IFRS® Accounting

Staff paper

Agenda Paper 3

Capital Markets Advisory Committee

Date	**October 2022**
Project	**Provisions—Targeted Improvements to IAS 37**
Topic	**Discount rates—credit risk**
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Purpose of this session

To obtain CMAC members' views on:

1. the discount rates companies use to measure provisions within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and
2. information companies disclose in their financial statements about the discount rates they have used.

Focusing on provisions for asset decommissioning and environmental rehabilitation obligations.

Questions for CMAC members

1	**Basis for determining discount rate** (slides 4–8)	IAS 37 requires long-term provisions—for example, provisions for asset decommissioning and environmental rehabilitation obligations—to be discounted to their present value. Some companies use a risk-free interest rate; other companies use a higher rate that reflects the credit risk associated with the provision (a credit-adjusted rate). **a) Would measures of provisions in financial statements be more useful to you if all companies used the same basis for determining the discount rates they use?** **b) If so, would you prefer companies to use a risk-free rate or a credit-adjusted rate?**
2	**Information disclosed** (slides 9–11)	**a) Do companies with long-term provisions disclose enough information about the discount rates they have used to measure their provisions?** **b) If not, what further information would be useful to you?**

Background information—discount rates

- Requirements of IAS 37
- Discount rates used in practice
- IASB project to amend IAS 37
- Some factors the IASB might consider

Requirements of IAS 37

- IAS 37 applies to provisions—liabilities of uncertain timing or amount—not within the scope of another IFRS Accounting Standard.
- It 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 of discounting is most likely to be material for large long-term provisions—for example, the provisions for asset decommissioning and environmental rehabilitation obligations reported by companies in the oil & gas, mining and utilities (including power generation) sectors.
- IAS 37 requires the discount rate to 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 credit risk.

Discount rates used in practice

Our research indicates that, in measuring long-term provisions for asset decommissioning and environmental rehabilitation costs:

- companies tend to reflect the variability in the cash flows required to settle the provision by adjusting those cash flows, not adjusting the discount rate.
- there is diversity in the basis on which companies determine the discount rates—some apply a risk-free rate (eg government bond rate), while others apply a (higher) credit-adjusted rate.
- diversity exists across sectors (oil & gas, mining and utilities) and across regions.
- companies view the decision on whether to include credit risk 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 specify in IAS 37 whether companies should adjust discount rates for credit risk.

The IASB has not yet discussed this topic—it plans to have its first discussion at its October 2022 meeting.

Some factors the IASB might consider

Factor	In support of INCLUDING a credit adjustment	In support of EXCLUDING a credit adjustment
Conceptual	The interest/discount rate for other liabilities includes a credit adjustment. All provisions subject to the same degree of non-performance risk should be measured using a discount rate that includes the same adjustment for that risk.	Interest and discount rates for some liabilities (eg loan or lease liabilities) reflect credit risk because the company is required to pay a premium to the counterparty to compensate the counterparty for credit risk. The credit adjustment in the discount rate serves to record that payment as an expense over the period in which the counterparty bears the risk. In contrast, the cash flows required to settle an asset decommissioning or environmental rehabilitation provision do not include a risk premium payable to the counterparty—there is no credit risk expense to record.
Measurement uncertainty/ comparability	Although the amount of credit risk associated with a provision is unlikely to be observable, there might be an observable rate that could be used as a reasonable approximation.	Risk-free rates are observable. The credit risk associated with a provision is unlikely to be observable—for various reasons, it can differ from the observable credit risk associated with the company's borrowings. Subjective judgements required to measure credit risk could lead to loss of comparability between companies.
Convergence with US GAAP	US GAAP requires provisions for asset decommissioning obligations to be discounted using a credit-adjusted risk-free rate.	There are several major differences between US GAAP and IFRS accounting requirements for measuring provisions within the scope of IAS 37. Aligning the discount rate for asset decommissioning obligations would eliminate only one difference. It would not be enough to make IFRS and US GAAP measures comparable.

Background information—disclosure

- Disclosure requirements
- Disclosure practice

Disclosure requirements

IAS 37

No **specific** requirements to disclose:

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

IAS 1 *Presentation of Financial Statements*

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.

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* 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 practice

A recent academic study sampling financial statements of oil & gas, mining and utilities companies with asset decommissioning and environmental rehabilitation provisions found that:*

- approximately half of these financial statements disclosed the discount rates the company had used to measure the provisions.
- the incidence of disclosure varied by jurisdiction—for example, the incidence was higher than average among companies 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.

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* Research report *Black Box Accounting: Discounting and disclosure practices of decommissioning liabilities*, published by the research panel of ICAS.