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Staff paper

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Accounting Standards Advisory Forum meeting

Date	**9 December 2022**
Project	**Provisions—Targeted Improvements to IAS 37**
Topic	**Discount rates—non-performance risk**
Contacts	**Joan Brown (jbrown@ifrs.org)** **Megumi Iijima (miijima@ifrs.org)**

Purpose of this session

To obtain ASAF members' views on:

1. discount rates used to measure long-term provisions within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and
2. information disclosed about the rates used.

Focusing on:

provisions for asset decommissioning and environmental rehabilitation costs

Paper overview

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Further information

Information summarised in this paper is explained in more detail in October 2022 IASB meeting Agenda Paper 12A *Provisions—Targeted Improvements: Discount rates—non-performance risk*.

Cross references to paragraphs or chapters in that paper are flagged IASB AP12A .

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Topic 1—discount rates for provisions

- Requirements of IAS 37
- Non-performance risk
- Discount rates used in practice
- IASB project to amend IAS 37
- Factors that could affect the IASB's decision
- Questions for ASAF members

Requirements of IAS 37

IASB AP12A | Chapters 2–3

- IAS 37 applies to provisions—liabilities of uncertain timing or amount—not within the scope of another IFRS Accounting Standard.
- IAS 37 requires those liabilities to be measured at the best estimate of the expenditure required to settle the present obligation, with that expenditure being discounted to its present value if the effect of the time value of money is material.
- The effect is most likely to be material for large long-term provisions—for example, provisions for asset decommissioning and environmental rehabilitation costs reported by entities in the oil & gas, mining and utilities (including power generation) sectors.
- IAS 37 requires the discount rate to also reflect ‘the risks specific to the liability’ if those risks are not reflected by adjusting the estimates of the cash flows.
- **IAS 37 does not specify whether the discount rate should reflect non-performance risk.**

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IASB AP12A | Page 2 and paragraphs 5.5–5.9

Non-performance risk

What we mean by non-performance risk	• The risk that an entity will not fulfil its obligation. • It is specific to a liability—it varies from one type of liability to another.

Possible components	• The main component of non-performance risk is likely to be credit risk.
	• Credit risk is affected by the entity's overall credit standing and liability-specific factors, eg:
	  • the value of any assets securing the liability
	  • the value of any assets ring-fenced to fund the liability
	  • where the liability would rank relative to others if the entity is liquidated—eg, in some jurisdictions environmental obligations rank above all other liabilities.
	• Other components could arise from, eg, operational, commercial or regulatory risks.

How the risk affects provisions	• Many liabilities (eg commercial loans) include an obligation to pay a risk premium to the counterparty to compensate the counterparty for accepting non-performance risk. In contrast, provisions typically include **no** such obligation. • The non-performance risk for a provision is typically unobservable—it has to be estimated.

Discount rates used in practice

IASB AP12A | Chapter 4

Information we have gathered by reviewing academic research and consulting national standard-setters indicates that, in measuring long-term provisions for asset decommissioning and environmental rehabilitation costs:

- entities tend to reflect the variability in the cash flows required to settle the provision by adjusting those cash flows, not by adjusting the discount rate.
- there is diversity in the basis on which entities determine the discount rate they use for provisions—some use a risk-free rate (eg government bond rate), while others use a (higher) credit-adjusted rate—effectively including non-performance risk.
- diversity exists across sectors (oil & gas, mining and utilities) and across regions.
- the decision on whether to include non-performance risk is viewed by some as an accounting policy choice.

IASB project to amend IAS 37

The IASB has a project Provisions—Targeted Improvements on its workplan.

As part of that project, the IASB will consider developing proposals to amend IAS 37 to standardise the bases used to determine discount rates—by either requiring or prohibiting the inclusion of non-performance risk.

The IASB started discussing this topic at its October 2022 meeting. The agenda paper for that meeting provides background information on the topic and discusses factors that could affect the IASB's decision. IASB AP12A

The IASB is now seeking input from stakeholders before making a decision.

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Factors that could affect the IASB's decision (1 of 3)

	Factor	Preliminary IASB staff analysis	IASB AP12A paragraphs
1	Whether non-performance risk is 'specific to the liability'	Non-performance risk is specific to the liability—see page 6.	5.5–5.9
2	The intentions of the International Accounting Standards Committee (IASC) when it developed IAS 37	In referring to 'the risks specific to the liability', the IASC was referring to the variability in the cash flows required to settle the obligation (generally reflected by *decreasing* the discount rate)—not the possibility that the entity would fail to settle the obligation (which would be reflected by *increasing* the discount rate).	5.10
3	Measurement concepts in the *Conceptual Framework For Financial Reporting (Conceptual Framework)*	The *Conceptual Framework* discusses three current value measurement bases for liabilities. The measurement objective in IAS 37 is possibly closest to fulfilment value. Fulfilment value reflects non-performance risk. However, the *Conceptual Framework* notes that modifying a measurement basis (for example, to exclude the effects of non-performance risk) may sometimes result in information that is more relevant to the users of financial statements, or that may be less costly to produce or to understand.	5.11-5.14

Factors that could affect the IASB's decision (2 of 3)

	Factor	Preliminary IASB staff analysis	IASB AP12A paragraphs
4	A difference between provisions and other liabilities	Many liabilities arise from commercially-priced exchange transactions. These transactions are priced to include a premium payable to the counterparty for accepting non-performance risk, and the non-performance risk adjustment in the discount rate reflects the premium payable. In contrast, provisions within the scope of IAS 37 tend not to arise from commercially-priced exchange transactions, and the expenditure required to settle a provision typically includes no premium payable to the counterparty for accepting non-performance risk.	5.15-5.30
5	IAS 37 measurement objective	IAS 37 describes two concepts within its measurement objective. One of these concepts could possibly support the *exclusion* of non-performance risk, whereas the other could possibly support its *inclusion*.	5.31-5.38
6	Information provided to investors	Whether an entity includes non-performance risk in the discount rate used to measure a provision affects the type of information it provides in its financial statements. See pages 12 and 13.	5.39-5.43

Factors that could affect the IASB's decision (3 of 3)

	Factor	Preliminary IASB staff analysis	IASB AP12A paragraphs
7	Subsequent measurement—'counter-intuitive' results and accounting mismatches	Concerns about the 'counter-intuitive' results of changes in non-performance risk (eg a weakening financial position resulting in recognition of a gain) might carry less weight for provisions than for some other liabilities. Typically, changes in asset decommissioning and environmental rehabilitation provisions are not recognised as income or expenses in the period of change. Typically, they are added to or deducted from the carrying value of the related property, plant and equipment.	5.44-5.49
8	Measurement uncertainty	Any estimate of a non-performance risk adjustment is likely to be subject to significant measurement uncertainty, which could lead to loss of comparability.	5.50-5.55
9	Convergence with US GAAP	A requirement to discount an asset decommissioning or an environmental rehabilitation obligation at a credit-adjusted risk-free rate would eliminate one difference between IAS 37 requirements and US GAAP. However, several other significant differences would remain, meaning that measures of provisions would still not be directly comparable.	5.56

If the discount rate **excludes** non-performance risk…

- The resulting measure of the provision represents the amount the entity would need to invest in risk-free assets at the reporting date to fund the settlement of the obligation (to pay the certainty equivalent of the estimated future cash flows) when it becomes due.
- The unwinding of the discount each period quantifies the time value of money. The absence of an adjustment for non-performance risk reflects the difference between provisions and other types of liabilities (such as commercial loans). Provisions do not include an obligation to compensate the counterparty for accepting non-performance risk—the entity incurs no non-performance risk expense.
- The discount rate is subject to less measurement uncertainty. It is typically based on observable market risk-free rates; there is no need to estimate the effect of non-performance risk.

If the discount rate **includes** non-performance risk…

- The resulting measure of the provision places an economic value on the entity's obligation, reflecting the transfer of non-performance risk to the counterparty and making the provision more comparable with other liabilities measured at a current value.
- The measure tells investors that a provision (which does not include an obligation to pay the counterparty a premium for accepting non-performance risk) is less onerous than an otherwise-identical liability that does include such an obligation.
- The unwinding of the discount quantifies the time value of money and the non-performance risk transferred to the counterparty.
- The discount rate is subject to more measurement uncertainty. Non-performance risk has to be estimated on initial recognition and updated at each subsequent reporting date.
- Investors say they need additional information to enable them to understand how non-performance risk has affected the measure of the provision (see page 19).

Questions for ASAF members

Topic 1

Whether to require or prohibit inclusion of non-performance risk

What are your views on this topic?

a) Do you think the IASB should develop proposals to amend IAS 37 to specify whether the discount rate for provisions includes non-performance risk?

b) If so, which of the factors listed on pages 9–11 do you think should carry most weight in deciding whether to require or prohibit the inclusion of non-performance risk?

c) Are there other factors you think the IASB should consider?

Topic 2—disclosure of information about discount rates

- Existing disclosure requirements
- Disclosure practices
- Information requested by investors
- Questions for ASAF members

Existing disclosure requirements

IASB AP12A | Paragraphs 6.7–6.9

IAS 37

Unlike other IFRS Accounting Standards, IAS 37 has no **specific** requirements to disclose information about:

- the rates used to discount provisions, or
- the basis on which those rates have been determined.

IAS 1 *Presentation of Financial Statements*

IAS 1 has **general** requirements to disclose:

- assumptions about the future and other major sources of estimation uncertainty *
- other judgements made in applying accounting policies **
- material accounting policy information
- other information relevant to an understanding of the financial statements.

* Information about assumptions management makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

** Other judgements that management has made in applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Disclosure practices

IASB AP12A | Paragraphs 6.10–6.13

A recent academic study reviewing more than 4,000 financial statements of oil & gas, mining and utilities entities with asset decommissioning and environmental rehabilitation provisions in 2005 – 2016 found that:*

- approximately half of these financial statements disclosed the discount rate(s) the entity had used to measure its provisions.
- the incidence of disclosure varied by jurisdiction—for example, the incidence was higher than average among entities incorporated in Canada.
- the amount of information disclosed varied from ‘basic’ to ‘comprehensive’. The most comprehensive information included, for example:
    - assumptions—for example, about the undiscounted cash flows and their timing
    - a discussion of the uncertainties
    - sensitivity analyses.

* Research report Michelon, G., Paananen, M., and T. Schneider, 2020, *Black Box Accounting: Discounting and disclosure practices of decommissioning liabilities*, published by the research panel of ICAS.

Information requested by investors

Some investors have told the IASB that financial statements do not always provide the information they need to understand how discounting has affected the measure of a provision. Investors have suggested adding to IAS 37 requirements to disclose:

1. the rate—or range of rates—used to discount provisions.
2. the basis for determining those rates, eg:
   a. the market investments whose yields are the basis for the discount rates (eg the type and duration of the investments and their country of issue)
   b. whether those rates are adjusted and, if so, for what factors and with what effect.
3. specific inputs to the calculation:
   a. the undiscounted cash flows
   b. the assumptions made about the timing of those cash flows—and particularly, for decommissioning provisions, assumptions about when the decommissioning will start.

Additional information requested by investors if discount rates reflect non-performance risk

In October 2022 IASB members discussed discount rates for provisions with members of its Capital Markets Advisory Committee. Members had differing views on whether including non-performance risk would result in more useful or less useful information about asset decommissioning and environmental rehabilitation provisions.

Some members suggested requiring entities to (a) measure provisions using a rate that **includes** non-performance risk, and (b) provide further information to enable investors to **exclude** the effect if they wish to. Entities could be required to:

1. disaggregate the provision to separately identify:
    a. the undiscounted cash flows
    b. the effect of discounting those cash flows at a risk-free rate, and
    c. the effect of the non-performance risk adjustment.
2. provide a sensitivity analysis—identifying the effect that, say, a one percentage point change in the discount rate would have on the measure of the provision.

Questions for ASAF members

Topic 2

Disclosure of information about discount rates

What are your views on this topic?

a) Do you think the IASB should develop proposals to add to IAS 37 specific requirements to disclose information about the discount rates used to measure provisions?

b) If so, which of the items of information listed on pages 18 and 19 do you think entities should be required to disclose?

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