

IASB meeting

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Project	Provisions—Targeted Improvements
Topic	Discount rates—non-performance risk
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Session overview

The International Accounting Standards Board (IASB) has on its work plan a project to make three targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

One improvement relates to the discount rate an entity applies in measuring a provision. The IASB will consider developing proposals to specify in IAS 37 whether that rate should reflect 'non-performance risk'—the risk that the entity will not fulfil its obligation.

The staff are gathering information to help the IASB reach a tentative decision on this question at a future meeting. This paper presents the information we have gathered to date, along with a preliminary staff analysis of factors that could affect the IASB's decision.

At this meeting, we will invite questions and comments from IASB members, including on:

- (a) what, if any, further information they need to reach a tentative decision at a future meeting; and
- (b) the completeness of the staff analysis—whether there are other factors the IASB should consider in reaching its decision.

Next steps

Before asking the IASB for a decision, we plan to:

- (a) obtain any further information requested by IASB members;
- (b) update the staff analysis to reflect IASB members' comments at this meeting; and
- (c) seek views from some of the IASB's advisory groups—including the Capital Markets Advisory Committee, the Global Preparers Forum and the Accounting Standards Advisory forum.

Terminology—'non-performance risk' versus 'own credit risk'

IFRS 7 *Financial Instruments: Disclosures* refers to 'credit risk', which it defines as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'.

Both IFRS 13 *Fair Value Measurement* and IFRS 17 *Insurance Contracts* refer to 'non-performance risk', which IFRS 13 defines as 'the risk that an entity will not fulfil an obligation'.

IFRS 13 states that non-performance risk includes, but may not be limited to, the entity's own credit risk.

An entity's own credit risk is often the main source of non-performance risk for a liability, and the terms 'non-performance risk', 'credit risk' and 'own credit risk' are sometimes used interchangeably.

The discussion in this paper generally applies to all forms of non-performance risk. So the paper uses that term, except where it:

- (a) refers specifically to the component of non-performance risk that relates to an entity's credit standing; or
- (b) quotes from a source that uses the term credit risk or the term own credit risk.

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1 Why we are discussing this topic

- 1.1 Between 2014 and 2017 the IASB conducted a [research project on Discount Rates in IFRS Standards](#). In that project, the IASB examined why different IFRS Accounting Standards require different discount rates. In February 2019 the IASB completed this project by publishing a summary of its findings: [Project Summary Discount Rates in IFRS Standards](#).
- 1.2 The project summary reported that the IASB had no plans to conduct a separate project on discount rates, but had identified several matters that it could consider addressing in other projects. Among those matters, the report noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is unclear on which inputs to include in the discount rates used to measure provisions—and, in particular, on whether to include non-performance risk.¹
- 1.3 In January 2020 the IASB added the [maintenance project Provisions—Targeted Improvements](#) to its workplan, with the objective of:
- (a) aligning the IAS 37 liability definition and requirements for identifying liabilities with the liability definition and supporting concepts in the IASB's *Conceptual Framework for Financial Reporting*;
 - (b) clarifying which costs to include in the measure of a provision; and
 - (c) specifying whether an entity reflects non-performance risk in the rate at which it discounts a provision for the time value of money.
- 1.4 Due to other priorities, the IASB has not discussed the Provisions—Targeted Improvements project further until now. However, in the meantime, the staff have been gathering evidence to help the IASB reach a tentative decision on whether to require the discount rate for provisions to reflect non-performance risk. We are therefore asking the IASB to start its technical discussions by considering this question.

¹ Page 8 of [Project Summary Discount Rates in IFRS Standards](#).

2 When the discount rate is important, and why

IAS 37 defines a provision as ‘a liability of uncertain timing and amount’. It defines a liability as ‘a present obligation ... the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits’.

IAS 37 requires an entity to:

- (a) measure a provision at the best estimate of the expenditure required to settle the present obligation; and
- (b) discount that expenditure to its present value if the effect of the time value of money is material.

This chapter:

- (c) identifies types of provisions for which the time value of money is most likely to be material;
- (d) illustrates how the rate used to discount a provision can affect various metrics of financial performance and financial position; and
- (e) explains why differences in the bases used to determine discount rates make comparisons difficult.

Types of provisions for which the time value of money is most likely to be material

- 2.1 The time value of money is most likely to be material for large long-term provisions—those that will be settled only many years after they arise. Notable examples are the provisions for asset decommissioning and environmental rehabilitation costs recognised by entities operating in the oil & gas, mining, utility (including energy generation) and telecommunications sectors.

Example 1—magnitude of the effect of discounting

The estimated useful life of a nuclear power plant may be 50 years or longer, and large nuclear power generation entities may recognise decommissioning and waste management provisions amounting to billions (or even tens of billions) of \$US.

Expenditure of \$10 billion discounted at 4% per year for 50 years has a present value of \$1.4 billion.

Metrics affected by the discount rate

- 2.2 Reflecting non-performance risk in the discount rate for a provision increases that rate. Increasing the rate affects various metrics of an entity's financial performance and financial position.

Example 2—metrics of financial performance and financial position affected by the discount rate

Two oil entities each commission an oil rig with a useful life of 30 years and expected decommissioning costs of 1,000 currency units (CU1,000) at the end of that life. Applying IAS 37, each entity recognises a provision for the decommissioning costs when it recognises the cost of the rig. Applying IAS 16 *Property, Plant and Equipment*, each entity includes the initial estimate of the provision as part of the cost of the rig, allocating that cost over the rig's useful life using the straight-line method. Each entity recognises the periodic depreciation charge as part of its cost of sales in arriving at a measure of gross profit.

Each entity discounts its decommissioning provision for the time value of money, and recognises the periodic unwinding of the discount in profit or loss as a finance cost.²

² Applying paragraph 8 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

Entity A uses a discount rate of 2% per year (a risk-free rate); Entity B uses a rate of 5% per year (the same risk-free rate increased to reflect non-performance risk).

As a result of using a higher discount rate, Entity B reports (relative to Entity A):

- throughout the rig's 30-year useful life:
 - a smaller cost for its rig, and a smaller decommissioning liability;
 - smaller total liabilities and lower gearing;
 - a smaller depreciation charge, and hence a larger gross profit and a higher gross profit margin; and
 - a larger finance charge;
- in the earlier years of the rig's life, a larger profit before tax; and
- in the later years of the rig's life, a smaller profit before tax.

Entity A—decommissioning costs discounted at 2%

Effect on financial position	End of year 10	End of year 20	End of year 30	
	CU	CU	CU	
On assets: Added to oil rig (initially CU552)	368	184	-	
On liabilities: Provision (initially CU552)	(673)	(820)	(1,000)	
On net assets	(305)	(636)	(1,000)	

Effect on financial performance	Years 1–10	Years 11–20	Years 21–30	Total
	CU	CU	CU	CU
On gross profit	(184)	(184)	(184)	(552)
On finance cost	(121)	(147)	(180)	(448)
On profit before tax	(305)	(331)	(364)	(1,000)

Entity B—decommissioning costs discounted at 5%

Effect on financial position	End of year 10	End of year 20	End of year 30	
	CU	CU	CU	
On assets: Added to oil rig (initially CU231)	154	77	-	
On liabilities: Provision (initially CU231)	(377)	(614)	(1,000)	
On net assets	(223)	(537)	(1,000)	

Effect on financial performance	Years 1–10	Years 11–20	Years 21–30	Total
	CU	CU	CU	CU
On gross profit	(77)	(77)	(77)	(231)
On finance cost	(146)	(237)	(386)	(769)
On profit before tax	(223)	(314)	(463)	(1,000)

Comparing amounts measured using discount rates calculated on different bases

- 2.3 If two entities use discount rates calculated on different bases, it can be difficult to compare their financial performance and financial position. Users of financial statements (investors) would need to be aware that the rates have been calculated on different bases, and have the information needed to adjust the amounts one entity reports so they are calculated on the same basis as the amounts the other entity reports. The calculations required could be relatively complex and, as discussed in Chapter 6, not all entities disclose the information investors would need to make the necessary adjustments.

3 Discount rate requirements

This chapter sets out:

- (a) information about the discount rates required for provisions by IAS 37; and
- (b) for comparison, a brief summary of the discount rates required:
 - (i) for other liabilities by IFRS Accounting Standards; and
 - (ii) for provisions by US Generally Accepted Accounting Principles (US GAAP).

Discount rates required for provisions by IAS 37

Measurement objective

- 3.1 Paragraph 36 of IAS 37 sets out the measurement objective for provisions, and paragraph 37 seeks to clarify that objective.

36 The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

37 The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the end of the reporting period. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

Requirements relating to risk and discounting

3.2 Paragraphs 42–47 and 60 of IAS 37 set out requirements relating to risk and discounting:

42 The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

43 Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. ...

...

45 Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

46 Because of the time value of money, provisions relating to cash outflows that arise soon after the reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

47 The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been discounted.

...

60 Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Additional guidance published by the UK Accounting Standards Board

FRS 12

3.3 IAS 37 was developed by the IASB's predecessor body, the International Accounting Standards Committee (IASC), working jointly with the UK Accounting Standards Board (UK ASB). When the IASC issued IAS 37 in 1998, the UK ASB issued FRS 12 *Provisions, Contingent Liabilities and Contingent Assets*.

3.4 The two standards are virtually identical. Appendix VI of FRS 12 states that:

... all the requirements of the IAS are included in the FRS and there are no differences of substance between those common requirements. The FRS, additionally, deals with the circumstances under which an asset should be recognised when a provision is recognised and gives more guidance than the IAS on the discount rate to be used in the present value calculation.

3.5 The additional guidance on the discount rate is in paragraphs 49–50 of FRS 12:

49 Using a discount rate that reflects current market assessments of the time value of money and the risks specific to the liability is a method of reflecting the risk associated with the cash flows in the present value calculation. It is likely that this method will be the easiest method of reflecting risk. However, an acceptable alternative is to adjust the cash flows for risk and to discount them using a risk-free rate (eg a government bond rate). Whichever method of reflecting risk is adopted, care must be taken that the effect of risk is not double-counted by inclusion in both the cash flows and the discount rate.

50 If the cash flows to be discounted are expressed in current prices, a real discount rate will be used. If the cash flows are expressed in expected future prices, a nominal discount rate will be used.

- 3.6 Unlike IAS 37 (which was issued without an accompanying Basis for Conclusions), FRS 12 is accompanied by an appendix (Appendix VII—The development of the FRS) explaining the reasons for some of the Standard’s requirements. On the requirements for discounting, it states that:

24 ... The background to the requirements on discounting is set out in the Working Paper ‘Discounting in Financial Reporting’ (published in April 1997). The proposals in the FRS are consistent with that Paper.

UK ASB Working Paper Discounting in Financial Reporting

- 3.7 The UK ASB published [Working Paper Discounting in Financial Reporting](#)³ (Working Paper) the year before it issued FRS 12.
- 3.8 The Working Paper discusses the role of discounting in measuring assets and liabilities using discounted cash flow techniques. Chapter 2—‘Risk’ explains that the value of a set of future cash flows is affected not only by the time value of money, but also by the variability associated with the cash flows. For liabilities with uncertain cash flows it states that:
- 2.10 As a mirror image of assets, liabilities with uncertain cash flows will generally be more onerous than liabilities with certain cash flows—entities that are risk-averse will tend to prefer a fixed cash outflow to a cash outflow that is of equal expected amount but may vary.
- 3.9 The Working Paper notes that, for liabilities, the variability of the cash flows can be reflected in two ways. An entity can either:
- (a) adjust the estimate of the future cash flows—increasing the estimate to a ‘certainty equivalent’ amount—and discount the adjusted cash flows at a risk-free rate; or
 - (b) adjust the discount rate for risk and discount the estimated future cash flows at that risk-adjusted discount rate.

³ Available on the UK Financial Reporting Council website (frc.org.uk) at [Accountants / Accounting and Reporting Policy / UK Accounting Standards / Exposure Drafts and Consultations](#).

- 3.10 The Working Paper uses a simple example to illustrate how a risk-adjusted discount rate for a liability would be *lower* than a risk-free rate:

Example 3—how risk adjustments reduce discount rates for liabilities (Example from UK ASB Working Paper)

Fact pattern

Suppose a provision is expected to give rise to one of the following cash outflows in three years' time and that the risk-free rate of return is 5%:

Likelihood of cash flow	Cash flow	Expected value
25%	£100	£25
50%	£150	£75
25%	£200	£50
Total		£150

Discussion

The expected value of the cash outflow in three years' time is £150. However, there is the possibility that the cash outflow will instead be £100 or £200. The reporting entity is risk averse and would settle the liability for a certain payment of, say, £160 in three years' time. The entity can express the effect of risk in calculating the present value by:

- (a) discounting the certainty equivalent cash flow of £160 at the risk-free rate of 5%, giving a present value of £138; or
- (b) discounting the expected cash flow of £150 at a risk-adjusted rate that will give the present value of £138, ie 2.8%.

- 3.11 From this example, we can infer that the type of risk the UK ASB and IASC members had in mind when developing FRS 12 and IAS 37 was the variability in the cash flows required to settle the entity's obligation (and 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).

- 3.12 Chapter 4 of the Working Paper argues that the appropriate risk adjustment for a liability depends on the measurement basis. It says that:
- (a) if the objective is to simulate fair value, the measure should reflect the market's assessment of risk, which in some cases will include an assessment of the entity's own credit risk; but
 - (b) it is questionable whether it is always desirable to reflect an entity's own credit risk:
 - 4.3 ... It can be argued that the going concern assumption on which financial statements are prepared does not allow the entity to record a liability at an amount that reflects a possibility that the entity will not meet the liability in full, except where a counterparty has accepted that possibility (by agreeing terms that take it into account).
- 3.13 Chapter 4 of the Working Paper also refers to a Discussion Paper *Provisions* that preceded FRS 12. This Discussion paper had proposed that a provision should be measured at the least cost of settling it, by either:
- (a) paying a third party to take over the obligation; or
 - (b) investing in assets that will grow (with reasonable certainty) to match the amount required to settle the obligation at the due date.
- 3.14 The Working Paper notes that it will not often be possible to transfer a provision to a third party, and rarely possible to identify a group of assets whose cash flows will match those of a provision (and whose rate of risk could be taken as a reasonable risk adjustment for the provision). It suggests that, unless a group of matching assets can be identified:
- 4.8 ... it is assumed that the variability of the cash flows will make the provision more onerous than one with fixed cash flows of equal expected value. A prudent estimate of expected value (ie increased to reflect the risk) should, therefore, be discounted at a risk-free rate.

IFRS Interpretations Committee agenda decision

- 3.15 In 2010 the IFRS Interpretations Committee (Committee) was asked to clarify whether the discount rate required by IAS 37 should reflect the entity’s own credit risk.
- 3.16 In March 2011 the Committee decided not to add this matter to its agenda. The [agenda decision](#) notes that:
- (a) IAS 37 does not explicitly state whether own credit risk should be included; and
 - (b) the IASB was already considering the matter in its (then) project to replace IAS 37 with a new liabilities Standard.
- 3.17 The agenda decision also noted the Committee’s understanding that the predominant practice at that time was to exclude own credit risk, which it said was ‘generally viewed in practice as a risk of the entity rather than a risk specific to the liability’.

Discount rates required for other liabilities by IFRS Accounting Standards

- 3.18 Several IFRS Accounting Standards specify how to apply present value techniques to measure liabilities within their scope. Some of those Standards prescribe a specific discount rate while others describe factors to capture in the measure of the liability (either by adjusting the discount rate or by another means). As noted in [Project Summary Discount Rates in IFRS Standards](#), published by the IASB in February 2019, the requirements vary:

Table 1: Discount rate requirements of IFRS Accounting Standards

Type of liability	Applicable Standard	Requirements relating to the discount rate
Liabilities measured at fair value	IFRS 13 <i>Fair Value Measurement</i>	Capture in the measure: <ul style="list-style-type: none"> (a) an estimate of future cash flows; (b) expectations about possible variations in the amount and timing of the cash flows;

Type of liability	Applicable Standard	Requirements relating to the discount rate
		<p>(c) the time value of money—represented by the rate on risk-free monetary assets with maturity dates that coincide with the cash flows;</p> <p>(d) the price for bearing the uncertainty inherent in the cash flows (a risk premium);</p> <p>(e) other factors that market participants would take into account in the circumstances; and</p> <p>(f) for a liability, the non-performance risk relating to that liability, including the entity’s own credit risk.⁴</p>
Performance obligation to a customer	IFRS 15 <i>Revenue from Contracts with Customers</i>	If the timing of the consideration the entity receives for goods or services provides the entity or the customer with a significant financing benefit, adjust the consideration to the price the entity would have charged if the customer had paid for the goods when it received them. The adjustment should reflect the time value of money, the credit characteristics of the party receiving financing and any collateral or security provided. ⁵
Lessee lease liabilities	IFRS 16 <i>Leases</i>	Discount the lease payments at the rate implicit in the lease if that rate can be readily determined (or at the lessee’s incremental borrowing rate if not). ⁶

⁴ Paragraph B13 of IFRS 13 *Fair Value Measurement*.

⁵ Paragraphs 60, 61 and 64 of IFRS 15 *Revenue from Contracts with Customers*.

⁶ Paragraph 26 of IFRS 16 *Leases*.

Type of liability	Applicable Standard	Requirements relating to the discount rate
Insurance contract liabilities	IFRS 17 <i>Insurance Contracts</i>	Discount future cash flows at a rate that reflects the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts. Do not reflect the non-performance risk of the entity ⁷ .
Post-employment benefits	IAS 19 <i>Employee Benefits</i>	Discount obligations at the market yields on high quality corporate bonds (or the market yields on government bonds if there is no deep market for high quality corporate bonds in the currency of the obligations). ⁸

- 3.19 The Basis for Conclusions accompanying IFRS 17 explains why the IASB decided to require measurements of insurance contract liabilities to exclude non-performance risk:

BC197 ... Some stakeholders expressed the view that information about own credit risk relating to a liability that must be fulfilled by the issuer, and about gains and losses arising from changes in the issuer's own credit risk, is not relevant for users of financial statements. The Board concluded that including the effect of a change in the entity's own non-performance risk in the measurement of an insurance contract liability would not provide useful information.

- 3.20 In explaining the discount rate requirements for pension obligations, the Basis for Conclusions accompanying IAS 19 focuses on whether the rate should reflect the expected return on the assets held by the pension fund. On non-performance risk, it states only that:

BC134 ... the discount rate should not reflect the entity's own credit rating, because otherwise an entity with a lower credit rating would recognise a smaller liability.

⁷ Paragraphs 31 and 36 of IFRS 17 *Insurance Contracts*.

⁸ Paragraph 83 of IAS 19 *Employee benefits*.

Discount rates required for provisions by US GAAP

3.21 US GAAP requirements are set out in the Accounting Standards Codification (ASC) issued by the US Financial Accounting Standards Board (FASB). Three ASC topics apply to provisions, contingent liabilities and contingent assets within the scope of IAS 37:

Table 2: FASB ASC Topics that apply to provisions, contingent liabilities and contingent assets

Topic	Subtopic	Scope
410	410-20	Asset retirement obligations—including associated environmental remediation obligations
	410-30	Other environmental remediation obligations
420	420-10	Exit or disposal cost obligations
450	450-20	Loss contingencies
	450-30	Gain contingencies

Asset retirement and associated environmental remediation obligations

3.22 FASB ASC Subtopic 410-20 applies to the types of provisions that are most likely to be long-term—obligations associated with the retirement of tangible long-lived assets, including environmental remediation obligations resulting from the normal operation of those assets and associated with their retirement.

3.23 The requirements of FASB ASC Subtopic 410-20 differ from those of IAS 37 in several ways. FASB ASC Subtopic 410-20 requires entities to:

- (a) recognise legal obligations, *but not constructive obligations*;
- (b) measure the obligations at *fair value* on initial recognition;
- (c) if estimating fair value using an expected present value technique, discount the expected cash flows *using a credit-adjusted risk-free rate*;

- (d) after initial recognition, update the measurement of the liability to reflect:
 - (i) the passage of time; and
 - (ii) changes in the estimate of the undiscounted cash flows—*but not changes in discount rates*.
- (e) classify the expense resulting from the passage of time as an *operating* item in the statement of income.

Other environmental remediation obligations, loss contingencies

- 3.24 FASB ASC Subtopic 410-30 applies to environmental remediation obligations other than those associated with asset retirement. An example is an obligation to clean up an oil spill. FASB ASC Subtopic 410-30 states that an obligation may be discounted to reflect the time value of money if the aggregate amount of the liability and the amount and timing of cash payments for the liability are fixed or reliably determinable. Discounting is permitted but not required when these criteria are met.
- 3.25 FASB ASC Topic 450, which applies to contingencies, does not refer to discounting. However, the SEC staff provide staff guidance on loss contingencies in Staff Accounting Bulletin (SAB) Topic 5.Y *Accounting and Disclosures Relating to Loss Contingencies* (reproduced in FASB ASC paragraph 450-20-S99-1). Guidance on the rate used to discount an environmental remediation or product liability states that:

The rate used to discount the cash payments should be the rate that will produce an amount at which the environmental or product liability could be settled in an arm's-length transaction with a third party. Further, the discount rate used to discount the cash payments should not exceed the interest rate on monetary assets that are essentially risk free [as described in FASB Concepts Statement 7 *Using Cash Flow Information and Present Value in Accounting Measurements*] and have maturities comparable to that of the environmental or product liability.

Exit or disposal cost obligations

- 3.26 FASB ASC Subtopic 420-10 requires entities to measure exit or disposal cost obligations initially at fair value and subsequently by updating the measure for changes in the estimated amount or timing of the cash flows, but not changes in discount rates.

4 Current practice

This chapter summarises evidence we have gathered about the discount rates entities use in practice to measure provisions—specifically, whether entities include non-performance risk, and in what circumstances.

The evidence includes:

- (a) findings of academic research;
- (b) feedback from national standard-setters;
- (c) information published by the UK Financial Reporting Council (FRC); and
- (d) information we obtained by reviewing financial statements.

Findings of academic research

IAAER-KPMG research programme

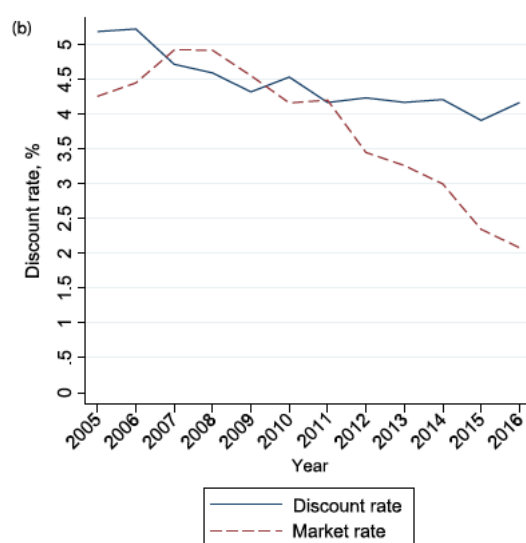
- 4.1 The International Association for Accounting Education and Research (IAAER) and KPMG sponsor a research programme *Informing the IASB Standard Setting Process*. This programme supports academic research projects that provide evidence-based inputs to the IASB's decision-making process.
- 4.2 A recent project obtained evidence of the information entities report about environmental liabilities.⁹ The researchers examined 4,788 annual reports published by 399 European oil & gas, mining and utilities entities over the period 2005–2016. They found, among other things, that:
 - (a) the proportion of entities disclosing rates used to discount environmental liabilities rose from approximately 25% to approximately 50% over that period; and

⁹ *IAAER – KPMG Research Opportunities Programme Round 6*. Research findings presented to the IASB in 2021 by Mari Paananen, Emmeli Runesson and Niuosha Samani.

- (b) in the earlier years, reported discount rates were to some degree aligned with long-term government bond rates. However, from 2011 onwards (a period with very low market interest rates in the aftermath of the financial crisis), this alignment discontinued.¹⁰

Figure: Comparison of reported discount rates and market rates

Reproduces Figure 2b on page 20 of Paananen et al (2021)



ICAS research report

- 4.3 Chapter 6 of this paper discusses a report [Black Box Accounting: Discounting and disclosure practices of decommissioning liabilities](#), published by the research panel of ICAS¹¹ ([ICAS research report](#)). That report summarises the findings of its three academic authors' research into the information entities provide in financial statements about the rates they use to discount provisions for decommissioning and environmental obligations.
- 4.4 In addition to analysing financial statements, the authors interviewed 27 people with an interest in financial reporting (preparers and auditors of financial statements, investors, regulators, standard-setters and representatives of environmental non-governmental

¹⁰ The findings are published in *Accounting Forum*. Paananen, M., Runesson, E., and Samani, N. (2021) 'Time to clean up environmental liabilities reporting: disclosures, media exposure and market implications', *Accounting Forum*, 45 (1), 85-116.

¹¹ Also known as the Institute of Chartered Accountants of Scotland.

organisations). Among other things, the authors asked interviewees whether they were aware of significant diversity in the rates used for discounting decommissioning and environmental obligations and, if so, what factors might explain that diversity.

- 4.5 Pages 31–32 of the [ICAS research report](#) discuss the responses to that question. Notably, the authors concluded that ‘diversity in practice is the norm, not the exception’ noting, among other things, that:
- (a) what came across clearly in the interviews was that auditors, regulators and standard-setters considered that entities applying IAS 37 had the choice to use either a risk-free rate or a credit-adjusted rate to discount provisions.
 - (b) the IFRS Interpretations Committee’s agenda decision had not helped to reduce diversity—‘it just reinforced that there might be an element of judgement’.
 - (c) comments supported two of the authors’ previous findings¹² that Canadian mining entities with large decommissioning liabilities and significant exposure to the US equity market are more likely than other Canadian mining entities to reflect credit risk in their discount rates (thereby maintaining a degree of comparability with their US peers).

Information from national standard-setters

- 4.6 The people interviewed for the ICAS research were all based in North America and Europe—mainly in Canada and the UK.
- 4.7 To obtain evidence of practice in other regions, we consulted members of the Asian-Oceanian Standard Setters Group (AOSSG) and the Group of Latin American Accounting Standard Setters (GLASS). We asked those members:
- (a) whether entities within the member’s jurisdiction reflect credit risk in the rates they used to discount provisions; and
 - (b) if there is diversity in practice, whether the members are aware of any factors that might affect decisions on which rate to use.

¹² Schneider, T., Michelon, G. and Maier, M. (2017), "Environmental liabilities and diversity in practice under international financial reporting standards", *Accounting, Auditing and Accountability Journal*, 30 (2), 378-403.

Feedback from AOSSG members

- 4.8 Five members of AOSSG replied. Of these:
- (a) four—from Australia, China, Hong Kong and Korea—reported diversity in practice in their regions, with some entities including credit risk and others excluding it; and
 - (b) one—from Malaysia—reported that, although few entities in that country have large long-term decommissioning or environmental provisions, there are some that discount those provisions at a rate that includes credit risk.
- 4.9 Of the members reporting diversity in practice:
- (a) the Australian and Korean members reported that the predominant practice is to exclude credit risk;
 - (b) the Hong Kong member reported that neither practice appears to predominate;
 - (c) the Chinese member was unable to say which practice predominates in China because entities often disclose insufficient information about the basis for determining the discount rates they have used; and
 - (d) none of the members said they had identified any variation in practice between sectors (oil & gas, mining, utilities, etc). In other words, diversity in practice exists across and within sectors.

Feedback from GLASS members

- 4.10 Three members of GLASS replied, reporting that:
- (a) although it is not common for Brazilian entities to reflect credit risk in discount rates for provisions, there are exceptions—entities in some industries reflect credit risk in the rates they use to discount asset decommissioning provisions;
 - (b) there is no prevailing practice in Argentina; and
 - (c) Mexican financial reporting standards require entities to discount asset decommissioning provisions at a rate that reflects credit risk.

Information published by the UK FRC

- 4.11 In May 2022 the UK FRC published the report [Thematic Review: Discount Rates](#).¹³ This report comments on application by UK entities of the discount rate requirements of IFRS Accounting Standards—in particular, the requirements of IAS 36 *Impairment of Assets* and of IAS 37. The report summarises application issues identified by the FRC’s Corporate Reporting Review team and other FRC departments and provides guidance to entities on how to avoid errors. Among other guidance, the report includes:
- (a) an illustration of how for liabilities a risk-adjusted discount rate is lower than the risk-free rate;
 - (b) a statement that the FRC does not commonly see own credit risk being included in the measure of a provision; and
 - (c) a warning that the FRC is likely to challenge entities that adjust rates for discounting provisions to include their own credit risk, if it is not clear why the adjustment is justified for the specific liability.
- 4.12 The FRC uses the report to remind preparers of financial statements to use real (not nominal) discount rates if they estimate the future cash flows at current prices. And it notes that, at the time of publishing the report, real risk-free rates were negative in some currencies, including pounds sterling.

Information obtained by reviewing financial statements

- 4.13 Performing a key word search on the AlphaSense research platform, we identified 115 sets of financial statements issued by entities that apply IFRS Standards and recognise asset decommissioning or environmental rehabilitation provisions. Of these 115 sets:
- (a) 57 disclosed the basis on which the discount rate was determined; and
 - (b) seven disclosed that the rate reflected credit risk. Six of these entities were Canadian.

¹³ Available at: <https://www.frc.org.uk/accountants/corporate-reporting-review/corporate-reporting-thematic-reviews>.

- 4.14 Five of the 115 sets of financial statements we reviewed for reporting periods between 2018 and 2022 disclosed that the reporting entity had, in the reporting period we reviewed, changed the basis on which it determined the discount rates for its provisions:
- (a) two oil & gas entities—one Canadian and one Norwegian—changed from *including* credit risk to *excluding* it. The Canadian entity disclosed that the effect of the change was to reduce its discount rate from 6% to 0.2%. The Norwegian entity disclosed that it had changed its policy to better represent the risks specific to the decommissioning liability, and that the change increased the measure of that liability at the end of the reporting period from US\$20 billion to US\$23 billion.
 - (b) three Canadian oil & gas entities changed from *excluding* credit risk to *including* it. The effect of the change was (i) to increase their discount rates from between 0.2% and 2.2% to between 5.1% and 7.5%, and (ii) to approximately halve the measure of their asset decommissioning liabilities. In explaining the reasons for their change in accounting policy, all three entities asserted that the use of a credit-adjusted risk-free rate:
 - (i) results in reliable and more relevant information for readers of the financial statements;
 - (ii) provides a more accurate representation of (or more closely approximates) the value at which the liabilities could be transferred to a third party; and
 - (iii) increases the comparability of the entity's financial statements to those of ('certain') peers.

5 Factors that could affect the IASB's decision

This chapter discusses factors that could affect the IASB's decision on whether to require the rates used to discount provisions to reflect non-performance risk:

- (a) whether non-performance risk is specific to the liability;
- (b) the intentions of the International Accounting Standards Committee (IASC) when it developed IAS 37;
- (c) measurement concepts in the IASB's *Conceptual Framework for Financial Reporting (Conceptual Framework)*;
- (d) a difference between provisions and other liabilities;
- (e) the measurement objective of IAS 37;
- (f) information provided to investors;
- (g) subsequent measurement—'counter-intuitive' results and accounting mismatches;
- (h) measurement uncertainty; and
- (i) convergence with US Generally Accepted Accounting Principles (US GAAP).

The discussion in this chapter incorporates learning from a previous IASB workstream on non-performance risk in liability measurement.

Previous IASB workstream on non-performance risk in liability measurement

- 5.1 In June 2009 the IASB published [Discussion Paper Credit Risk in Liability Measurement](#), a short Discussion Paper that introduced and invited feedback on a [Staff Paper Credit Risk in Liability Measurement](#) (Staff Paper). The Staff Paper, written by Wayne S Upton Jr, outlined the most often-cited arguments for and against including non-performance risk in the measure of a liability.

- 5.2 The IASB received 123 [comment letters](#) on the Staff Paper. In October 2009 having discussed the feedback in the comment letters, the IASB decided to:
- (a) stop work on non-performance risk as a free-standing work stream, without reaching a general conclusion on non-performance risk; and
 - (b) consider the question of non-performance risk in other projects involving a current measurement of liabilities.¹⁴
- 5.3 The arguments discussed in the Staff Paper and the feedback in the comment letters focused on the initial and subsequent measurement of financial liabilities, and especially on fair value measurement of such liabilities. This focus reflected the IASB's work plan at the time—the IASB was developing proposals that led to additions to IFRS 9 *Financial Instruments* on classification and measurement of financial liabilities (2010) and to IFRS 13 *Fair Value Measurement* (2011).
- 5.4 However, both the Staff Paper and some of the comment letters extended some aspects of their discussion to non-financial liabilities, including provisions within the scope of IAS 37. The staff analysis in this chapter reflects those aspects of the discussion.

Whether non-performance risk is specific to the liability

- 5.5 As reported in paragraph 3.17, in March 2011 the IFRS Interpretations Committee published an agenda decision in which it stated its understanding that an entity's own credit risk was generally viewed in practice as a risk of the entity rather than a risk specific to a liability.
- 5.6 However, the IASB has on several occasions expressed a view that the non-performance risk associated with a particular liability of an entity *is* specific to that liability because, although it depends in part on the entity's overall credit standing, it also depends on other factors that are specific to the liability.

¹⁴ [IASB Update, October 2009](#).

5.7 The Introduction to [Staff Paper Credit Risk in Liability Measurement](#) states that:

2 Commentators frequently refer to the role of credit risk as ‘own credit’. An entity’s credit standing affects the credit risk of its liabilities, but the effect may be different from one liability to another. For example, a well-collateralised liability has less credit risk than an entity’s other liabilities. For other liabilities, the credit risk of the entity translates directly to the credit risk of the liability. The International Accounting Standards Board has stressed that it is the particular liability that is being measured, and the relevant credit risk is the risk associated with that liability.

5.8 Both IFRS 9 and IFRS 13 discuss liability-specific components of non-performance risk:

(a) paragraph 5.7.7(a) of IFRS 9 discusses presentation of changes in the fair value of a financial liability attributable to a change in the credit risk of the liability. Application guidance in Appendix B to IFRS 9 clarifies that:

B5.7.13 ... The requirement in paragraph 5.7.7(a) relates to the risk that the issuer will fail to perform on that particular liability. It does not necessarily relate to the creditworthiness of the issuer. For example, if an entity issues a collateralised liability and a non-collateralised liability that are otherwise identical, the credit risk of those two liabilities will be different, even though they are issued by the same entity. The credit risk on the collateralised liability will be less than the credit risk of the non-collateralised liability. The credit risk for a collateralised liability may be close to zero.

(b) IFRS 13 states that:

43 When measuring the fair value of a liability, an entity shall take into account the effect of its credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled. That effect may differ depending on the liability, for example:

- (a) whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability).
- (b) the terms of credit enhancements related to the liability, if any.

5.9 In addition to the existence of collateral, there are other liability-specific factors that can affect the non-performance risk associated with a liability. These include, for example:

- (a) sources of non-performance risk other than the credit standing of the entity—for example regulatory, operational or commercial risks.
- (b) the legal status of the counterparty—some counterparties can have ‘preferred creditor’ status, meaning that those parties’ claims are settled ahead of other claims if the entity is liquidated. In some jurisdictions, an entity’s environmental obligations rank above all other liabilities in the event of the entity’s bankruptcy.
- (c) whether the liability is contractually subordinated to other liabilities, meaning that the liability would be settled after the liabilities to which it is subordinated if the entity is liquidated.
- (d) the possible existence and value of resources ring-fenced to fulfil the liability, and not available to other creditors—for example, a pension fund or asset decommissioning fund.

The intentions of the IASC when it developed IAS 37

5.10 Although the non-performance risk associated with a liability is specific to that liability, it is not necessarily one of the risks that the IASC intended entities to reflect in the rate at which they discount a provision. As discussed in paragraphs 3.3–3.14, the available evidence suggests that 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, as described in paragraphs 42-43 of IAS 37 (and 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).

Measurement concepts in the *Conceptual Framework*

- 5.11 Chapter 6 of the *Conceptual Framework* sets out concepts for measuring assets and liabilities. It discusses three current value measurement bases for liabilities: fair value, fulfilment value and current cost. The measurement objective in IAS 37 is possibly closest to fulfilment value, which the *Conceptual Framework* defines as ‘the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability’.¹⁵
- 5.12 The *Conceptual Framework* notes that fulfilment value reflects the same factors as fair value, but from an entity-specific perspective rather than from a market-participant perspective. It lists the factors reflected in fair value and states that these factors include the possibility that the entity may fail to fulfil its liability.¹⁶
- 5.13 The *Conceptual Framework* notes that fulfilment value cannot be observed directly and is determined using cash-flow-based measurement techniques.¹⁷ In discussing such techniques the *Conceptual Framework* states that:
- 6.92 Cash-flow-based measurement techniques can be used in applying a modified measurement basis, for example, fulfilment value modified to exclude the effect of the possibility that the entity may fail to fulfil a liability (own credit risk). Modifying measurement bases 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. However, modified measurement bases may also be more difficult for users of financial statements to understand.
- 5.14 IFRS 17 *Insurance Contracts* is an example of an IFRS Accounting Standard that has a measurement objective based on fulfilment value but requires a discount rate that excludes non-performance risk—justifying the exclusion on the grounds that information about the effect of a change in the non-performance risk associated with an insurance contract liability is not useful information (as detailed further in paragraph 3.19).

¹⁵ Paragraphs 6.11 and 6.17 of the *Conceptual Framework*.

¹⁶ Paragraphs 6.14, 6.15 and 6.20 of the *Conceptual Framework*.

¹⁷ Paragraphs 6.20 of the *Conceptual Framework*.

A difference between provisions and other liabilities

- 5.15 In deciding how to account for non-performance risk associated with a liability, a factor to consider is how that risk has affected the pricing of the transaction giving rise to the liability. Non-performance risk does not necessarily affect the pricing of transactions that give rise to provisions in the same way as it affects the pricing of transactions that give rise to other types of liabilities.

When and how non-performance risk affects the pricing of a transaction

- 5.16 Non-performance risk affects the pricing of a commercial exchange transaction if one party to the transaction fulfils its obligations (transfers economic resources) before the other party:
- (a) the party that is first to transfer economic resources demands economic resources of greater value from the other party in return, one component of the difference being a non-performance risk premium—compensation the first party requires for accepting the risk that the other party will not fulfil its obligations; and
 - (b) applying IFRS Accounting Standards, each party recognises that non-performance risk premium over the period between the first and second legs of the exchange—the period over which the first party bears the risk of non-performance by the other party. The non-performance risk premium is generally recognised as finance income by the recipient, and as a finance cost by the payer.

Loans with interest payments

- 5.17 A non-performance risk premium is most obviously present in a loan with interest payments. The lender increases the required loan repayments to reflect the borrower's credit standing and any other factors affecting the risk of non-repayment of the loan.
- 5.18 The non-performance risk premium required by a lender depends not only on the probability of non-performance, but also on the amount and duration of the loan. So it can be added into the repayments by increasing the rate of interest charged on the balance outstanding.

Zero-coupon bonds

- 5.19 Instead of obtaining a loan from a commercial lender, an entity might issue bonds to investors. The bonds might provide holders with annual interest. Alternatively, they might be 'zero-coupon' bonds that are issued at a discount to their maturity value and provide the bondholder with a return in the form of maturity proceeds that exceed the issue price. Like the interest on a loan, the return to the bondholder (the annual interest or difference between maturity proceeds and issue price) will be priced to include a non-performance risk premium.
- 5.20 The issuing entity accounts for a zero-coupon bond by initially measuring the bond liability at the discounted amount it has received from bondholders. It may subsequently measure the bond at 'amortised cost', increasing the measure (unwinding the discount) each period by the effective interest rate—the single rate that increases the measure of the bond liability to reach the maturity value of the bond by its maturity date. The unwinding of the discount on the bond reflects a future cash outflow, and the portion of the unwinding that relates to the non-performance risk reflects the cash outflow for the non-performance risk premium, recognising that cash outflow as an expense over the period in which the bondholder bears the risk.

Example 4—recognition of non-performance risk premium**Fact pattern**

On 1 January 20X1, an entity issues zero-coupon bonds with a maturity value of CU1,540, maturing in five years on 31 December 20X5. The entity issues the bonds at a discounted amount of CU1,000.

Of the CU540 difference between the issue price and maturity proceeds, CU180 reflects the premium that bondholders demand as compensation for non-performance risk.

Effective interest rate

The effective interest rate (the amount that discounts CU1,540 to CU1,000) is 9% per year. A portion of this effective interest rate is attributable to the premium for non-performance risk.

Year	20X1	20X2	20X3	20X4	20X5	Total
	CU	CU	CU	CU	CU	CU
Liability at 1 January	1,000	1,090	1,188	1,295	1,412	
Unwinding of discount (9%)	90	98	107	117	128	540
Repayment	-	-	-	-	(1,540)	
Liability at 31 December	1,090	1,188	1,295	1,412	-	
Unwinding represents:						
- non-performance risk premium ¹⁸	27	30	35	41	47	180
- other components of lender's return	63	68	72	76	81	360
	90	98	107	117	128	540

Other liabilities arising from commercial exchange transactions

- 5.21 It is perhaps most obvious that the cash flows required to settle a liability include a non-performance risk premium if the liability is a commercial lending arrangement (for example, a loan, bond or lease) with an effective interest rate that depends on the entity's credit standing, and that can be measured by comparing monetary amounts lent to the entity (the loan or bond proceeds or the market purchase price of leased assets) with monetary amounts repayable to the lender.
- 5.22 The cash flows required to settle other types of liability might also reflect non-performance risk, albeit in a less obvious way. For example:
- (a) an entity might sell goods or services to a customer, requiring payment in advance on terms that provide the entity with a significant financing benefit. In such cases, the price that the entity would rationally charge for the goods or services would reflect that

¹⁸ The total amount that unwinds in each period (eg CU90 in the first year), and the total amounts that unwind for each component (eg CU180 for the non-performance risk premium) are fixed. However, these totals can be allocated between components and periods in various ways. The method of allocation used in this example is explained in footnotes to Example 5 below paragraph 5.28.

financing benefit, either explicitly or implicitly—the price would be reduced by an explicit or implicit amount to reflect the time value of money, the entity's credit characteristics, and any other factors affecting the non-performance risk associated with the entity's performance obligations.

- (b) an entity's employees might consider the entity's financial position in assessing the acceptability of the pension benefits promised by the entity. The employees would rationally require higher pension benefits to compensate them for a risk that the entity will not fulfil its pension obligations. By discounting a liability to pay those higher benefits at a rate that reflects the non-performance risk associated with them, the entity would measure the service cost recognised when the employees provide their service at the present value of that service.

- 5.23 In some cases, the non-performance risk premium associated with a liability might be subject to a high degree of measurement uncertainty. For example, the amount of any non-performance risk premium required by a group of employees is likely to be highly uncertain and difficult for an entity to measure. It might be smaller than the non-performance risk premium associated with the entity's other liabilities, and less closely correlated to its own credit standing, because many jurisdictions have regulations to protect pension holders from the risk of non-performance—for example, preferred creditor status and minimum funding requirements.

Provisions within the scope of IAS 37

- 5.24 Unlike many other liabilities, provisions within the scope of IAS 37 tend not to arise from commercially-priced exchange transactions. Provisions often arise from non-reciprocal transactions—being triggered by the entities own actions. They may stem from statutory requirements (for example, to pay a levy on revenue generated by operating in a specific market, or to rehabilitate land damaged by the entity's operations) or from other legal requirements (for example, to compensate another party for harm caused by an act of negligence). The counterparty to a provision (for example, a government acting on behalf of its citizens) is not necessarily in a position to demand a premium to compensate it for non-performance risk. It might bear the risk without compensation, or it might seek to protect itself in a different way—for example, by requiring the entity to contribute to a fund that will settle the obligations of contributors in the event of their bankruptcy.

- 5.25 So we cannot assume that the expenditure required to settle a provision includes a non-performance risk premium. Indeed, for many provisions it will be obvious that there is no such premium, for example:
- (a) if the provision relates to an obligation to provide goods or services (for example, an obligation to decommission an asset or rehabilitate land) and the only expenditure required to settle the provision is the cost of providing those goods or services; or
 - (b) the provision is for a government levy on entities operating in a specific market and the amount each entity pays is independent of that entity's credit standing.
- 5.26 There may be some (perhaps rare) circumstances in which the expenditure required to settle a provision includes a non-performance risk premium, for example:
- (a) if a government permits an entity to defer payment of a levy, on the condition that the entity pays interest on the deferred amount at a rate that reflects non-performance risk; or
 - (b) if a claimant in a legal dispute has agreed to settle on terms that allow the entity to pay it in instalments, and the settlement amount reflects those terms, including the risk of non-performance.

Implications for the IASB's decision

- 5.27 The analysis above suggests that, when an entity includes non-performance risk in a discount rate for a liability, doing so:
- (a) reflects the effect of non-performance risk on the pricing of a transaction, and the entity's obligation to pay a premium to the counterparty to compensate it for non-performance risk; and
 - (a) recognises the obligation to pay that premium over the period in which the counterparty bears the non-performance risk.

- 5.28 To apply a similar approach for provisions:
- (a) the discount rate for a provision would reflect non-performance risk if—but only if—the cash flows required to settle the provision (and so included in the measure of the provision) include a premium payable to the counterparty to compensate it for that risk; and
 - (b) the discount rate would be increased by the amount required to:
 - (i) reduce the initial measure of the provision (and of the associated expense or asset received) by the amount of the non-performance risk premium; and
 - (ii) recognise that premium over the expected duration of the provision, as the discount unwinds.

Example 5—recognising an obligation to pay a counterparty for accepting non-performance risk

Fact pattern

On 1 January 20X1, an entity recognises a provision that it expects to settle five years later on 31 December 20X5. The entity's best estimate of the cash flows required to settle the provision—adjusted to reflect the uncertainty in those cash flows—is CU1,540. This amount comprises:

- CU1,360—the certainty equivalent of the best estimate of the expenditure required to settle the present obligation, and
- CU180—an amount the entity is additionally required to pay to the counterparty to compensate the counterparty for non-performance risk.

The current yield on high quality five-year government bonds is 6.35%.

Adjustment to discount rate to reflect non-performance risk

To reflect non-performance risk in the discount rate, the entity increases the rate from 6.35% to 9%, an increase of 2.65%. This increase is required to:

- omit the non-performance risk premium of CU180 from the initial measure of the liability (and of the associated expense or asset received), and
- recognise that premium over the 5 years in which the counterparty bears non-performance risk.

Year	20X1	20X2	20X3	20X4	20X5	Total
	CU	CU	CU	CU	CU	CU
Provision at 1 January	1,000	1,090	1,188	1,295	1,412	
Unwinding of discount (9%)	90	98	107	117	128	540
Repayment	-	-	-	-	(1,540)	
Provision at 31 December	1,090	1,188	1,295	1,412	-	
Unwinding reflects ¹⁹ :						
- non-performance risk premium ²⁰	27	30	35	41	47	180
- time value of money ²¹	63	68	72	76	81	360
	90	98	107	117	128	540

¹⁹ The total amount that unwinds in each period (eg CU90 in the first year), and the total amounts that unwind for each component (eg CU180 for the non-performance risk premium) are fixed. However, these totals can be allocated between components and periods in various ways. In this example, we've allocated all the incremental effects of the non-performance risk premium to that component, as detailed in footnotes 20 and 21.

²⁰ Non-performance risk adjustment (2.65% x opening balance) + time value of money adjustment attributable to non-performance risk premium (6.35% x non-performance risk premium included in opening balance).

²¹ Time value of money adjustment attributable to costs other than non-performance risk premium (6.35% x opening balance of provision excluding non-performance risk premium included in that provision).

- 5.29 Requirements based on such an approach might result in many (perhaps almost all) provisions being discounted at a rate that *excludes* non-performance risk. As discussed in paragraphs 5.24–5.25, the expenditure required to settle a provision typically includes no premium compensating the counterparty for non-performance risk.
- 5.30 An [analysis of comments](#) on [Staff Paper Credit Risk in Liability Measurement](#) reported that there was little support for including credit risk in the measure of pensions liabilities, insurance contract liabilities or provisions. One of the reasons reported in the analysis was that ‘credit risk should only be included in measurement of a liability when it is priced into the (usually cash) transaction that gives rise to the liability’.²²

The measurement objective of IAS 37

- 5.31 Consistency with the measurement objective of IAS 37 could be an important factor to consider in deciding whether the measure of a provision should reflect non-performance risk.
- 5.32 However, the measurement objective of IAS 37 is unclear. In particular, there is a tension between:
- (a) the ‘black letter’ objective in paragraph 36 of IAS 37, which requires a prediction of the outcome—the best estimate of the expenditure required to settle the present obligation; and
 - (b) the clarification that follows in paragraph 37 of IAS 37, which introduces a notion of a valuation—the amount the entity would rationally pay to settle the obligation at the end of the reporting period, or transfer it to a third party at that time.

²² Paragraph 27 of October 2009 IASB meeting [Agenda Paper 6 Credit Risk in Liability Measurement—Comment letter analysis](#).

- 5.33 The IASB has previously considered amending IAS 37, deleting either paragraph 36 or paragraph 37 and retaining the other paragraph as the sole description of the measurement objective. However, the IASB did not proceed with the amendments on either occasion.²³ So IAS 37 retains two concepts within its measurement objective, one of which could possibly support the exclusion of non-performance risk and the other of which could possibly support its inclusion.
- 5.34 It could be argued that:
- (a) paragraph 36 of IAS 37 implies that the discount rate should *exclude* non-performance risk (unless the cash outflows include a premium to compensate the counterparty for non-performance risk)—as explained in paragraph 5.35–5.36; but
 - (b) paragraph 37 of IAS 37 implies that the discount rate should *include* non-performance risk (irrespective of whether the cash outflows include a premium to compensate the counterparty for non-performance risk)—as explained in paragraphs 5.37–5.38.

Consistency with paragraph 36—the best estimate of the expenditure required to settle the present obligation

- 5.35 Discounting future cash flows at a rate that reflects non-performance risk—without the entity paying a premium to the counterparty for accepting that risk—has the effect of reducing the measure of an obligation to reflect the probability of non-performance.

²³ In 2010, as part of a previous project to replace IAS 37 with a new IFRS Accounting Standard for non-financial liabilities, the IASB published [Exposure Draft *Measurement of Liabilities in IAS 37*](#). In that Exposure Draft, the IASB proposed a measurement objective based on **paragraph 37** of IAS 37. Stakeholders expressed concern about this proposal, and about other proposals developed in the same project. The project was stopped at the end of 2010.

In January 2020, in reaching decisions about the scope of this current project to make targeted improvements to IAS 37, the Board considered whether to clarify the measurement objective and requirements of IAS 37 by redrafting them using the description of fulfilment value in the *Conceptual Framework*. This redrafting could have included deleting paragraph 37 of IAS 37, retaining **paragraph 36** as the sole description of the measurement objective. See paragraphs 17–22 of IASB January 2020 meeting [Agenda Paper 22 *Provisions—Project proposal*](#). Some IASB members expressed concern that including this topic in the project could significantly expand the scope of an otherwise targeted project.

5.36 It could be argued that:

- (a) reducing the measure of a provision in this way would be inconsistent with the measurement objective in paragraph 36 of IAS 37. The measurement objective is the best estimate of the expenditure required to *settle* the entity's obligation (see paragraph 3.1)—not the best estimate of the expenditure that will be incurred when the entity *either settles or fails to settle* the obligation.
- (b) discounting a provision at a rate that reflects non-performance risk would be consistent with the measurement objective in paragraph 36 of IAS 37 only if—and to the extent that—the cash flows required to *settle* the provision include a premium to the counterparty to compensate it for that risk.

Consistency with paragraph 37—the amount the entity would rationally pay to settle or transfer the obligation

5.37 Paragraph 37 states that ‘the best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time’.

5.38 It could be argued that a measure of the amount that an entity would rationally pay to settle or transfer the obligation at the end of the reporting period would take into account the probability that the entity will fail to settle the obligation at a future date. This measure could be achieved by either:

- (a) including non-settlement as one of the possible outcomes, and applying a risk-free rate to discount the certainty equivalent of the cash flows for all those possible outcomes; or
- (b) excluding non-settlement from the possible outcomes, but increasing the discount rate to reflect the effect of non-performance risk.

Information provided to investors

- 5.39 Whether an entity includes non-performance risk in the rate at which it measures a provision affects the type of information it provides in its financial statements.

If the discount rate excludes non-performance risk

- 5.40 Suppose an entity discounts a provision at a rate that includes non-performance risk only if—and to the extent that—the expenditure required to settle the provision includes a premium payable to the counterparty for non-performance risk.
- 5.41 The expenditure required to settle many (perhaps almost all) provisions includes no such premium. By discounting such provisions at a rate that excludes non-performance risk:
- (a) the measure of the provision would represent the amount the entity would need to invest in risk-free assets at the end of the reporting period to fund the settlement of the obligation (to pay the certainty equivalent of the estimated future cash flows) at a future date; and
 - (b) the measure of the discount rate would provide information about the time value of money. The absence of a risk premium would tell investors that the entity incurs no expense for non-performance risk—it is not required to compensate the counterparty for accepting that risk.
- 5.42 In the (perhaps rare) circumstances, in which the cash flows required to settle a provision include a premium to the counterparty to compensate it for accepting non-performance risk:
- (a) the measure of the provision would represent the amount the entity would need to invest in risk-free assets at the end of the reporting period to fund the settlement of the obligation at a future date, including the portion of the risk premium accrued by the end of the reporting period; and
 - (b) the rate at which the discount unwinds would provide information about the non-performance risk premium charged by the counterparty—the expense actually incurred by the entity.

If the discount rate includes non-performance risk

- 5.43 Suppose that an entity instead discounts a provision at a rate that reflects the non-performance risk associated with that provision (irrespective of whether the expenditure required to settle the provision includes a premium payable to the counterparty to compensate it for accepting that risk):
- (a) the measure of the provision would place an economic value on the entity's obligation (and the counterparty's claim), reflecting the transfer of non-performance risk and making the provision more comparable with other liabilities measured at a current value. The measure would tell investors that, if settling a provision does not require an entity to pay a non-performance risk premium to the counterparty:
 - (i) that provision is less onerous than an otherwise-identical liability that does require the entity to pay a non-performance risk premium; and
 - (ii) the value of the counterparty's claim is lower than it would have been if the counterparty had required compensation for accepting non-performance risk.
 - (b) the measure of the expense incurred, or the cost of the asset received, would accurately reflect the economic value of that expense or asset.
 - (c) the discount rate used to measure the provision would provide information about the time value of money and the level of non-performance risk associated with the provision and transferred to the counterparty. This non-performance risk exists and transfers to the counterparty, irrespective of whether the entity compensates the counterparty for accepting that risk.
 - (d) the unwinding of the discount in each period would reflect the extent to which the non-performance risk has expired during the reporting period.

Subsequent measurement—‘counter-intuitive’ results and accounting mismatches

- 5.44 IAS 37 requires an entity to update the measure of a provision at each reporting date, using current estimates of cash flows and risks, and current market assessments of the time value of money.
- 5.45 If an entity measures a liability using a discount rate that reflects non-performance risk, an increase in that risk from one reporting period to the next (for example, because of a *decline* in the entity’s credit quality) reduces the measure of the liability, which can result in the entity recognising a *gain*. Conversely, a reduction in the risk of non-performance (for example, because of an *improvement* in the entity’s credit quality) increases the measure of the liability, which can result in the entity recognising a *loss*.
- 5.46 People often describe such results as counter-intuitive, arguing that a decline in an entity’s financial position should result in recognition of a loss (not a gain), and an improvement should result in recognition of a gain (not a loss).
- 5.47 Some people go on to argue that:
- (a) although the gain recognised from a decline in an entity’s financial position may be justified in theory—it results in a wealth transfer from the entity’s lenders to its equity holders²⁴—recognising that gain and a reduction in the entity’s liability provides relevant information only if the entity is able to realise the gain, for example by repurchasing the liability or transferring it at a discounted amount. Many liabilities cannot be repurchased or transferred. If a liability will not be repurchased or transferred, a decline in the entity’s financial position does not reduce the entity’s obligation—the entity must still pay the same amounts. In such cases, recognising a gain from a decline in credit quality is potentially misleading and can mask a deteriorating situation.
 - (b) a decline in an entity’s financial position is also likely to reduce the fair value of the entity’s assets. Unless those assets are also remeasured, remeasuring the liability creates an accounting mismatch.

²⁴ As explained further in paragraphs 32 – 41 of [Staff Paper Credit Risk in Liability Measurement](#).

- 5.48 These objections to updating liability measurements for changes in non-performance risk have influenced the IASB's decisions in developing requirements for other IFRS Accounting Standards. For example:
- (a) as reported in paragraph 3.19, in explaining why IFRS 17 requires measurements of insurance contract liabilities to exclude non-performance risk, the Basis for Conclusions accompanying IFRS 17 refers to a view that information about gains and losses arising from changes in the credit risk of an entity with an insurance contract liability is not relevant for investors.
 - (b) Paragraph 5.7.7 of IFRS 9 addresses the presentation of changes in the fair value of a financial liability that has been designated under the fair value option. It requires the amount attributable to a change in the credit risk of the liability to be presented in other comprehensive income instead of in profit or loss (unless doing so would create or enlarge an accounting mismatch in profit or loss). The Basis for Conclusions explains that:

BC5.35 ... if an entity designates a financial liability under the fair value option, IAS 39 required the entire fair value change to be presented in profit or loss. However, many users and others told the IASB over a long period of time that changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.
- 5.49 The arguments described in paragraph 5.45–5.47 might carry less weight for provisions than for some other liabilities. As discussed in Chapter 2, information about the effects of discounting a provision is most likely to be material for decommissioning and environmental rehabilitation provisions. Typically, changes to these provisions resulting from changes in the discount rate are not recognised as income or expenses in the period of change. Applying IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*, the changes are typically added to or deducted from the cost of the related property, plant and equipment.

Measurement uncertainty

- 5.50 There might be little evidence available to quantify the non-performance risk associated with a provision within the scope of IAS 37. Such obligations tend not to arise from commercially-priced exchange transactions and are rarely traded. Consequently, any estimate of a non-performance risk adjustment might be subject to significant measurement uncertainty, leading to loss of comparability.
- 5.51 The best observable estimate of the non-performance risk associated with a provision might be the non-performance risk reflected in the entity's borrowing rate. However, for a variety of reasons (including those listed in paragraph 5.9), the non-performance risk associated with a provision might be significantly different from that associated with the entity's borrowings, meaning the entity's observable borrowing rate might not provide a sufficiently accurate proxy.
- 5.52 In some cases, the level of measurement uncertainty could be so high that it may be questionable whether any estimate would provide a sufficiently faithful representation of the risk (or, to use IAS 37 phraseology, a 'sufficiently reliable'²⁵ measure of the risk).
- 5.53 An [analysis of comments](#) on the [Staff Paper Credit Risk in Liability Measurement](#) reported that there was little support for including non-performance risk in the measure of pension liabilities, insurance contract liabilities or provisions. One of the reasons reported in the analysis was that 'it is very difficult or even impossible' to measure the non-performance risk for these liabilities because no observable market price exists.²⁶
- 5.54 However, there would be relatively little measurement uncertainty if:
- (a) the cash flows required to settle a provision (and so included in the measure of the provision) include a premium to compensate the counterparty for non-performance risk; and
 - (b) that premium is readily measurable—for example, it is an explicit amount payable to the counterparty in addition to the other costs of settling the obligation.

²⁵ Paragraph 25 of IAS 37.

²⁶ Paragraph 27 of October 2009 IASB meeting [Agenda Paper 6 Credit Risk in Liability Measurement—Comment letter analysis](#).

- 5.55 If the IASB decided to propose that the rate used to discount a provision should reflect non-performance risk only if the cash flows include a non-performance risk premium (as described in paragraphs 5.27–5.29), it could consider also proposing criteria relating to the evidence available to support the measure of that premium.

Convergence with US GAAP

- 5.56 Requiring an entity to discount an asset decommissioning or environmental rehabilitation obligation at a credit-adjusted risk-free rate would align the discount rate requirements of IAS 37 with those of US GAAP. However, as summarised in paragraph 3.23, there are several differences between US GAAP and IAS 37 requirements for asset decommissioning and environmental rehabilitation obligations—eliminating only one of them might be of little value to preparers of financial statements and investors.

6 Related matters—liquidity characteristics, disclosure

In developing proposals on non-performance risk, the IASB might need to consider two related matters:

- (a) whether to require the discount rate for a provision to reflect the liquidity characteristics of the provision; and
- (b) the adequacy of the information entities disclose about the discount rates they have used to measure provisions.

This chapter discusses these matters.

Liquidity characteristics

- 6.1 When discussing whether discount rates for provisions should reflect non-performance risk, some stakeholders raise a related question—whether the rate should also reflect the liquidity characteristics of the provision.
- 6.2 Suggestions that the rate should reflect those characteristics arise from observations that:
 - (a) estimates of the time value of money often start with the notion of a risk-free rate. And in determining the risk-free rate for a provision, entities often look to the yield on a government bond of similar duration to the provision.
 - (b) a government bond is often a highly liquid asset—a bondholder can often sell the bond in the market at short notice without incurring significant costs or affecting the market price. Investors place value on an option to realise an investment at any time. So the yield investors require on a government bond is lower than the yield they would require on an asset that is less liquid but otherwise identical.
 - (c) a holder of rights arising from an entity's provision (the counterparty) typically cannot sell those rights in a market—the rights are illiquid. So, in theory, a counterparty would require a higher return from those rights than it would require from a liquid bond. It would require a 'liquidity premium' to compensate it for not being able to trade its rights or exchange them for cash during the period of illiquidity.

- 6.3 Illiquidity and non-performance risk have features in common. They are both factors for which a counterparty to a commercially-priced liability would rationally demand a premium over the yield on a risk-free government bond. And in both cases, the amount of the premium would depend on the duration of the liability and the amount outstanding. So it could be argued that an entity should recognise both types of premiums over the duration of its liability, as an increase in the discount rate applied to the cash flows.
- 6.4 For this reason, we think that it is possible that the conclusions the IASB reaches on non-performance risk could affect any conclusions it would reach on illiquidity.
- 6.5 This is a matter the IASB could return to when it has reached tentative decisions on non-performance risk.

Disclosure

- 6.6 When we discuss discount rates for provisions with stakeholders, stakeholders often tell us that the problems created by diversity in practice are exacerbated by inadequate disclosure of information about the rates entities have used. Some stakeholders—including some investors—have suggested that the IASB consider strengthening the disclosure requirements of IAS 37. Specifically, stakeholders have suggested adding to IAS 37 requirements for entities to disclose the discount rates they used and the basis on which they determined those rates.

Existing disclosure requirements

- 6.7 Several IFRS Accounting Standards permit or require entities to measure assets or liabilities by estimating the present value of uncertain future cash flows. Those Standards generally require entities to disclose (among other inputs or assumptions) the discount rates used in estimating the present value of the cash flows, and some of the Standards require entities to disclose the approach used to determine the discount rates.²⁷

²⁷ IFRS 2 *Share-based Payment*, paragraph 47(a)(i).
IFRS 13 *Fair Value Measurement*, paragraph 93(d) and Illustrative Example 17.

- 6.8 In contrast, IAS 37 has no specific requirement for entities to disclose either the discount rates used in measuring provisions or the basis on which those rates have been determined. This means that entities need to disclose such information only if management judges disclosure as being necessary to meet overarching requirements of IAS 1 *Presentation of Financial Statements* to disclose:
- (a) information about the 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.
 - (b) 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.
 - (c) material accounting policy information. Among the examples given of information that management is likely to view as material is information about accounting policies whose application requires the assumptions or judgements described in bullets (a) and (b).
 - (d) information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.²⁸
- 6.9 These requirements of IAS 1 are most likely to apply to information about large long-term provisions, such as the decommissioning and environmental rehabilitation provisions recognised by oil & gas, mining, utility and telecommunications entities. However, judgements about when and how these requirements apply to provisions are subjective. Furthermore, because there is no cross reference in IAS 37 to the requirements of IAS 1, it is possible that some preparers of financial statements overlook the requirements of IAS 1.

IFRS 17 *Insurance Contracts*, paragraphs 117(c)(iii) and 120.

IAS 19 *Employee Benefits*, paragraph 144.

IAS 36 *Impairment of Assets*, paragraph 134(d)(v).

²⁸ IAS 1 *Presentation of Financial Statements*, paragraphs 112(c), 117, 117B(d), 122 and 125.

Disclosure practices

ICAS research report

- 6.10 In October 2020, the research panel of ICAS published a research report [Black Box Accounting: Discounting and disclosure practices of decommissioning liabilities](#), (ICAS [research report](#)). That report summarises the findings of research by its three academic authors²⁹ into the information disclosed in financial statements about discount rates:
- (a) used by entities in oil & gas, mining and utilities industries;
 - (b) in applying IFRS Accounting Standards to measure provisions for decommissioning, clean-up and other related environmental obligations (decommissioning liabilities).
- 6.11 The authors analysed 4,339 sets of financial statements reporting decommissioning liabilities covering periods between 2005 and 2016. Of these financial statements, 2,103 (48%) disclosed the rate(s) the entity had used to discount the liabilities, the percentage being higher for entities incorporated in Canada and generally lower for entities incorporated elsewhere:

For example, among the countries most represented in the O&G sector, about 70 percent of Canadian companies disclose the discount rate, whereas the incidence of disclosing companies in the UK, Australia and Norway is relatively low (9.2%, 2.9% and 1.8%, respectively). This finding indicates that Canada is a special case, the reason for which emerged in the interviews: previous Canadian GAAP dictated disclosure of the discount rate. Such disclosure is also the expectation of securities regulators, as indicated in a comment from a Canadian regulator interviewee:

“I think people have carried that forward. From my perspective, I think that falls under IAS 1. ... I don’t think anyone even questioned that because it was already disclosed, so companies are not trying to hide it.”³⁰

²⁹ Giovanna Michelin, Professor of Accounting, University of Bristol, UK
Mari Paananen, Associate Professor of Accounting, University of Gothenburg, Sweden
Thomas Schnieder, CPA, CMA, Associate Profession of Accounting, Ryerson University, Toronto, Canada.

³⁰ Page 8 of the [ICAS research report](#).

- 6.12 The authors also found a wide range of discount rates being disclosed—of the entities that disclosed the rates they used, half disclosed rates of between 2.00% and 8.75%, but the rest disclosed rates ranging from 0% to 33.1%. The authors reported that the reason for those variations was unclear because entities are not fully transparent regarding how they determine the discount rate. However, the authors inferred from the business’s general context that high discount rates were usually associated with adopting a rate that reflected the location of operations. For example, the entity that disclosed the highest discount rate had operations in Argentina, where risk-free rates in the years covered by the sample were generally in double digits.³¹
- 6.13 The authors noted wide variations in the extent of the information entities disclosed about the discount rates they had used. Page 24 of the [ICAS research report](#) reproduces examples of basic, extended and comprehensive disclosures. In the summary of their findings, the authors noted that:
- (a) entities disclosing more comprehensive information provided the discount rates used and other underlying assumptions, including about the amount of the undiscounted cash flows and their timing;
 - (b) the most comprehensive disclosures also included other information—for example, detailed descriptions of the cash flows, a discussion of the uncertainties or sensitivity analyses; and
 - (c) interviews with stakeholders revealed that to get a more transparent view into the ‘black box’ of decommissioning liability measurements, investors need that more comprehensive information.³²

³¹ Page 8 and Table 4 on page 25 of the [ICAS research report](#).

³² Page 9 of the [ICAS research report](#).

UK FRC Thematic Review findings

- 6.14 In October 2021, the UK Financial Reporting Council (FRC) published a report [Thematic Review: IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'](#).³³ The report summarises the key findings of an FRC review of 20 entities' 2020/21 annual reports and accounts. The aim of the review was to identify how effectively those annual reports and accounts met the disclosure requirements of IAS 37.
- 6.15 Page 24 of the report discusses information disclosed about discount rates. It concludes that:
- (a) entities that provided better information:
 - (i) quantified the discount rates; and
 - (ii) explained how the rates had been determined, including whether different rates had been used for different parts of the business; and
 - (b) most entities provided little or no detail as to how discount rates were estimated. (However, for most provisions, the effect of discounting was not material.)
- 6.16 Page 24 of the report also describes ways in which entities could improve the information they disclose, setting out the FRC's expectations:

We expect companies to disclose the discount rate and how it is calculated where the effect of discounting is material. This disclosure aids comparability from one period to the next and across companies.

We expect companies to consider whether their disclosure explains each of the following matters, where this is material to understanding the estimation uncertainty:

- how the discount rate has been determined from benchmark rates, and what adjustment (if any) has been applied for cash flow risk, especially where the risk profile (and hence rate adjustment) has changed from the prior period;
- the use of different rates for different provisions and how this relates to the risks inherent in each liability;

³³ Available at: <https://www.frc.org.uk/accountants/corporate-reporting-review/corporate-reporting-thematic-reviews>

- use of a real discount rate where projected cash flows have not been increased for inflation or a nominal rate where inflation has been applied in forecasting; and
- why an adjustment (if made) for own credit risk is justified in the specific context of the liability.

Implications for this project

- 6.17 If the IASB decides to specify whether, and if so when, to reflect non-performance risk in discount rates for provisions, the IASB could also consider the adequacy of existing disclosure requirements relating to the rates used.
- 6.18 This is a matter the IASB could return to after it has reached tentative decisions on non-performance risk. In the meantime, the staff plan to seek:
- (a) further views from investors on the information they would find useful; and
 - (b) views from preparers of financial statements on the costs of providing such information.

7 Questions for IASB members

- 7.1 At a future meeting, the IASB will be asked to tentatively decide whether to propose amendments to IAS 37 to specify whether the discount rate for a provision should reflect non-performance risk.
- 7.2 Before asking the IASB for this decision, we plan to:
- (a) obtain any further information requested by IASB members;
 - (b) update the staff analysis to reflect IASB members' comments at this meeting; and
 - (c) seek views from some of the IASB's advisory groups—including the Capital Markets Advisory Committee, the Global Preparers Forum and the Accounting Standards Advisory forum.

Question for IASB members

Do you have any questions or comments on this paper?

We would be particularly interested to know of any relevant information that might be missing from this paper:

- 1 Chapter 5 discusses nine factors that could affect the IASB's decision. Are there any other factors you think the IASB should consider?
- 2 Is there any other information you will need to reach a tentative decision?