[EFRAG SECRETARIAT PAPER FOR PUBLIC EFRAG TEG MEETING]

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EFRAG Research Project Discounting with Current Interest Rates – Cover Note

Background of the project

Objective of the project

1 Various Standards require to measure assets or liabilities at the present value of the future cash inflows or outflows. Some of these Standards require to update the discount rate at each reporting date.

2 Different concerns have been raised about the implication of negative and low interest rates in relation to discounting:

(a) In the presence of negative discount rates, the present value of an asset or liability would exceed its ultimate recoverable or settlement amount. Many consider that this outcome is counterintuitive and does not provide relevant information.

(b) In the presence of discount rates that are close to zero, the impact of minor changes can result in very significant remeasurement. Some claim that when these impacts become too large, reporting them in profit or loss does not allow to depict the entity's real 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.

(c) In the presence of diminishing discount rates, the carrying amount of liabilities, especially long-term provisions like decommissioning liabilities under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and pension liabilities under IAS 19 *Employee Benefits*, progressively increase. Some claim that this accounting outcome could force behavioural changes in business choices, like reducing the nature of employee benefits' promise.

3 The objective of the project is to consider whether the current level of interest rates has emphasised application issues in discounting. The project accepts the conceptual premise that the concept of time value of money is a core principle in finance.

Scope of the project

4 At this stage, it has been agreed that the scope of the project is two-fold:

(a) To discuss whether discounting with a negative rate provides relevant information in all circumstances;

(b) To discuss how remeasurement of liabilities due to the reassessment of the discount rate should be presented in the statement of comprehensive income.

Past history

Past discussions of EFRAG TEG

5 EFRAG TEG and the Board had a number of discussions on the scope of the project and some application issues in discounting in the current interest rate environment.

6 At the start of the project, EFRAG Secretariat assessed 5 topics in relation to the application of negative rates to financial instruments. Finally, EFRAG TEG did not advise to publish any formal document.

7 In April 2015, some EFRAG Board members suggested extending the project to low interest rates. In July 2015, EFRAG TEG observed that:

(a) there is a case for considering accounting requirements when rates are negative;

(b) low discount rates do not limit the usefulness of present values; and

(c) some imperfections in the current IFRS are exacerbated by low interest rates and could be identified and highlighted.

8 Based on this input, a general scope project on discounting was removed from the EFRAG Research work plan. In September 2015, the EFRAG Board:

(a) agreed that addressing negative and low 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) agreed to consider short papers addressing topical issues and discussing, on the basis of practical illustrations, whether the low interest environment is highlighting the limitations of current accounting requirements in providing reliable and understandable information and if so what possible remedies may be considered.

9 In March 2016 EFRAG TEG discussed a paper that focused on the issues of extrapolation techniques for discount rates on very long duration and consistency of assumptions on cash flows and discount rates. EFRAG TEG:

(a) Confirmed 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;

(b) held the view that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* could include explicit guidance to ensure consistency in cash flow and discount rates estimates;

(c) noted that, in the current low interest rate environment, the quantitative effects of discounting are amplified and therefore some EFRAG TEG members saw a need for guidance on how to extrapolate longer term rates;

(d) recommended that, as part of its future work, the EFRAG Secretariat should explain how its project could complement the IASB's research project on discount rates and collect quantitative data on long-term provisioning and different methodologies that can be observed in practice.

10 In May 2016, EFRAG TEG discussed a revised version of the technical paper. While EFRAG TEG members expressed some support for additional guidance in IAS 37 regarding risk adjustments, there was no overall support for proceeding with the project.

11 In July 2016, the EFRAG Board reaffirmed their persuasion that the current low interest rate environment raises issues in the accounting that should be investigated. The EFRAG Board set up a working group to steer the project.

12 In October 2016, EFRAG TEG agreed to a Research Project based on the scope described in paragraph 6 above.

Past discussions of EFRAG User Panel

13 The EFRAG User Panel discussed the project and in general, the participants agreed that there was no supporting argument to move away from the use of spot rates in the measurement of assets and liabilities. Some also pointed out that if the use of spot discount rates was challenged, then a similar argument could be made about fair values.

14 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.

Future steps

15 In the April TEG meeting, EFRAG Secretariat plans to bring a paper on the presentation of remeasurement of liabilities due to reassessment of discount rate. The paper will build on prior EFRAG TEG discussion about the role of Profit or Loss and Other Comprehensive Income.

16 At the suggestion of a TEG member, EFRAG Secretariat also plans to investigate if the guidance in IAS 36 *Impairment of Assets* could provide useful elements to the selection of discount rates for liabilities.

Planned final outcome

17 The expected output of the project could be a short paper to be presented at an international event (IFASS or ASAF).

Agenda papers

18 In addition to this cover note, agenda paper 09-02 *Issues Paper Relevance of discounting with a negative rate* has been provided for the session.