IFRS Accounting

Staff paper

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Project	**Provisions—Targeted Improvements**
Topic	**Discount rates**
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Session overview

1. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* does not precisely specify the basis on which an entity determines the discount rate it uses to measure a provision. In this session, the IASB will be asked to decide:

   (a) whether to propose amendments to IAS 37 to specify more precise requirements for determining the discount rate; and

   (b) if so, what requirements to propose.

2. Paragraphs 6–21 of this paper provide background information on:

   (a) the discount rate requirements in IAS 37 and the way entities apply those requirements in practice;

   (b) the project objectives;

   (c) stakeholder feedback on possible new requirements; and

   (d) the IASB's discussions to date—including tentative preferences expressed by IASB members in the light of stakeholder feedback.

3. In paragraphs 22–34, we analyse two possible requirements that IASB members asked us to explore further:

    (a) OPTION 1: aligning the discount rate requirements in IAS 37 with those in IAS 19 *Employee Benefits*. Discount rates would be determined by reference to an observable market rate that reflects the time value of money and some non-performance risk.

    (b) OPTION 2: requiring entities to discount provisions at a rate that reflects the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk. The rate could be determined by reference to an observable market proxy for a risk-free rate, for example the yield on a government bond.

4. In developing our analysis of Option 1, we asked accounting practitioners about the potential benefits and potential practical difficulties of applying IAS 19 discount rate requirements to provisions within the scope of IAS 37. Their feedback is reported within the staff analysis of that option.

5. In paragraph 35, the staff recommend that the IASB:

    (a) develop proposals to amend IAS 37 to specify more precisely the basis on which an entity determines the discount rate it uses in measuring a provision; and

    (b) propose to specify that an entity uses a rate that reflects the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk (Option 2).

Background information

IAS 37—requirements and application in practice

6. IAS 37 requires an entity to measure a provision by estimating the expenditure that will be required to settle the entity's present obligation. IAS 37 requires the entity to discount this expenditure 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—typically, the asset decommissioning and environmental rehabilitation provisions recognised by entities operating in the power generation, oil & gas, mining and telecommunications sectors.

7. IAS 37 requires an entity to discount the expenditure at a 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.

8. The risks specific to the liability include the uncertainty in the amount or timing of the expenditure required to settle the liability. This type of risk typically *increases* the measure of the liability and it can be reflected by:

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

   (b) decreasing the rate used to discount the expenditure to its present value.

   The evidence we gathered during our research indicates that most or all entities with large long-term provisions reflect this risk by increasing the estimates of the expenditure. We found no evidence of any entities reflecting the risk by decreasing the discount rate.

9. IAS 37 does not specify whether the risks specific to the liability also include non-performance risk—the risk that the entity will not settle the liability. Reflecting non-performance risk *decreases* the amount at which a liability is measured. It is reflected by increasing the discount rate.

10. In the absence of specific requirements in IAS 37 on whether and how to reflect non-performance risk, practice varies: some entities omit non-performance risk (applying a 'risk-free' rate), while others include non-performance risk (applying a 'credit-adjusted' rate).

> **Note on terminology**
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> Where this paper refers to risk-free rates in the context of discount rates used in practice, it is referring to the observable market rates (for example, government bond yields) that entities apply as proxies for risk-free rates.

Project objectives

11. As part of its project to make targeted improvements to IAS 37, the IASB is considering developing proposals to specify in IAS 37:
    (a) whether discount rates for provisions reflect non-performance risk; and
    (b) if so, how.

First IASB discussion—October 2022

12. The IASB first discussed this topic at its October 2022 meeting. The staff paper for that meeting, Agenda Paper 12A *Provisions—Targeted Improvements—Discount rates—non-performance risk*:
    (a) explains the reasons for considering this matter—including information about the nature and extent of diversity in practice; and
    (b) discusses factors that could affect views on whether the risks reflected in the discount rate for a provision should include non-performance risk.

13. In that paper, the staff note that:

    (a) it can be argued that the non-performance risk associated with a provision is specific to that provision. Although the risk depends in part on the entity's general credit standing, it also depends on other factors that are specific to the provision—for example, whether the provision is funded by ring-fenced assets.

    (b) the requirements of IAS 37 could be interpreted in two ways—permitting entities either:

        (i) to exclude non-performance risk, or

        (ii) to include the non-performance risk specific to the provision being discounted.

    (c) although these two approaches differ in the types of information they provide about the entity's financial position and financial performance, each provides information that could be useful to investors.

14. IASB members discussed the factors that could affect their decision on whether discount rates for provisions should include or exclude non-performance risk. Several IASB members said that it was particularly important for them to understand the views of users of financial statements (investors) on which approach better meets their information needs.

Consultation with stakeholders—October 2022–March 2023

15. After that initial IASB discussion, the staff consulted stakeholders, including investors, preparers of financial statements and national standard-setters. The stakeholders' feedback is reported in paragraphs 16–42 of Agenda Paper 22A *Provisions—Discount rates—stakeholder feedback* for the IASB's July 2023 meeting.

16. The key messages are summarised in the table below:

Key messages in stakeholder feedback
(a) Need for standardisation Most of the stakeholders commenting on the need for standardisation said they would be in favour of discount rates being specified more precisely, the investors saying that measures of provisions would be more useful if they were more comparable. However, a few investors and national standard-setters said they thought enhancing the disclosure requirements would be sufficient.
(b) Preference for observable market-based rates Most of the investors and some of the preparers commenting expressed a preference for rates determined by reference to observable market rates. The two main reasons were that: (i) such rates can be determined objectively. In contrast, the non-performance risk adjustment required for a provision is not observable and estimates would be highly subjective. Investors said that this subjectivity would impede comparability. Preparers said that the adjustment would be difficult and costly to estimate and audit. (ii) the results of measuring a provision at an amount that reflects the entity's own credit standing are counter-intuitive—an entity with a weak credit standing would report a smaller liability than an entity with a stronger credit standing, and an entity with a deteriorating credit standing would report a reduction in its liabilities.
(c) Preference for a risk-free rate Some of the stakeholders expressing a preference for a market-based rate specifically advocated a risk-free rate. Reasons included views that: (i) IAS 37 requires an entity to reflect its obligations, not its ability or intentions to fulfil those obligations; and (ii) regulations governing asset decommissioning and environmental rehabilitation obligations often seek to minimise non-performance risk, for example by requiring entities to fund the obligations, or by ranking the obligations higher than other liabilities in a liquidation.

Key messages in stakeholder feedback
(d) Preference for a rate that reflects non-performance risk A few investors and some preparers expressed a different view. They think the discount rate for a provision should reflect the non-performance risk associated with that provision: (i) a few equity investors said that a discount rate that reflects non-performance risk could assist in the valuation of an entity—the measure of the provision would better approximate the fair value of the entity's liability; (ii) some preparers said that unless the rate at which a liability is discounted reflects non-performance risk, the liability is measured at an amount that exceeds its economic value—misrepresenting the entity's financial position; and (iii) both investors and preparers noted that a requirement to use a discount rate that reflects non-performance risk would avoid creating a difference between IFRS requirements and US Generally Accepted Accounting Principles (US GAAP) for measuring asset decommissioning obligations.
(e) Suggestions for alignment with other IFRS Accounting Standards A few stakeholders (investors, preparers and a standard setter) suggested aligning the discount rate requirements in IAS 37 with those in other IFRS Accounting Standards. Some specifically suggested alignment with the requirements for defined benefit pension obligations in IAS 19.
(f) Preparers' ability to measure non-performance risk specific to a provision None of the preparers we talked to said they think they would be able to measure the adjustment needed to reflect the non-performance risk specific to a provision—some said they had no idea how they would do it. Entities that discount provisions at a credit-adjusted rate at present use a rate—for example, the entity's incremental borrowing rate—that reflects the credit standing of the entity but *not* the non-performance risk specific to the provision.

Second IASB discussion—July 2023

17. At its July 2023 meeting, the IASB considered the stakeholder feedback and various options for moving forward in the light of that feedback. These options, and a staff analysis of the advantages and disadvantages of each, are described further in paragraphs 43–59 of Agenda Paper 22A *Provisions—Discount rates—stakeholder feedback* for that meeting.

18. IASB members were invited to comment on the options. Their comments indicated a general consensus that:

    (a) the IASB should continue to explore options for standardising the rates entities use to discount provisions. Most investors commenting on the need for standardisation said that measures of provisions would be more useful if they were more comparable. An 'enhanced disclosures' option would be a last resort that the IASB should consider at a later stage only if all other options prove to be unworkable.

    (b) the IASB should not pursue further the option of requiring entities to discount provisions at a rate that includes the non-performance risk specific to the provision. Board members referred to the concerns about including this risk expressed by stakeholders, noting in particular:

        (i) preparers' concerns about the operational complexity—and hence cost—of measuring the non-performance risk associated with a provision;

        (ii) investors' concerns about the subjectivity of the resulting measures and the counter-intuitive effects of differences and changes in non-performance risk; and

        (iii) other possible consequences of a requirement to discount provisions at a rate that reflects non-performance risk—specifically possible calls for the effects of changes in non-performance risk to be presented in other comprehensive income instead of in profit or loss in some

circumstances (as required by IFRS 9 *Financial Instruments* for financial liabilities designated as at fair value through profit or loss[1]).

19. Some IASB members acknowledged that requiring an entity to discount an asset decommissioning or environmental rehabilitation provision at a credit-adjusted rate would align the IAS 37 discount rate requirements for those provisions with US GAAP. But they noted that applying US GAAP, discount rates for those provisions are fixed on initial recognition and not updated subsequently, meaning that the measures are not subject to the counter-intuitive effects of changes in non-performance risk. Furthermore, there are several differences between IAS 37 and US GAAP recognition criteria and measurement requirements for asset decommissioning and environmental rehabilitation provisions—even if the discount rate requirements were aligned, the measures would not be comparable.[2]

20. IASB members expressed an interest in exploring further two options:

    (a) OPTION 1: aligning the discount rate requirements in IAS 37 with those in IAS 19 for defined benefit pension obligations. Discount rates would be determined by reference to an observable market rate that reflects the time value of money and some non-performance risk.

    (b) OPTION 2: requiring entities to discount provisions at rate that reflects only the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk. The rate could be determined by reference to an observable market proxy for a risk-free rate, for example the yield on a government bond.

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1 See paragraph 5.7.1(c) of IFRS 9 *Financial Instruments.*

2 For more information on the differences between US GAAP and IAS 37 requirements for recognising and measuring asset decommissioning and environmental rehabilitation provisions, see paragraphs 3.21–3.26 of Agenda Paper 12A *Provisions—Targeted Improvements—Discount rates—non-performance risk* for the IASB's October 2022 meeting.

Staff activity since the second IASB discussion

21. Following the second IASB discussion, the staff consulted accounting practitioners on the practicability of determining discount rates for provisions applying the requirements in IAS 19 for defined benefit pension obligations. We contacted seven large accounting firms. Three responded, with pensions and provisions specialists within these firms providing us with information about their experience of applying the IAS 19 discount rate requirements in practice, and personal views on the potential benefits and potential practical difficulties of applying these requirements to asset decommissioning and environmental rehabilitation provisions. The information and views we gathered from these accounting practitioners are included in the staff analysis below.

Staff analysis

22. In this section we compare:

    (a) OPTION 1: aligning the discount rate requirements in IAS 37 with those in IAS 19 (paragraphs 23–28); and

    (b) OPTION 2: requiring entities to discount provisions at a rate that reflects the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk (paragraphs 29–34).

> **Note on drafting**
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> With either Option 1 or Option 2, the requirements would be drafted in a way that clarifies that the measure of a provision is adjusted to reflect one type of risk—the uncertainty in the amount or timing of the expenditure required to settle the liability—as required by paragraph 42 of IAS 37. As discussed in paragraph 8 of this paper, entities typically reflect this risk by adjusting (up) estimates of the expenditure required to settle the provision, not by adjusting (down) the discount rate. We will consider drafting options after the IASB has reached tentative decisions on the discount rate requirements.

Option 1—aligning IAS 37 requirements with those in IAS 19

23. If the discount rate requirements in IAS 37 were aligned with those in IAS 19, entities would discount provisions at a rate determined by reference to current market yields on bonds denominated in a currency, and with a term, consistent with those of the provision. The reference bonds would be:

    (a) high quality corporate bonds—if there is a deep market in such bonds in the applicable currency; or

    (b) government bonds—if there is not a deep market in high quality corporate bonds in the applicable currency.[3]

24. In favour of aligning the requirements in IAS 37 with those in IAS 19, it has been noted that:

    (a) stakeholders sometimes question the extent to which the discount rates required by IFRS Accounting Standards vary from one Standard to another. They say the variation adds complexity to financial reporting—increasing costs for preparers of financial statements and impeding communication with investors. Reducing the range of requirements would reduce that complexity.

    (b) asset decommissioning and environmental rehabilitation obligations share important characteristics with defined benefit pension obligations. Both are:

        (i) often long-term in nature, with uncertain cash flows;

        (ii) typically settled by the entity rather than transferred between entities; and

        (iii) often regulated to minimise non-performance risk, for example through minimum funding requirements or laws that rank the obligations higher than others in a liquidation.

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[3] Paragraph 83 of IAS 19 *Employee Benefits*.

(c) it could be argued that the relatively small amount of non-performance risk reflected in the yield on a high quality corporate bond is a reasonable proxy for the relatively small amount of non-performance risk associated with an asset decommissioning or environmental rehabilitation provision.

(d) IAS 19 requirements are long-established—there are well-developed practices for applying them, and accounting practitioners could carry these practices across to the application of IAS 37.

25. However, all the accounting practitioners we spoke to expressed concerns, or at least reservations, about aligning the discount rate requirements in IAS 37 with those in IAS 19. Their main concern is the subjectivity of judgements required to apply the IAS 19 requirements. They noted that judgement is required in determining, for example:

(a) whether there is a deep market for high quality corporate bonds;

(b) which high quality corporate bonds to include in the basket of rates used to determine an average rate—for example, where to cut off the distribution of rates to exclude outliers, which credit rating agencies' ratings to include, and whether to include (and if so how to weight) bonds of entities that have only recently gained high quality status.

(c) how to adjust the yields on corporate bonds to compensate for duration mismatch. Asset decommissioning and environmental rehabilitation obligations can be of very long duration—commonly 40 or 50 years, and in some cases up to 80 or 90 years. In contrast, few corporate bonds have a duration of more than 15 years. The adjustments required to extrapolate the rates to periods so far outside observable time frames add more subjectivity.

26. The accounting practitioners said that these judgements can be difficult and hence subjective, in part because the required rates lack a measurement objective. Consequently, there is significant diversity in practice, requiring time-consuming

discussions over the rationale for the judgements made and giving entities opportunities to 'cherry-pick' rates.

27. Other concerns are that:

(a) applying the IAS 19 requirements to provisions could be costly for many entities. Actuaries have the expertise and experience needed to make the judgements described in paragraph 25, and while little extra work might be needed for entities that already engage actuaries to measure defined benefit pension obligations, many entities do not have such obligations—even in countries where defined benefit pension plans used to be common, companies that had such plans have closed them so liabilities are tailing off, and newer companies do not have defined benefit pension plans at all.

(b) for many currencies, there is not a deep market in high quality corporate bonds, so a significant proportion of pension obligations are instead discounted using government bond yields. The IASB would achieve greater standardisation of rates used for provisions if it specified a single measurement basis to be used for all currencies.

(c) aligning the discount rate requirements in IAS 37 with those in IAS 19 could lead to calls for the IASB to also align the IAS 37 requirements for presenting the effect of a change in the discount rate. IAS 19 requires this effect to be presented in other comprehensive income (unless another IFRS Accounting Standard requires or permits it to be included in the cost of an asset)—not in profit or loss.[4]

[4] Although, the effect of a change in the discount rate for an asset decommissioning or environmental rehabilitation provision is often included in the cost of a related asset, the effect of an increase in the rate may exceed the carrying value of that asset, with the excess being recognised as a gain. This outcome is seen in practice when an asset (for example, a nuclear power plant) is approaching the end of its planned lifespan and a decision is taken to extend its life. The decommissioning provision is discounted over the extended life, so the effect of a change in discount rate may be large. In contrast, the asset's carrying value may be small, most of the asset's cost having been depreciated over the original estimate of its lifespan.

28. One accounting practitioner noted that, because many entities in the oil and gas sector currently discount provisions using a risk-free rate, a requirement to use the higher rates specified in IAS 19 would reduce the amounts at which these entities measure their asset decommissioning and environmental rehabilitation provisions. The practitioner suggested the IASB would need to have strong grounds for instigating such a change at a time of increasing focus on the adequacy of provisions for costs that may be incurred or brought forward in transitioning to a low-carbon economy.

Option 2—requiring entities to discount provisions at a risk-free rate

29. Option 2 would be to require entities to discount provisions at a rate that reflects the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk.

30. The IASB could add guidance to IAS 37 on how to estimate this rate. Guidance could state that the rate could be estimated by reference to an observable market proxy—for example, the yield on government bonds in a currency consistent with, and with a term as close as possible to, those of the estimated expenditure required to settle the provision.

31. In favour of this option, it could be argued that:

    (a) the process of estimating a risk-free rate would be less complex than the process of applying the IAS 19 requirements, and the resulting estimates would be less subjective:

        (i) the requirement would have an underlying measurement objective on which to anchor judgements;

        (ii) there would be no need to judge whether a deep market exists for high quality corporate bonds; and

(iii) governments issue bonds with longer durations than those of corporate bonds, reducing the extent to which the rates would need to be adjusted for duration mismatch. US treasury bonds have durations of 20 to 30 years. Bonds in several other currencies have durations up to 50 years.

(b) the measurement objective for the discount rate would be consistent with the overall 'black letter' measurement objective in IAS 37. This overall objective is 'the best estimate of the expenditure required to settle the present obligation'. It implies an amount that is not reduced to reflect the possibility that the entity will fail to settle its obligation.

32. Also of note are the transition costs. Overall, the costs of transitioning to a requirement to determine discount rates by reference to government bond yields are likely to be lower than the costs of transitioning to requirements aligned with those in IAS 19. Many entities already discount provisions by reference to government bond yields either:

(a) because their policy is to discount provisions at a risk-free rate; or

(b) as the starting point for estimating a credit-adjusted rate.

In contrast, few entities at present determine the discount rates for provisions on the same basis as they determine the discount rates for defined benefit pension obligations.

33. Those opposed to discounting a provision at a rate that excludes non-performance risk note that the resulting measure of the provision exceeds the theoretical economic/fair value of the entity's liability, which they say:

(a) impedes investors' ability to compare provisions with other liabilities (those measured at fair value), and deprives equity investors of information that could assist in valuing the entity; and

(b) misrepresents the entity's financial position.

34. However, the measure of a provision that excludes the effect of non-performance risk can be rationalised:

    (a) as explained further in paragraphs 5.15–5.26 of [Agenda Paper 12A *Provisions—Targeted Improvements—Discount rates—non-performance risk*] for the IASB's October 2022 meeting, there is an economic difference between provisions and most other types of liabilities:

        (i) most other types of liabilities arise from commercial exchange transactions for which the transaction price includes (explicitly or implicitly) a premium payable to the counterparty to compensate the counterparty for accepting non-performance risk; whereas

        (ii) asset decommissioning and environmental rehabilitation obligations do not include an obligation to compensate the counterparty (society at large) for accepting non-performance risk—the expenditure required to settle the obligation does not include a premium for non-performance risk.

    (b) the absence of a non-performance risk premium from the expenditure required to settle a provision can be represented in financial statements in two ways:

        (i) the future expenditure can be discounted at a rate that excludes non-performance risk. The resulting provision represents the amount the entity would need to invest in risk-free assets at the reporting date to fund the settlement of the provision at its expected settlement date. And as the discount unwinds at a risk-free rate, the (lower) finance expense reflects the benefit to the entity of the absence of the non-performance risk premium. In other words, the financial statements reflect the benefit of the absence of a non-performance risk premium as that benefit is realised over the duration of the provision.

        (ii) alternatively the future cash flows can be discounted at a rate that includes non-performance risk. Discounted at this rate, the provision represents the amount the entity would rationally pay to transfer the

obligation to another party. The financial statements reflect the full benefit of the absence of a risk premium on initial recognition of the provision, not as the benefit is realised over the duration of the provision.

(c) typically, entities do not transfer asset decommissioning and environmental rehabilitation obligations to other parties (unless they sell the related assets). Typically entities retain the obligations until they settle them using their own resources or by paying subcontractors. So it can be argued that:

(i) a measure of a provision that reflects the amount the entity would need to invest now to fund the settlement of its obligation is more useful than a measure that reflects the amount the entity would rationally pay to transfer the obligation; and

(ii) a measure of finance expense that reflects the benefit of the absence of a risk premium over the period in which that benefit is realised is more useful than one that reflects the full amount of the benefit on initial recognition of the provision.

Staff recommendation

35. On the basis of the IASB's previous discussions, feedback from stakeholders and the staff analysis in paragraphs 22–34, the staff recommend that the IASB:

(a) develop proposals to amend IAS 37 to specify more precisely the basis on which an entity determines the discount rate it uses in measuring a provision; and

(b) propose to specify that an entity uses a rate that reflects the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk (Option 2).

36. If the IASB agrees with the staff recommendation, the next step will be to consider at a future meeting:

    (a) supporting guidance—whether to propose guidance on how an entity estimates a risk-free rate, and if so what guidance to propose;

    (b) drafting options—in particular, options for:

        (i) clarifying that although the measure of a provision does not reflect non-performance risk, it does reflect the uncertainty in the amount or timing of the expenditure required to settle the provision (as discussed in paragraph 8); and

        (ii) possibly simplifying the requirements on how to reflect that uncertainty.

    (c) disclosure requirements—whether to propose requirements for an entity to disclose information about the rate it has used to discount a provision, and if so what requirements to propose.

Question for the IASB

Questions for the IASB
Do you agree with the staff recommendation in paragraph 35?