Discount Rates in Accounting: How Practitioners Depart the IFRS Maze Towards the End of Determinism in Accounting

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Introduction: IASB's discount rate project (2014-2019)

At a glance

From 2014 to 2017, the Board conducted a research project on discount rates in IFRS Standards.

The objectives of the project were to:

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

Summary of findings

The Board's investigation found that:

- in some cases, inconsistencies arise between requirements relating to discount rates in IFRS Standards.
- these inconsistencies arise in specifying either:
  - which types of inputs to use in a present value measurement technique; or
  - how to determine the amount of the inputs.
- some of those inconsistencies 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.

Conclusions and follow-up

In March 2017 the Board concluded that:

- the project had met its objectives; and
- the Board had no need to seek public feedback on the outputs of the project.

The project has two outputs:

- the research findings (see page 8); and
- a summary listing matters that the staff will consider in the future when developing recommendations for the Board on present value measurement requirements (see page 11).

The Board will use those outputs in other projects in considering:

- whether and how to address some of the inconsistencies identified; and
- how to avoid creating unjustifiable inconsistencies in the future.

The Board has no plans to conduct a separate project on discount rates.

https://www.ifrs.org/projects/completed-projects/2019/discount-rates/

Research content

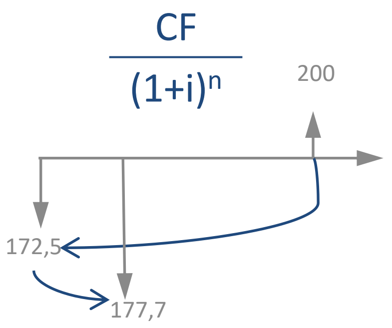
- THE DUAL NON-MONETARY ORIGIN OF DISCOUNT RATES
- DISCOUNT RATES IN IAS/IFRS
- LITERATURE REVIEW
- OUR QUALITATIVE STUDY: HOW DO PRACTITIONERS BRIDGE THE GAP BETWEEN THEORIES AND PRACTICES?

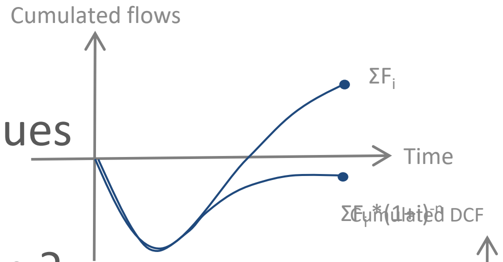
Discount Rates in IFRS

Standard	Text
IAS 36	§ 55 The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of: **(a) the time value of money; and (b) the risks specific to the asset for which the future cash flow estimates have not been adjusted.**
IAS 36	§ A18 However, these rates must be adjusted**: (a) to reflect the way that the market would assess the specific risks associated with the asset's estimated cash flows; and (b) to exclude risks that are not relevant to the asset's estimated cash flows** or for which the estimated cash flows have been adjusted. **Consideration should be given to risks such as country risk, currency risk and price risk.**
IAS 36	§ 57 When an asset-specific rate is not directly available from the market, **an entity uses surrogates to estimate the discount rate.**
IFRS 15	§ 64 To meet the objective in paragraph 61 when adjusting the promised amount of consideration for a significant financing component, (…) An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. **After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk.**
IAS 36	§ A17 As a starting point in making such an estimate, the entity might take into account the following rates: **(a) the entity's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model; (b) the entity's incremental borrowing rate; and (c) other market borrowing rates.**
IAS 36	§ A19 **The discount rate is independent of the entity's capital structure and the way the entity financed the purchase of the asset,** because the future cash flows expected to arise from an asset do not depend on the way in which the entity financed the purchase of the asset.
IAS 19	§57 (…) **a) discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost** (see paragraphs 67–69 and 83–86).

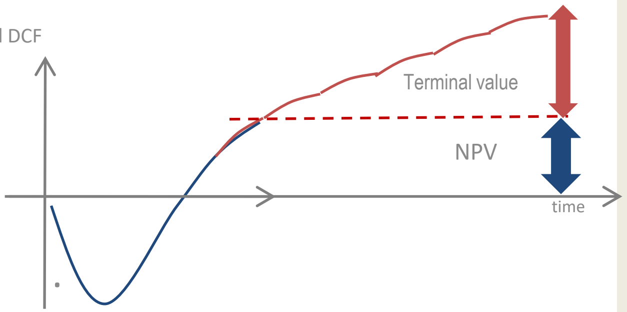
Some issues related to discount rates

- Multiple definitions & measures across IFRS sometimes relying on DCF methods
  - Fair value measurement in IFRS 17 and IAS 19, IFRS 2, etc.
- Significant impacts of DR on balance sheet and financial expenses (unwinding, rate variations…)

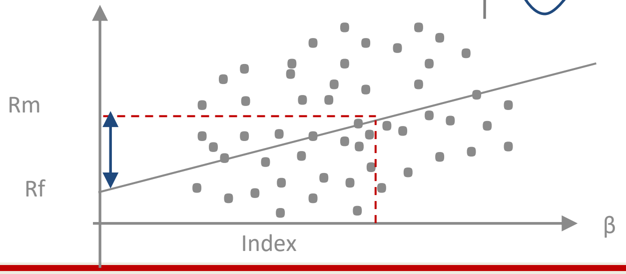




- Dual role of discounting: capturing Time and Risk values



- Level of the DR (e.g. Impairment test): Entity or group ?
- Inconsistency between published rates and used rates
- Perpetual rent is problematic
- Reluctancy to apply CAPM :
  – risk-free ? Market premium ? Data period ? Index ?
  – Historical data ? Sampling ? Sources ? Cost of sources ?
  – Little faith in little relevant model

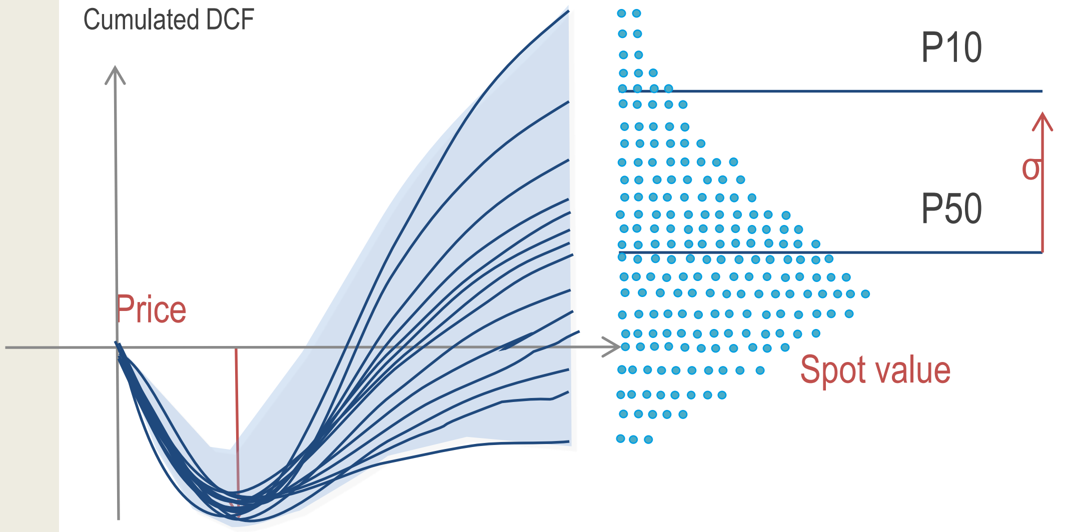


Issues in risk representation

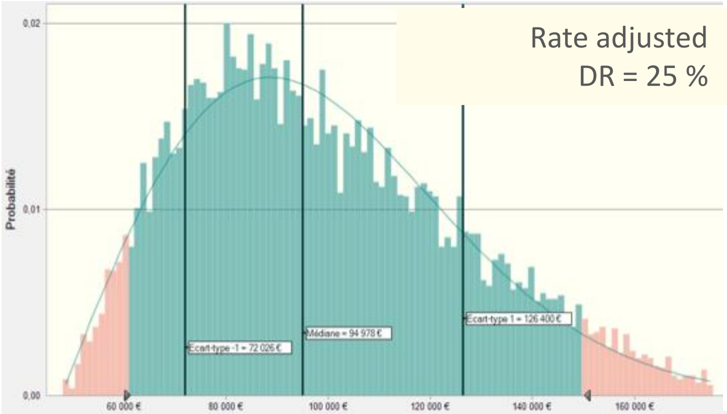
Reliability of fair value estimates (Badia, Barth, Duro & Ormazabal, 2019 TAR)

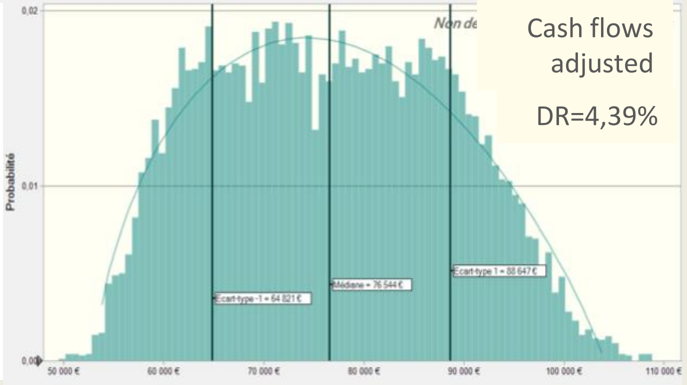
*« Our study also relates to the literature examining **the reliability of fair value estimates.** This literature addresses the concern that **value estimates are fraught with estimation error and bias, which diminishes their potential informativeness.***

*The focus of this literature is on estimates of **fair value, which is the mean of the asset value distribution**. Only a few studies in this literature examine an association with firm risk, and **those that do focus on financial assets.** »*



IFRS 13 § B33 An entity can include a risk premium in the fair value measurement of a liability or an entity's own equity instrument that is not held by another party as an asset in one of the following ways: **(a) by adjusting the cash flows** (I.e. as an increase in the amount of cash outflows); or **(b) by adjusting the rate used to discount** the future cash flows to their present values (i.e. as a reduction in the discount rate).





Recommendations

Recommendation n°1 : **IFRS could provide more insights on the dispositions, by explaining objectives and concepts.**

Recommendation n°2 : **A more precise vocabulary should be employed.**

Recommendation n°3 : **IASB may identify and hierarchize the information sources.**

Recommendation n°4 : **IASB should allow the term structure of interest rate and its information source.**

Recommendation n°5 : **The concepts of cost of equity and cost of capital should be clarified, when it is needed.**

Recommendation n°6 : **Risks could be better captured in the cash flows, thereby withdrawing the additive rate.**

Recommendation n°7 : **Risks could be better captured in the cash flows, in a non-deterministic manner.**

Recommendation n°8 : **The use of prospective evaluation should be better guided.**

Thank you

Questions ?