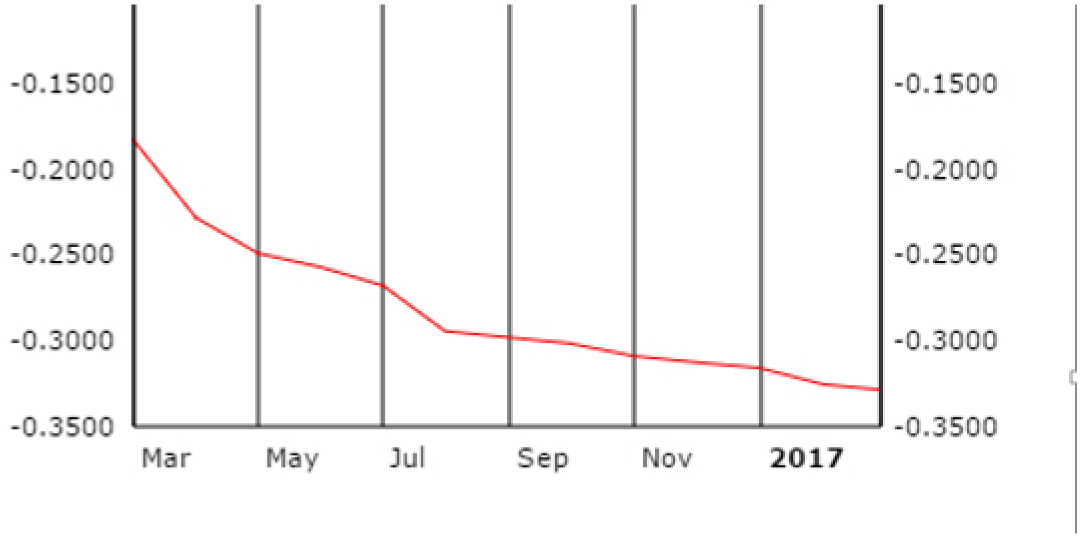
Objective

1 The objective of this paper is to provide a summary of the discussions around the topic of discounting in the current interest rate environment, and decide on how to proceed forward.

Current interest rate environment[1]

2 The interest for this topic arose from the current level of interest rates in the Eurozone, as well as other regions. While there has been a marginal increase in the last weeks, interest rates continue to be at historical low levels. Since March 2016, the ECB has left its benchmark refinancing rate unchanged at 0%.

3 The first chart below shows the trend in the Euribor 3 months over the last year:



4 The following table compares the yields of Triple-A government bonds in Europe for different durations. In July, yields for 10-year bonds entered in negative territory, while in July 2015 5-year durations were still offering positive yields. In the last 12 months, rates have been substantially unchanged.

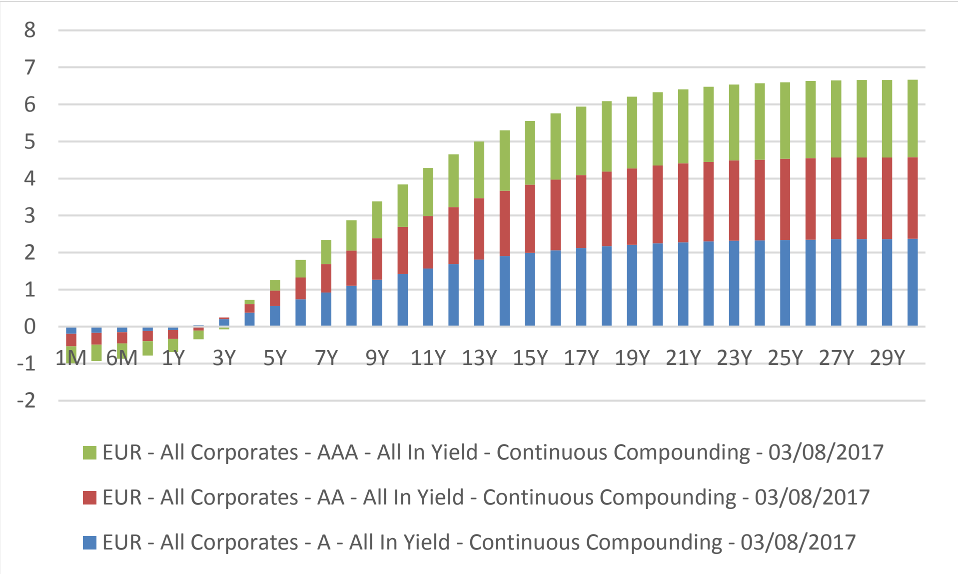
[1] Data as at 15 March

Duration	Latest Value	1 Month Prior	1 Year Prior
3 Month	-0.89	-0.73	-.049
1 Year	-0.90	-0.76	-0.50
2 Year	-0.88	-0.78	-0.52
5 Year	-0.45	-0.38	-0.32
7 Year	-0.08	0.00	-0.05
10 Year	0.37	0.45	0.33
15 Year	0.82	0.88	0.75
20 Year	1.07	1.11	0.99
30 Year	1.31	1.34	1.24

5 Government bonds in Europe reached historical lows in the second half of 2016. In July 2016, 10-year German bonds entered into negative territory, while in September 10-year French bonds reached 10bp. 10-year French bonds were below 100bp almost without interruption in 2015 and 2016.

6 The trend does not affect only Government bonds – which may be perceived as relatively risk-free – but also corporate bonds. The average yield on investment-grade corporate bonds in euros dropped to 0.61 at the end of August, the lowest in Bank of America Merrill Lynch index data going back to 1998. In September the FT reported on the first ever negative yielding euro corporate bonds sold by non-state owned companies.

7 The following chart illustrates the current yield curves for investment-grade corporate bonds in Euro for different durations.



8 These charts show that the period of near-zero interest rates is continuing and their level may not turn around soon.

What are the perceived issues with near-zero and negative interest rates?

9 Various IFRS Standards require assets or liabilities to be measured at the present value of the future cash inflows or outflows. Some of these Standards require the discount rate to be updated at each reporting date. Different concerns have been raised about the implication of near-zero and negative discount rates.

10 In the presence of **negative discount rates,** the present value of an asset or liability would exceed its ultimate recoverable or settlement amount. Some consider that this outcome is counterintuitive, because an entity may not be willing to settle a liability for an amount higher than the ultimate settlement amount. However, EFRAG TEG disagreed with this assessment – in a negative rate environment, the present value of a future cash flow is higher, because there is a cost to hold cash.

11 In the presence of **near-zero discount rates,** the impact of minor changes can result in very significant remeasurement. The following table illustrates the absolute and relative impact of a change in 100 basis point on the present value of an amount of 100 discounted for 20 years:

	Absolute change	Relative change
From 10% to 9%	2.98	20.0%
From 2% to 1%	14.66	21.7%

A shift 10% to 9% increases the present value from 14.86 to 17.84, while a shift from 2% to 1% increases the present value from 67.30 to 81.95.

12 Some claim that when these impacts become too large, reporting them in profit or loss does not properly depict the entity's performance. For instance, one major energy company disclosed in its 2014 report that a change in 20 basis points to the rate applied to discounting its provision related to domestic nuclear generation would amount to approximately 10% of its pre-tax result.

13 It is also pointed out that these impacts may be subject to reversal before the recovery of the asset or the settlement of the liability. Moreover, there are inconsistencies across Standards about reporting the impact of changes in the discount rates, with IAS 19 *Employee Benefits* requiring to recognise them in other comprehensive income, and IAS 37 requiring the use of profit or loss.

14 It should however be remembered that IAS 37 *Provisions, Contingent Assets and Contingent Liabilities* requires the use of a free-risk interest rate only to the extent that all uncertainties surrounding the provision have already been included in the estimated cash outflows. Otherwise, the rate should be adjusted for the risks specific to the liability.

15 In the presence of **diminishing discount rates,** the carrying amounts of liabilities, especially long-term provisions like decommissioning liabilities under IAS 37 and pension liabilities under IAS 19 *Employee Benefits*, progressively increase. Some claim that this accounting outcome could lead to behavioural changes (i.e. changes in business decisions), such as companies revisiting the nature of their post-employment benefit arrangements.

16 Finally, some perceive that there is an **accounting mismatch** when the promised return on an obligation (such as pensions or participating contracts) is linked to the return generated by an asset, but the discount rate applied to the liability does not reflect this economic linkage. This perceived accounting mismatch is not related to a specific level of interest rates.

The international debate

17 EFRAG Secretariat has been informed that other jurisdictions have been debating the implications of discounting with the current interest rates. The Accounting Standards Board of Japan recently issued PITF No. 34 *Practical Solution on the Tentative Solution Regarding the Discount Rate Used to Measure Post-employment Benefit Obligations When the Bond Yield is Negative*.

18 Under Japanese GAAP, entities are required to discount their pension liabilities using the rate of high quality bonds, which include government bonds and high quality corporate bonds

19 Following the decision of the Japanese Central Bank to pursue a “yield curve control” strategy, which is to set the target yield for 10-year Japanese government bonds to 0%, government bonds with maturities equal to or less than 7 years are in negative territory. No corporate bonds are in negative territory.

20 In 2016[2], the ASBJ had debated in a public session the implications of the current level of interest rates. While no formal decision had been taken, the public discussion had indicated that the use of discount rate of zero would likely not affect the measurement in a material way.

21 PITF n. 34 allows an option to use a zero rate (a “zero floor”) for the discounting of their pension liabilities. The rationale is that an entity would not be willing to settle the liability at an earlier date for an amount that exceeds the ultimate settlement amount. An entity would not choose to do so because it has the option to hold the cash rather than investing in financial instruments with a negative return. Also, measurement of a pension liability should be based on a notion of fulfilment amount, because pension obligations are normally not traded.

22 The IASB is expected to hold in the next few months a public education session on low and negative discount rates. In an agenda paper for the IASB’s meeting in March, the IASB staff acknowledged that, whilst beyond the scope of the IASB’s research project on discount rates, the topic had triggered a public debate in the last few months.

Summary of the TEG discussions

23 Initially, the focus was on the consequences of *negative rates* in the accounting for financial instruments. EFRAG Secretariat identified 5 possible issues in relation to the application of negative rates to financial instruments:

(a) Presentation of negative income;

(b) Initial recognition of instruments with a negative effective interest rate;

(c) Application of impairment;

(d) Separation of embedded derivatives for instruments with a legal or contractual zero-floor; and

(e) Hedging of sub-LIBOR exposures.

24 EFRAG TEG noted that some of these issues were already being considered by the IFRS IC (issue 1 in a IAS 18/IAS 39 environment and issue 4[3]) or that the general requirements would apply (issue 2). Overall, EFRAG TEG advised against publishing any formal position paper recommending a zero floor.

25 Following a request from the EFRAG Board to extend the discussion to near-zero interest rates, in **July 2015** EFRAG TEG debated the scope of a possible project and agreed that, while the near-zero rates do not limit the usefulness of present values, some imperfections in the current IFRS may be exacerbated in that environment and are worth investigating.

26 In **September 2015**, the EFRAG Board discussed the EFRAG TEG input and:

[2] In Japan, most of the corporations have a 31 March reporting date.

[3] Discussed respectively in the IFRIC meetings of January 2015 and September 2015.

(a) Agreed that addressing negative and near-zero interest rates are two separate issues;

(b) Rejected the proposal of a long-term research project that would embrace broad economic considerations on the time value of money and not have clear implications from a financial reporting perspective;

(c) Recommended that the Secretariat consider short papers addressing topical issues and discussing, on the basis of practical illustrations, whether the current environment is highlighting limitations of current accounting requirements and, if so, what remedies may be considered; and

(d) Agreed that the quality of the first short paper(s) would determine whether the project should be pursued.

27 In **March 2016**, EFRAG Secretariat identified some possible issues and EFRAG TEG discussed a technical paper. EFRAG TEG concluded that it did not consider low interest rates as creating specific accounting problems and were not in favour of moving away from point-in-time measurements. Some members supported more guidance on how to extrapolate rates for longer durations.

28 **In May 2016**, EFRAG TEG discussed a revised version of the technical paper and concluded that, while additional guidance could help in the areas of interactions between expected cash flows and discount rates and risk adjustments, they did not it a priority for EFRAG.

29 **In October 2016**, EFRAG User Panel discussed how the current interest rate environment affects their analysis. In general, EFRAG User Panel members stated that there was no supporting argument to move away from the use of spot rates in the measurement of assets and liabilities. Some members pointed out that if the use of spot discount rates was challenged, then a similar argument could be made about fair values.

30 In relation to the reporting of performance, views were more nuanced. Some noted that there could be a basis to exclude the impact of negative interest rates or discount rates that are close to zero from profit or loss.

31 **In October 2016**, EFRAG TEG discussed the scope of the research project and EFRAG TEG recommended that the scope of the research be narrowly defined and focus first on the implications of discounting with negative rates and the impact of interest rate volatility on financial reporting.

32 In **January 2017**, EFRAG TEG discussed whether the relevance of a present value measurement is affected by the use of negative discount rates. EFRAG TEG rejected the arguments in favour of a zero-floor and concluded that present value are relevant under negative rates, even though there may be conceptual issues to investigate around discounting.

Some possible directions for the EFRAG Research project

33 During the technical discussions with EFRAG TEG and User Panel, different views have been expressed about whether or not discounting under the current level of interest rates gives rise to an accounting issue. Some have expressed the view that discounting maintains its relevance under these circumstances, as it is simply reflecting the economic reality. Others argue that the current level of interest rates may have highlighted some limitations and application issues in discounting.

34 EFRAG Secretariat considers that there are a number of ways forward for this project. The options discussed in this paper are:

(a) Move beyond the accounting issues in the strict sense and investigate more broadly the economic phenomenon of the current interest rate environment;

(b) Discuss broadly the purpose and relevance of discounting to understand if and how it may be affected by the current interest rate environment;

(c) Identify application issues and develop guidance on those; or

(d) Terminate the project and issue a publication summarising the discussions so far.

35 The first option is based on the premise that the issue is fundamentally an economic one – therefore it would be helpful to investigate what are the factors and causes of the current interest rate environment. This may in turn provide some insight into whether or not discounting using a negative interest rate is appropriate (e.g. does it provides relevant information?)

36 EFRAG Secretariat does not dismiss this option, but it notes that it goes beyond the normal focus of EFRAG Research activities and may require specific skills and knowledge beyond what is available in-house. There has been a lot of discussion in academic (and political) circles about the topic of near-zero and negative interest rates and their implications for the economy. If the EFRAG Board supports this line of inquiry, EFRAG Secretariat would suggest as a first step to commission a literature review on the topic.

37 The second option is to assess what the purpose of discounting is and how it is currently applied in IFRS Standards. It has been pointed out that there is a lack of consistency across Standards, in relation for instance to how rates are determined, how uncertainty should be incorporated in a present value measurement or how the effects of remeasurements are presented. This analysis could result in identifying opportunities to improve the existing requirements.

38 EFRAG Secretariat notes that the focus of the IASB Research project was an investigation of inconsistencies and practical application issues around discounting. The IASB was initially expected to publish the Research summary in 2016, but at its March 2017 meeting decided to limit the output of the research project to internal guidance, such as a reference guide to support IASB staff on projects dealing with discount rates.

39 EFRAG Secretariat considers that focusing on the conceptual basis and consistency of requirements around discounting would substantially duplicate the work already performed by the IASB. So we would not advise to pursue this option.

40 The third option would be to focus more on implementation issues. There are open questions in IFRS Standards – for instance, IAS 37 allows the inclusion of risk adjustments either in the projected cash flows or in the discount rate but this could result in different measurement. Additional guidance could be explored in specific circumstances, such as extrapolation of long-term duration assets or liabilities.

41 EFRAG Secretariat considers that this line of inquiry could be helpful. However, it is doubtful if IFRS Standards should include very detailed guidance on measurement techniques which may not be consistent with a principle-based approach. EFRAG Secretariat is not aware that there is a high level of concern from European constituents and EFRAG TEG was not supportive of this approach.

42 EFRAG Secretariat notes that during the Agenda consultation specific concerns were expressed about the discount rate requirements for defined benefit pension plans. This issue will however be considered in another EFRAG Research project.

43 A final option could be to summarise the different discussions that EFRAG TEG has had during the Research project and expose them in a publication. The publication would focus more on raising awareness on the range of issues rather than proposing any specific change in the requirements.

44 EFRAG Secretariat has some reservations about the usefulness of the publication. Had the IASB intended to expose the results of its Research and suggested amendments, a publication of the EFRAG discussions may have been helpful to constituents to assess the merit of the IASB proposals. In the absence of an IASB consultation, it is not clear what input would be pursued from constituents and how it would be used.

Question for EFRAG Board

45 Which of the four options described above in paragraph 34 does the EFRAG Board support?