Brewing Over

How to disclose judgements made in application of accounting policies

The International Accounting Standards Board (IASB) recently commissioned a project to research discount rates because requests for clarification submitted to the Board suggested that the different types of discount rates required or permitted by various IFRSs are not well understood.

The differences in the requirements of various standards regarding discount rates have led to inconsistent application. Following the completion of the research, the Board issued a feedback report in 2019 which will serve as a reference point for standard setting in the future and preparation of educational material.

Present value techniques are used to measure certain assets and liabilities for financial reporting. The inputs required to for these techniques generally include future cash flows and the discount rates used to translate those cash flows to present value.

IAS 36 Impairment of Assets

IAS 36 Impairment of Assets is the IFRS Standard that prescribes the requirements for impairment of non-current assets. An asset is impaired when the recoverable amount of the asset is lower than its carrying amount. The recoverable amount of an asset is the higher of its fair value less costs of disposal and its value in use.

The value in use of an asset is established by discounting the future cash flows expected to be generated by the asset using an appropriate discount rate. The discount rate should be a pre-tax rate that reflects time value of money and reflects the risks specific to the asset. Put differently, it is an estimate of the rate that the market would expect on an investment equally risky to the asset.

As these are usually unavailable, the starting point is usually the company's weighted average cost of capital (WACC) or the company's incremental borrowing rate (IBR) or some other market borrowing rate. Whichever rate is used as a starting point should be adjusted for the way the market would assess the specific risks associated with the asset and should exclude risks not relevant to the asset.

The company's WACC is often the rate of choice in this regard. It comprises the cost of debt and cost of equity each weighted for the proportion of debt and equity that the entity has.

IFRS 16 Leases

By contrast, a company may not use the WACC to compute the lease liability and right-of-use asset, as the WACC combines both equity and debt elements while IFRS 16 only permits use of the IBR as an alternative to the rate implicit in the lease, which is the first port of call. The rate implicit in the lease is defined as the rate of interest that causes the present value of the lease payments and the unguaranteed residual value to equal the sum of the fair value of the underlying asset and initial direct costs of the lessor. As lessees are generally not privy to the fair value of the underlying asset and the initial direct costs of the lessor, the standard permits the use of the IBR where the implicit rate is not determinable.

IBR is defined as the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment. The IFRS Interpretations Committee recently remarked, in response to an agenda consultation, that it would be consistent with the Board's objective for a lessee to refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease.

IAS 19 Employee Benefits

IAS 19 Employee Benefits outlines the requirements for accounting for post-employment benefit obligations that an entity would incur in a defined benefit plan. Preparers of financial statements are required to discount future payments to present value based on the expected timing of payments. In contrast to IAS 36 and IFRS 16, this Standard is somewhat more specific as to what discount rate should be used. It requires the use of high-quality corporate bonds. For currencies for which there is no deep market in such high-quality corporate bonds, the market yields (at the end of the reporting period) on government bonds denominated in that currency must be used. The currency and term of the corporate bonds or government bonds must be consistent with the currency and estimated term of the post-employment benefit obligations.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

A provision is a liability of uncertain timing and amount. As payment to settle a provision occurs in the future, the Standard requires a company to discount the estimated future amount to present value. This Standard does not delve into great detail as to what discount rate should be used; it simply states that the rate used should be a pre-tax rate that reflects current market assessments of the time value of money and risks specific to the liability.

The discount rate may not reflect risks for which future cash flow estimates have been adjusted.

IFRS 13 Fair Value Measurement

IFRS 13 provides a single IFRS framework for measuring fair value and is applicable to most Standards that require or permit fair value measures, for example IFRS 9 Financial Instruments, and IAS 40 Investment Property. The Standard recognises present value measures of future cash flows as a method of determining the fair value of an asset or liability. It sets out certain general principles that apply to discount rates that should be used where the present value technique is

used. In terms of the Standard, the discount rate should:

- Reflect assumptions that market participant would use when pricing the asset or liability;
- take into account only factors attributable to the asset or liability being measured;
- reflect assumptions that are consistent with those inherent in the cash flows; and
- be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

Summary

It is clear that the different Standards have differing requirements and guidance regarding discount rates. Preparers should be careful when selecting or developing discount rates so as not to use rates that do not comply with what is set out in the particular Standard.

Blaise Colyvas CA(SA), JSE Accredited IFRS Advisor

blaise@wconsulting.co.za

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