This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

IASB Project Summary on discount rates in IFRS Standards
Issues Paper

Objective

1 The objective of this session is to receive any comments EFRAG TEG may have on the conclusions of the IASB's project on discount rates in IFRS Standards and the IASB's follow-up activities.

2 The session has been added to the EFRAG TEG agenda as the IASB published the Project Summary related to the project in February 2019. The publication of the Project Summary was the last activity the IASB had envisaged in relation to its discount rates research project.

Background[1]

3 Several IFRS Standards permit or require entities to measure assets or liabilities by discounting estimates or future cash flows. IFRS Standards, however, require different inputs to be reflected when discounting the estimates. The reasons for these differences are not well understood.

4 Following the IASB's 2011 Agenda Consultation, the IASB started a research project on discount rates in 2014. The objectives of the project were to:

- (a) investigate reasons for inconsistencies between requirements relating to discount rates in IFRS Standards; and
- (b) assess whether the IASB should consider addressing those inconsistencies.

5 The study was carried out by:

- (a) Performing a desktop study, including:
  - (i) a review of requirements in IFRS Standards relating to discount rates;
  - (ii) a review of topics discussed by the IFRS Interpretations Committee relating to discount rates; and
  - (iii) a limited review of empirical evidence, including a sample of financial statements and a selection of academic literature.
- (b) Targeted consultation, including:
  - (i) meetings with actuaries and valuation professionals, auditors, investors, preparers of financial statements, regulators and standard-setters;
  - (ii) meetings with the IASB's advisory bodies, including ASAF; and

[1] The section is based on the IASB's Project Summary 'Discount rates in IFRS Standards' published in February 2019.

(iii) feedback received during the 2011 and 2015 IASB Agenda Consultations.

6 The project focused on the uses of present value measurement techniques in applying a current value measurement basis. It did thus not review the use of the techniques for historical cost measurements (for example, in relation to amortised cost measurements). The project did also not consider differences due to cost-benefit considerations. The requirement in IAS 12 *Income Taxes* which does not permit discounting was considered to be a result of cost-benefit considerations as the IASC concluded that discounting of deferred taxes would require scheduling of the timing of reversal of each temporary difference.

7 The main IFRS Standards that used present value measurement techniques in current value measurements when the study was performed were:

(a) IAS 19 *Employee Benefits*;

(b) IAS 36 *Impairment of Assets*;

(c) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and

(d) IFRS 13 *Fair Value Measurement*.

8 The investigation found that the inconsistencies relating to discount rates in IFRS Standards arise in specifying either:

(a) Which types of inputs to use in a present value measurement technique (that is, a measurement technique, used in applying a measurement basis, that expresses future cash flows as a present value). The findings showed that IFRS 13 and IAS 36 are sufficiently clear about which inputs are to be used in present value measurement techniques. IAS 37 and IAS 19 are unclear. The Summary Report indicates that there could be a link between this and the fact that IAS 19 does not specify a measurement basis and that although IAS 37 specifies a measurement basis, it does not describe it clearly. The research findings show that:

(i) The measurement requirements in IAS 19 are prescriptive, including inputs that do not directly relate to the cash flows and are in some respects inconsistent with requirements for other similar liabilities. Contrary to the requirements in IFRS 13 and IAS 36 the measurement inputs do thus not include a risk premium (the price for bearing the uncertainty that the ultimate outcome may differ from the central estimate of the cash flows) and liquidity to the extent it is not implicit in the high-quality corporate bond rate.

(ii) IAS 37 is not clear on which inputs should be included in the discount rates used to measure provisions. In particular, it is unclear on whether own credit risk is included, but mixed practice is also observed in relation to whether a risk premium is included.

(b) How to determine the amount of the inputs. The findings show that:

(i) IAS 19 includes the following inconsistent requirements on measurement inputs:

- If the amount of pension benefits depends on returns on assets, there is inconsistency between cash flow assumptions and the discount rates.
- The credit risk included in the IAS 19 discount rate does not relate to the cash flows. It reflects generic credit risk but not the reporting entity's own credit risk.

(ii) The requirement in IAS 36 to use only pre-tax rates when calculating value in use seems possibly unjustified. It is not required in IFRS 13, but in IAS 37 and implicitly in IAS 19.

(iii) The interaction between tax and discount rates in present value measurements not being clear in general. The findings show that the lack of a full explanation of the interaction between tax, discount rate and present value measurement can lead to errors in reporting, including when converting post-tax to pre-tax inputs for IAS 36. This can also be the case in other IFRS Standards.

(c) When to include income or expenses in other comprehensive income, instead of in profit or loss.

(d) How to present the unwinding of interest in profit or loss. The findings show that the unwinding of interest on defined benefit obligations is presented inconsistently within profit or loss.

(e) What information to be disclosed about present value measures.

9 The study also found inconsistencies between entities in presenting the effect on profit or loss of changes in present value measures (for example, in which line the net interest on net defined benefit liability is presented).

10 The Project Summary states that some of the inconsistencies mentioned in paragraph 7 above arise because different IFRS Standards adopt different measurement bases. Other inconsistencies, mostly relating to entity-specific current value measurements, arise partly because different IFRS Standards were developed at different times and with different areas of focus.

Future steps of the IASB

11 The IASB has no plan to conduct (an additional) separate project on discount rates. In its decisions on the 2015 Agenda Consultation, the IASB decided to prioritise a smaller number of projects and expressed its expectation that the discount rates research project would come to an end without a significant amount of further work.

12 The IASB will use the findings of its study in other projects in considering:

(a) Whether and how to address some of the inconsistencies identified.

(b) How to avoid creating unjustifiable inconsistencies in the future. For this purpose, the IASB staff has prepared a summary listing matters for it to consider in future standard-setting work. This summary is not available as part of the Project Summary, however, based on an agenda paper for the March 2017 IASB meeting, the EFRAG Secretariat has in the Appendix to this paper provided a rough draft of what this summary may contain. Among other things, the summary emphasises:

(i) that requiring discounting should be considered if the effect is material;

(ii) the benefits of an explicit and clear measurement basis in future standard-setting;

(iii) that the interaction between tax and discount rates should be a matter to consider in future standard-setting projects on particular topics;

(iv) that own credit risk should be considered in relation to particular topics;

13 Some of the issues identified may be dealt with in the following IASB projects:

(a) The Goodwill and Impairment research project which is reviewing the use of pre-tax rates in IAS 36 (see paragraph 8(b)(ii) above).

(b) The project Pension Benefits that Depend on Asset Returns which is considering the inconsistency in IAS 19 arising when the amount of pension benefits depends on returns on assets (see paragraph 8(b)(i) above).

(c) If the IASB decides to consider amending any aspect of IAS 37, for example, as a result of the revised guidance on the definition of a liability in the *Conceptual Framework for Financial Reporting*, it could also consider whether to clarify which elements should be included in the measurement of provisions and specifically whether credit risk is a part of the measurement (see paragraph 8(a)(ii) above). The Project Summary, however, mentions that the IASB staff is likely to recommend limiting the scope of a project to amend IAS 37. Reviewing the measurement basis is likely to be beyond the scope of any project recommended by the IASB staff. According, the project will likely not result in a clear description of the measurement basis (see paragraph 8(a) above).

(d) The IASB's Primary Financial Statements project is considering specifications that would reduce the variety in how to report net interest on a pension liability (see paragraph 8(d) above).

14 The IASB staff has previously considered that a standards-level review of disclosures in the Disclosure Initiative could include a cross-cutting review of disclosures relating to present value measurements. The project on a Target Standards-level Review of Disclosure requirements includes a review of IAS 19 and IFRS 13. However, based on the development in the Disclosure Initiative it may not result in detailed requirements about disclosures relating to present value measurements (see paragraph 8(e) above).

15 In the light of its discussions during the 2015 Agenda Consultation, the IASB does not currently plan to address the following potentially unjustified inconsistencies:

(a) Inconsistencies in requirements on when to use other comprehensive income, rather than profit or loss, in presenting the effect of changes in present value measurements (see paragraph 8(d)). The Project Summary mentions that the *Conceptual Framework for Financial Reporting* provides high level concepts on this.

(b) Inconsistencies between IAS 19 and other requirements for similar liabilities (see paragraph 8(a)(i) above).

(c) Potential inconsistencies in practice in how tax is reflected in the measurements, and in particular the interaction between income taxes and discount rates (see paragraphs 8(b)(ii) and 8(b)(iii)).

EFRAG Secretariat notes and comments

16 It may seem unusual that the IASB in 2019 issues a Project Summary on discount rates in IFRS Standards that does not consider the most recent IFRS Standards – most notably IFRS 17 *Insurance Contracts*. The EFRAG Secretariat expects the reason to be that the analysis reflected in the Project Summary was finalised several years ago.

17 In response to the 2015 IASB Agenda Consultation, 31% of the European respondents considered the project on discount rates to be a high priority and 19% thought it was a medium priority. As 49% of European respondents did not provide a rating, the topic thus seems to be considered important by European respondents. In its response, to the 2015 IASB Agenda Consultation, EFRAG also ranked the project as important. Many standard-setters to the IASB Agenda Consultation thought the project was important as the current inconsistencies between IFRS Standards means that the quality of the IFRS Standards is not as high as it could be and because it undermines comparability.

18 While the respondents to the 2015 IASB Agenda Consultation generally thought the IASB should address the inconsistencies related to discount rates, suggestions for solutions varied. Some respondents suggested that the work done should be used to inform the IASB and aid future standard-setting or to develop a Practice Statement, rather than create new standards at the moment. The activities performed by the IASB may thus satisfy those respondents.

19 Together with ICAS (the Institute of Chartered Accountants of Scotland), EFRAG is sponsoring an academic paper on the theory and practice of discounting in financial reporting. The study is expected to be published in 2019.

Questions for EFRAG TEG

20 Does EFRAG TEG have any comments on the IASB's Project Summary, including the conclusions presented and the IASB's follow-up activities?

Agenda papers

21 In addition to this issues paper, the IASB's Project Summary has been made available as background material as Paper 05-02.

Appendix

1 As a result of the IASB's discount rates research project, the IASB staff prepared a summary listing matters for it to consider in future standard-setting work. The summary should contribute to avoid creating unjustifiable inconsistencies relating to requirements on discount rates in IFRS Standards in the future. The summary has not been made available as part of the Project Summary. However, based on an agenda paper for the March 2017 IASB meeting, the EFRAG Secretariat has tried in this Appendix to provide a rough draft of what this summary may contain.

Matters to consider

Reflecting time value of money

2 For any measurement based on future cash flows, consider the following:

(a) Can time value of money be material to the initial or subsequent measurements? It is more likely to be material if a significant passage of time is expected between the measurement date and the time when the cash flows occur.

(b) What are the costs and benefits of reflecting time value of money in a particular measurement?

3 The *Conceptual Framework for Financial Reporting* envisages time value of money as a component of current value measurements and also of historical cost measurements for financial instruments. It does not explicitly refer to time value of money in historical cost measurements of non-financial assets. You may need to consider whether to adjust the historical cost of non-financial assets for the time value of money, beyond those adjustments already made by existing IFRS Standards to capitalise interest.

Setting a measurement objective

4 Having an explicit and clear measurement objective helps decide on elements to go in the measurement and helps entities exercise judgement when applying measurement requirements. A clear measurement objective also helps investors understand what information a measurement provides and how that information relates to other measurements in financial statements.

5 Some things to bear in mind when setting the measurement objective:

(a) Present value is not a measurement objective in its own right. Present value measurement techniques are used as a means of attaining a measurement objective.

(b) Regardless of the measurement objective selected, the initial measurement is likely to be the same, with the measurement objective making more difference in subsequent measurement.

6 The *Conceptual Framework for Financial Reporting* includes discussion of factors to consider when selecting a measurement objective along with characteristics of different measurements.

Present value measurement elements

7 For any present value measurement for which you are considering a current value measurement objective, you need to consider which elements to recommend the IASB should include in the measurement.

8 Current value measurement (both fair value and entity-specific measurements such as value in use and fulfilment value) that uses present value measurement techniques use current cash flows and current discount rate. The measurement objective will determine whether to adopt a market perspective or an entity-specific

market perspective. It will also determine which risks are reflected in the measurement.

9 If the measurement is at fair value, it will often be appropriate and sufficient just to refer to the guidance in IFRS 13 of fair value measurement.

10 If the measurement is at entity-specific current value, there is no specific IFRS Standard to provide guidance on what that measurement should include (IAS 36 comes close, for assets). However, the *Conceptual Framework for Financial Reporting* has some discussion on this. Some of the guidance on present value measurement techniques in IFRS 13 may also be useful, but it will need to be adapted if some or all characteristics of the measurement objective selected differ from the characteristics of fair value. Some things to consider in relation to entity-specific current values include:

(a) Which measurement elements are to be measured from the entity's own perspective (and thus potentially different from elements included in fair value measurement), and which from a market perspective (and thus consistent with elements included in fair value measurement)? Typically, an entity specific measurement would reflect the entity's perspective in estimating future cash flows. An adjustment for risk, if included, may also reflect the entity's perspective (this can depend on cost-benefit considerations and the perceived likelihood of differences between market and entity perspectives). On the other hand, reflecting the entity's perspective of time value of money may be impracticable and may produce measurements that are difficult for users of financial statements to understand and interpret.

(b) Specifically consider whether to include own credit risk if you are measuring liabilities.

(c) Consider being explicit about any liquidity premium if that can be material to the measurement.

(d) Always consider whether the inputs used are consistent with each other.

Level of detail in present value measurement techniques

11 Consider whether there is a need to provide specific guidance on how to arrive at the inputs for present value measurement. Things to consider include:

(a) How to reflect tax? The inputs to measurement can be either before or after tax. It may not be necessary to specify how the tax is reflected in the inputs as the outcome is the same as long as they are reflected consistently. However, there are complexities in the interaction of tax and measurement inputs and terms like pre-tax may be misunderstood and therefore need to be considered carefully.

(b) How to reflect inflation? The inputs to measurement can be real (after inflation) or nominal (before inflation). It may not be necessary to specify how inflation is reflected in the inputs as the outcome is the same as long as it is reflected consistently in all inputs used. If some inputs include the effect of inflation and others do not, misstatement would occur.

(c) How to reflect risk (if included in the measurement)? The risk can be reflected either in a rate or in cash flows, or as a separate input. If the same risk is reflected in more than one input, double-counting occurs. Consider whether it is necessary to be specific about how risk is reflected, which might depend partly on how material risk is to the measurement as a whole.

(d) Is unwinding of the discount on the measurement to be presented separately? If so, to achieve consistent reporting it may be important to specify that calculation of unwinding of discount reflects a rate determined in a particular manner (often the nominal rate before tax).

12 Additional points may be relevant:

(a) consider the use of yield curves or spot rates, and the need for more specific guidance; and

(b) consider the need for extrapolation for long durations and the need for any more specific guidance on how to extrapolate.

Presentation of changes in present value measurement

13 There are two things to consider relating to presentation of present value measurements:

(a) Which changes in present value measurement should be presented separately; for example, should changes in discount rate be presented separately from changes in the cash flows?

(b) Where should an entity present changes in present value measurement (and where should it present changes in individual inputs if presented separately)? For example, should an entity present changes in profit or loss or other comprehensive income and, if in profit or loss in which line item(s)?

14 A number of IFRS Standards are relevant in this respect, including IAS 1 *Presentation of Financial Statements*, IAS 7 *Statement of Cash Flows* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* as well as the *Conceptual Framework for Financial Reporting*.

15 The work in the project on Principles of Disclosure in the Disclosure Initiative is also relevant.