Staff paper

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IASB® meeting

Date	**April 2024**
Project	**Provisions—Targeted Improvements**
Topic	**Discount rates—application guidance**
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Session overview

1. The International Accounting Standards Board (IASB) is developing proposals for targeted amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

2. The proposals include specifying whether the discount rate an entity uses in measuring a provision reflects the risk that the entity will not settle the provision (non-performance risk).

3. At its November 2023 meeting, the IASB tentatively decided to propose a rate that reflects the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk.

4. In this session, we will ask the IASB to decide whether to propose application guidance to support this requirement, and if so what guidance to propose.

Background

Existing requirements

5. IAS 37 requires an entity to measure a provision by estimating the future expenditure required to settle the entity's present obligation. Paragraph 45 of IAS 37 requires the entity to discount this future expenditure to its present value if the effect of the time value of money is material.

6. Paragraph 47 of IAS 37 requires an entity use a discount rate that reflects:

   (a) current market assessments of the time value of money; and

   (b) the 'risks specific to the liability', to the extent that these risks are not reflected in the cash flows.

7. It is clear in IAS 37 that the risks specific to the liability include the uncertainty in the amount or timing of the expenditure required to settle the liability—as described in paragraphs 42–44 of IAS 37. This type of risk typically increases the measure of the provision and IAS 37 permits an entity to reflect it by either:

   (a) increasing the estimates of the expenditure required to settle the liability; or

   (b) *decreasing* the discount rate.

8. However, it is not clear in IAS 37 whether the risks specific to the liability also include non-performance risk. Reflecting non-performance risk decreases the measure of the provision. It is reflected by *increasing* the discount rate.

9. Practice varies—while some entities exclude non-performance risk, others include it and recognise smaller provisions as a result.

Proposed amendments—decisions to date

10. At its November 2023 meeting, the IASB tentatively decided to propose specifying in IAS 37 that the discount rate an entity uses in measuring a provision reflects the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk. Agenda Paper 22 *Provisions—Targeted Improvements—Discount rates* for that meeting sets out the background to that decision.

11. That paper also notes that the next step would be to consider whether to propose application guidance to support this requirement. This paper considers this matter.

Staff analysis

12. In this section we:

    (a) illustrate how IAS 37 could be amended to specify that the discount rate does not reflect non-performance risk (paragraph 13);

    (b) discuss whether to propose application guidance on estimating the time value of money:

        (i) whether to specify that the time value of money is represented by a risk-free rate (paragraphs 14–16); and

        (ii) if so, whether to provide guidance on estimating an appropriate risk-free rate (paragraphs 17–18).

Suggested amendments to reflect the tentative decision

13. The aim of the amendments would be to clarify that 'the risks specific to the liability' include the uncertainty in the cash flows required to settle the provision (as discussed in paragraph 7) but exclude non-performance risk. We suggest that this clarification could be achieved by describing these two types of risk separately. For example:

> **47 The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s):**
>
> **<u>(a)</u> current market assessments of the time value of money; and**
>
> **<u>(b)</u> ~~the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.~~ <u>risks surrounding the amount or timing of the expenditure required to settle the obligation (as described in paragraphs 42 – 44) if those risks are not reflected in the estimates of the cash flows.</u>**
>
> <u>47A The discount rate does not (or rates do not) reflect the risk that the entity will not settle the obligation (non-performance risk).</u>

Whether to add application guidance

Guidance on the meaning of 'time value of money'

14. The first question to consider in determining whether to add further guidance is whether to specify that the term 'time value of money' refers to a risk-free rate.

15. IFRS Accounting Standards generally use the term 'time value of money' to capture the concept that a unit of cash held today is more valuable than an identical unit of cash that is certain to be received at a future date, ie a risk-free rate. For example:

(a) paragraph B13 of IFRS 13 *Fair Value Measurement* requires a present value measure of the fair value of an asset or a liability to capture, among other inputs:

> … the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (ie a risk-free interest rate).

(b) paragraph 30 of IAS 36 *Impairment of Assets* requires the measure of an asset's value in use to reflect, among other inputs, 'the time value of money, represented by the current market risk-free rate of interest'.

(c) paragraph 32 of IFRS 17 *Insurance Contracts* requires an entity to discount an insurance contract liability at a rate that reflects 'the time value of money and the financial risks related to the future cash flows, to the extent that the financial risks are not included in the estimates of the future cash flows'. Paragraph BC19 in the Basis for Conclusions accompanying IFRS 17 clarifies that, if the financial risks are reflected in the estimates of the cash flows 'the discount rate will be a rate that reflects only the time value of money (ie not adjusted for risk)'.

16. However, wording in IAS 19 *Employee Benefits* might imply the time value of money could be represented by a rate that reflects some degree of risk. Paragraph 83 in IAS 19 requires an entity to discount its post-employment benefit obligations at a rate determined by reference to market yields on high quality corporate bonds. Paragraph 84 describes that rate as one that reflects the time value of money without also reflecting investment risk, the uncertainty in the cash flows or the entity's own credit standing—possibly implying that the market yield on a corporate bond reflects only the time value of money.

Guidance on estimating an appropriate risk-free rate

17. Even if IAS 37 clarifies that the time value of money is represented by a risk-free rate, the preparers of an entity's financial statements would need to apply judgement in estimating an appropriate rate. The rate might be determined by reference to the current market yield on a very low risk market investment (for example, a low risk government bond) in a currency consistent with that of the provision. But adjustments might be required, for example if the provision is of longer duration, or less liquid, than the closest available market investment.

18. The IASB could provide guidance on how to estimate an appropriate rate. However, against adding guidance it could be argued that:

    (a) practice is already well-established without any guidance in IAS 37. Many preparers of financial statements already estimate a risk-free rate for measuring provisions, either to implement a policy of discounting at a risk-free rate or as the starting point for estimating a credit-adjusted rate.

    (b) provisions within the scope of IAS 37 vary widely in their terms and the circumstances of their settlement. We may not be able to develop any guidance beyond high-level principles that are already widely understood.

    (c) as discussed in paragraph 15, several other IFRS Accounting Standards require assets or liabilities to be measured by reference to risk-free rates. Any guidance added to IAS 37 could have unintended consequences for those other Standards.

Staff recommendations and questions for the IASB

19. For the reasons in paragraphs 16 and 18, we recommend:

    (a) proposing to clarify that the time value of money reflected in the discount rate for a provision is represented by a risk-free rate; but

    (b) proposing no further application guidance on estimating the time value of money.

20. An indication of how the clarification could be drafted is illustrated in the appendix to this paper.

21. The Basis for Conclusions accompanying the amendments could explain the reasons for proposing no further application guidance, including an acknowledgement that the rate could be determined in various ways and might require adjustments to the yields on market investments to reflect factors such as those described in paragraph 17.

Questions for the IASB
1. Do you agree that the proposed amendments to IAS 37 should include clarifying that the time value of money reflected in the discount rate for a provision is represented by a risk-free rate? 2. Do you agree that the proposed amendments to IAS 37 should contain no further application guidance on estimating the time value of money?

Appendix—Indicative drafting for the recommended amendments to the discount rate requirements in IAS 37

47 The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s):

(a) current market assessments of the time value of money, represented by a risk-free rate; and

(b) ~~the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.~~ risks surrounding the amount or timing of the expenditure required to settle the obligation (as described in paragraphs 42 – 44) if those risks are not reflected in the estimates of the cash flows.

47A The discount rate does not (or rates do not) reflect the risk that the entity will not settle the obligation (non-performance risk).