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The Theory and Practice of Discounting in Financial Reporting Under IFRS

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Introduction

- Project overview
- A (very) brief history of discounting
- Key findings
- Conclusions

Project overview

- Conducted an in-depth literature review of research on discount rates in accounting as well as other disciplines where research on discount rates forms a much more significant body of work e.g., economics.

- Undertook a comparative analysis of the basis for conclusions across key standards where discount rates are a key input.

- Interviewed experts on the application and use of discount rates in practice in these key standards.

- Conducted a detailed international survey of accounting practitioners on the use of discount rates in IAS 19 to allow for a quantitative analysis.

A (very) brief history of discounting

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- Adam Smith and John Rae on the economics and psychology of intertemporal choice.

- Formalized by Paul Samuelson (1937) in his Discounted Utility (DU) model.

"A central assumption of the DU model is that all of the disparate motives underlying intertemporal choice can be condensed into a single parameter — the discount rate."

Frederick et al, (2002)

A (very) brief history of discounting

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- The DU Model was accepted quickly because of its simplicity and similarity to compounding and future values.

- Samuelson was himself concerned as to whether the proposed model was an adequate representation of the world, and questioned the validity of the normative prescriptions of the model.

- Assumptions of this model are not without challenge e.g. hyperbolic discounting.

- Major source of research and debate in economics but comparatively little in academic accounting?

Key findings: cross-standard comparisons

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- The basis for conclusions across standards are often inconsistent with each other.

- Some of the economic arguments put forward in the basis for conclusion can be questioned e.g. in the case of IAS 19, the conclusions state that future interest rates are predicted by forward rates.

- The expectations of the market in the current period, as reflected in the term structure of interest rates, do not forecast the prevailing rate of interest in subsequent periods.

  Sargent, (1972)

- There have been improvements in discounting approaches as standards have evolved e.g. leasing.

Key findings: interviews

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- There is an acknowledgement of a disjoint between the numbers presented in financial statements and regulation that dictates corporate behaviour e.g., in the UK the pensions regime is governed by The Pensions Regulator.

- The sensitivity of reported values to small changes in the discount rate were acknowledged by a range of interviewees and across standards.

- The response to this volatility has been different e.g. pensions vs decommissioning.

- The idea of economic consequences, i.e., that accounting numbers change behaviour and create economic reality, was largely restricted to shareholders and other investors.

Key findings: survey

- 101 responses to the survey with Germany, Netherlands, and the UK being the most common respondents.
- Large variation in discount rates applied across countries and within countries – can be over 100bps between high and low estimates.

Key findings: survey

Rank in order of importance the elements of the conceptual framework

[1=most important and 6=least important]

Faithful representation	2.72
Relevance	3.05
Comparability	3.37
Understandability	3.40
Verifiability	3.86
Timeliness	4.60

Conclusions

- There needs to be much more work by academics that engages with issues of discounting, and what is the ‘correct’ discount rate for a specific situation.

- Discount rates in IFRS Standards Project, February 2019 and the Third Agenda Consultation, March 2021.

- Principles-led best practice guide to help preparers clearly understand the objective of a standard in the context of the importance placed on faithful representation.