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Staff paper

Agenda Paper 1

Global Preparers Forum meeting

Date	**11 November 2022**
Project	**Provisions—Targeted Improvements to IAS 37**
Topic	**Discount rates—non-performance risk**
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Purpose of this session

To obtain GPF members' views on:

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

Focusing on provisions for asset decommissioning (retirement) and environmental rehabilitation costs.

Questions for GPF members

1	**Basis for determining discount rate** (pages 4–11)	The IASB is considering developing proposals to standardise the basis on which entities determine the discount rates they use to measure provisions. **Questions on page 11 ask GPF members for their views on:** **a) which discount rate leads to a better depiction of the obligations giving rise to a provision—a rate that includes non-performance risk, or a rate that excludes non-performance risk;** **b) what costs an entity would incur in calculating the non-performance risk adjustment for a provision and in disclosing information about that adjustment; and** **c) how entities might quantify the non-performance risk associated with a provision.**
2	**Information disclosed** (pages 12–17)	Investors have suggested adding to IAS 37 requirements to disclose more information about rates used to discount provisions. **Questions on page 17 ask GPF members for information about the costs of providing the types of information investors have requested.**

Which discount rate?

- Requirements of IAS 37
- Non-performance risk
- Discount rates used in practice
- IASB project to amend IAS 37
- Consequences of excluding non-performance risk
- Consequences of including non-performance risk
- Questions for GPF members

Requirements of IAS 37

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

Non-performance risk

- The risk that an entity will not fulfil its obligation.
- Non-performance risk is specific to a liability—it varies from one type of liability to another.
- The main component is likely to be credit risk, which is affected by both the entity's overall credit standing and liability-specific factors, for example:
    - the value of any assets (collateral) securing the liability, or of any assets ring-fenced to fund the liability
    - where the liability would rank relative to others if the entity is liquidated—for example, in some jurisdictions, environmental obligations rank above all other liabilities.
- Other components of non-performance risk could arise from, for example, operational, commercial or regulatory risks.
- Many liabilities (eg commercial loans and leases) include an obligation to pay a risk premium to the counterparty, to compensate the counterparty for accepting non-performance risk. In contrast, decommissioning and environmental provisions typically include **no** such obligation.
- The non-performance risk associated with a provision is typically unobservable and must be estimated.

Discount rates used in practice

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

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

IASB project to amend IAS 37

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

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

The IASB started discussing this topic at its October 2022 meeting. It is seeking input from stakeholders before making any decisions.

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

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

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

- The resulting measure places an economic value on the provision—the amount the entity would rationally pay to transfer or settle the obligation at the reporting date—making the provision more comparable with other liabilities measured at a current value.
- The measure tells investors that a provision (which does not include an obligation to pay the counterparty a premium for accepting non-performance risk) is less onerous than an otherwise identical liability that does include such an obligation.
- The unwinding of the discount quantifies the time value of money and the non-performance risk transferred to the counterparty.
- The discount rate is subject to more measurement uncertainty. Non-performance risk has to be estimated on initial recognition and updated at each subsequent reporting date.
- Investors say they need additional information to enable them to understand how non-performance risk has affected the measure of the provision (see page 16).

Questions for GPF members

1	**Basis for determining discount rate**	a) In your view, which discount rate provides a better depiction of a decommissioning or environmental rehabilitation provision—one that includes or one that excludes non-performance risk? b) What costs might an entity incur in quantifying the non-performance risk associated with a decommissioning or environmental rehabilitation provision, calculating the required non-performance risk adjustment, and disclosing information about that adjustment? Would you view these costs as acceptable? Explain why or why not. c) How might you go about quantifying the non-performance risk associated with a decommissioning or environmental rehabilitation provision?

Background information—disclosure

- Disclosure requirements
- Disclosure practices
- Additional information requested by investors
- Questions for GPF members

Disclosure requirements

IAS 37

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

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

IAS 1 *Presentation of Financial Statements*

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

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

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

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

Disclosure practices

A recent academic study sampling more than 10,000 financial statements of oil & gas, mining and utilities entities with asset decommissioning and environmental rehabilitation provisions in 2005 – 2016 found that:*

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

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

Additional information requested by investors

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

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

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

In October 2022 the IASB discussed discount rates for provisions with members of its Capital Markets Advisory Committee. Members had differing views on whether including non-performance risk would result in a more useful or less useful measure of a decommissioning / rehabilitation provision.

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

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

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Questions for GPF members

2	**Information disclosed**	a) What costs might an entity incur in providing the types of information listed on pages 15 and 16? b) If providing any of that information would require undue cost or effort, what alternative information could an entity provide with less cost or effort?

Further information

Further information

For further information about the IASB's Provisions project, visit the Provisions project pages on the IFRS Foundation website.

For further background information on the discount rates used to measure provisions and analysis of factors that could affect the IASB's decisions about non-performance risk, see IASB October 2022 Meeting Agenda Paper 12A *Provisions—Discount rates—non-performance risk*

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