Project **New items for initial consideration**

Topic **IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* - discount rate**

Purpose of this paper

1. This paper considers a request for the IFRS Interpretations Committee, to clarify whether the discount rate or the cash flows used to calculate provisions should be credit adjusted.

2. This paper:

   (a) Provides background information on the issue;

   (b) Analyses the issue within the context of IFRSs;

   (c) Makes a staff recommendation on the tentative agenda decision; and

   (d) Asks the Interpretations Committee whether they agree with the staff recommendation.

Background information

3. The submission (to be found in Appendix B) asserts that there is diversity in practice as to whether an entity should include an adjustment for its own credit risk in the discount rate used to calculate provisions. The submission asserts that the diversity has arisen because IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the Exposure Draft *Measurement of Liabilities in IAS 37*

are unclear as to whether the 'risks specific to the liability' include an adjustment for own credit risk.

4. Paragraph B2 of the submission asks 'can the discount rate or the estimated future cash flows be adjusted for the entity's credit risk when a provision is measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets?'* This question is further refined in paragraph B5, which states that, 'For purposes of the rest of this discussion we assume that the future cash flow estimates have not been adjusted for any expectations regarding the entity's credit risk, so we are concerned only with an adjustment to the discount rate.' Paragraph B20 specifically asks for 'interpretation of whether the phrase "risks specific to the liability" prohibits the inclusion of a provision for credit risk in the discount rate.'

5. Own credit risk[1] is also known as 'performance risk', meaning the risk that an entity will fail to perform as required when it comes to settling its liabilities. An entity's credit standing affects the credit risk of its liabilities, but the effect may be different for different types of liabilities within one entity.

6. Some think that the discount rate should be adjusted for credit risk, others think there is a choice whether to adjust or not, and yet others think that making the adjustment is prohibited. The large international accounting firms appear to be divided on this issue, according to the guidance in their manuals.

7. The staff analysis of the issue is presented below.

Analysis of the issue

IAS 37 and ED/2010/1

8. Paragraph 36 of IAS 37 states that the amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at

---

[1] For further background on the credit risk topic, refer to a Discussion Paper published by the Board on *Credit Risk in Liability Measurement* in January 2009: http://www.ifrs.org/NR/rdonlyres/F57B3E62-41F1-4817-B32D-531354E03D10/0/CreditRiskLiabilitStaff.pdf

the end of the reporting period. Paragraph 42 goes on to state that relevant risks and uncertainties shall be taken into account in the calculation of the best estimate.

9. Further, the entity may need to calculate the present value of the expenditures required to settle the obligation, if the time value of money is material (paragraph 45). Paragraph 47 states the discount rate used should 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*.' [emphasis added]. The standard states that *either* the discount rate *or* the cash flows being discounted should be adjusted for relevant risks, and not both.

10. The Exposure Draft ED/2010/1 *Measurement of Liabilities in IAS 37* was published in January 2010, as part of the project to develop a new IFRS to replace IAS 37. Paragraph B14 of the exposure draft states that 'the expected outflows shall be discounted to their present value using rates that reflect (a) current market assessments of the time value of money and (b) *risks specific to the liability* (but only if and to the extent that the risks are taken into account by adjusting the discount rates rather than by the other methods discussed in paragraph B16.' [emphasis added]

11. Paragraph B16 states that a risk adjustment can be included by either adjusting estimates of future outflows, or by adjusting the rate used to discount those future outflows, or by adding a risk adjustment to the calculated expected present value of the future outflows.

Diversity in practice

12. The diversity appears to arise on how entities (and their auditors) interpret 'risks specific to the liability'. Do the risks specific to the liability include credit risk? There are two views emerging from practice.

View A

13. Credit risk is a 'risk specific to the liability' and either the cash flows or the discount rate should be adjusted for this risk. As the submission states, credit risk is considered in the fair value measurement of financial liabilities – in both IAS 39 *Financial Instruments: Recognition and Measurement*, and in the

debates and due process documents in developing IFRS 9 *Financial Instruments*. From the staff's research of various literature, it appears that proponents of View A find it practically simpler to adjust the cash flows for risk, instead of the discount rate.

View B

14. Credit risk is not a 'risk specific to the liability', and therefore the measurement of (non-financial) liabilities should not include an adjustment for credit risk. Proponents of this view think that non-financial liabilities are quite different to financial liabilities, so including credit risk in the measurement of the latter has little bearing on the same treatment for non-financial liabilities.

15. The Liabilities project staff are aware of the diversity in practice. The issue was raised in a number of the comment letters received on Exposure Draft/2010/1 (the comment period ended in May 2010). The following is an extract from the comment letter analysis presented to the Board in September 2010[2]:

> 3.6.1 Some respondents ask to specify whether the discount rate should take into account non-performance risk. Some of these respondents—including two of the large auditing firms—note that different interpretations of IAS 37 requirements at present are causing material differences in liability measurements. The differences are so large because the future cash flows for asset decommissioning obligations may occur very far in the future.
>
> 3.6.2 In addition, respondents ask the Board to clarify:
>
> … (b) whether the non-performance risk (if included) would be that of an entity or a market participant and how the entity should recognise changes in non-performance risk.
>
> 3.6.3 Several respondents argue that measurement of the expected value of the resources required to fulfil an obligation should *exclude* non-performance risk, consistent with the proposals for insurance contracts and at least until the Board has finalised the measurement chapter in the revised conceptual framework. In

[2] Refer Agenda paper 7A *Comment letter summary – main issues* presented at the Board meeting in September 2010: http://www.ifrs.org/NR/rdonlyres/CF228047-0870-4F1C-8F21-6275273F226D/0/IAS370910b07AppAobs.pdf

particular, there should be no requirement to *re-measure* liabilities to take into account changes in non-performance risk.

16. At the September Board meeting (at which the above paper was discussed), the Board decided to continue its deliberations on the project to replace IAS 37, on the grounds that applying the standard has given rise to diversity in practice and needs amendment. As part of these deliberations, the Board plans to consider adding more guidance on whether discount rates should include non-performance (own credit) risk.

17. It appears to the staff that clarity is needed on the following points:

    (a) Is credit risk a 'risk specific to the liability'?

    (b) If yes, then:

        (i) **Must** the entity include an adjustment for credit risk in the discount rate? or

        (ii) **May** the entity include an adjustment for credit risk in the discount rate? or

        (iii) **Should** credit risk **be specifically excluded** from any adjustment made to the discount rate?

Staff recommendation

Agenda criteria assessment for the Committee

18. The staff's assessment of the agenda criteria is as follows:

    (a) The issue is widespread and has practical relevance.

    Yes, in light of the comments received on the Exposure Draft ED/2010/1, it appears that the issue is potentially widespread and practically relevant.

    (b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.

Yes, there is reportedly divergence in practice and it seems that IAS 37 and ED/2010/1 are not clear in their guidance on this issue. In September 2010, the Board acknowledged the need for more guidance to be incorporated into the new liabilities standard.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes. Whether or not an entity adjusts the discount rate for its own credit risk when measuring its liabilities, could have a material impact on the balance sheet. Comparability across entities would be improved if the principle was consistently applied.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

No. If the Committee believe current IFRSs should be clarified, the staff thinks the most efficient way of resolving the issue would be to incorporate the extra guidance required in the standard that is to replace IAS 37, and not through the interpretation process.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

No. The problem with the IAS 37 measurements in general, and discount rate requirements in particular, is that they are vague. There is not a clear measurement objective. Accordingly, any consensus the Committee reaches may be controversial, and could differ from the decisions made by the Board, as it continues its deliberations of the *Liabilities* project. The new liabilities standard is currently expected to be issued in 2011.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

Yes, this issue relates to the *Liabilities* project – see (e) above.

19. In the light of the above, the staff recommends that the Committee does not take this issue onto the agenda, but that the Committee recommends that the Board should make clear whether, and how, own credit risk should be reflected in the calculation of provisions, as part of the ongoing *Liabilities* project.

20. However, the staff notes that the submission specifically requests 'interpretation of whether the phrase "risks specific to the liability" **prohibits the inclusion** of a provision for credit risk in the discount rate.' [emphasis added]. In the staff's opinion, the principles in IAS 37 and ED/2010/1 are not clear and therefore it is not possible or appropriate to state that credit risk is prohibited from any risk adjustment to the discount rate.

Question 1 for the Committee
1. Does the Committee agree that the principles in IAS 37 and ED/2010/1 are not clear with regard to stating that credit risk is prohibited from any risk adjustment to the discount rate?

21. The staff provide the draft wording for the proposed tentative agenda decision in Appendix A.

Questions for the Committee
1. Does the Committee agree with the staff's recommendation that the Interpretations Committee not add this issue to its agenda, but that it be referred to the Board? 2. Does the Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A – Proposed wording for tentative agenda decision

A1 The staff proposes the following wording for the tentative agenda decision:

> **IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* – inclusion of the entity's own credit risk in the discount rate used to measure provisions**
>
> The Interpretations Committee received a request for interpretation of the phrase 'risks specific to liability' and whether this means that credit risk (performance risk) should be excluded from any adjustments made to the discount rate used to measure liabilities. This issue was also raised in the comment letters submitted on ED/2010/1 *Measurement of Liabilities in IAS 37*, where a request for guidance on the issue was made.
>
> The Committee observed that paragraph 47 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and paragraph B14 of ED/2010/1 state that 'risks specific to the liability' should be taken into account in measuring the liability. The Committee notes that it is not clear in current guidance whether credit risk should be or may be included as a 'risk specific to the liability' or not. The Committee did not think that the principles in IAS 37 intended for credit risk to be prohibited from any risk adjustment to the discount rate.
>
> The Committee noted that this request for guidance would be best addressed as part of the Board's project to replace IAS 37, and that the Board is already considering the request for additional guidance to be incorporated into the new liabilities standard. Consequently the Committee [decided] not to add this issue to its agenda.

Appendix B – Request for the Interpretations Committee agenda

A1. The staff received the following Interpretations Committee request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

Submission to the IFRS Interpretations Committee
IAS 37: Inclusion of Credit Risk in Measurement of Provisions

A2. **Issue** – Can either the discount rate or the estimated future cash flows be adjusted for the entity's credit risk when a provision is measured in accordance with IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets*?

Formatted: Bullets and Numbering

A3. Paragraph 36 of IAS 37 requires that "The amount recognized as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period." Additional guidance in paragraph 37 states that the amount "to settle" 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."

A4. IAS 37 requires that, when the effects of the time value of money are material, the provision is determined as the present value of the expenditures expected to be required to settle the obligation calculated using a discount rate. Paragraph 47 of IAS 37 provides more guidance on the rate stating that "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 adjusted." This latter statement is consistent with the guidance on the use of discounted cash flows to measure assets (IAS 36) and liabilities (IAS 37), which is explicit that all risks relating to the measurement should be included once, but only once. That is, for example, expectations about the possible variability in the amount or timing of future cash flows can be taken into account either in the cash flow estimates or by adjusting the discount rate.

A5. For purposes of the rest of this discussion we assume that the future cash flow estimates have not been adjusted for any expectations regarding the entity's credit risk, so we are concerned only with an adjustment to the discount rate. Of course, the cash flows could be adjusted for potential default risk so similar considerations would apply to that approach.

Current Practice —

A6. There are two views. The issue seems to be arising from how the phrase **"the risks specific to the liability"** is interpreted. Some believe considering "the risks specific to the liability" precludes the inclusion of the credit risk of the entity in the discount rate in determining a provision. Others permit an adjustment for the entity's credit risk in the measurement of provisions. As indicated in the IASB's Discussion Paper on "Credit Risk in Liability Measurement" issued in June 2009, prepared by its staff, there is support for both views.

Formatted: Bullets and Numbering

A7. First, a note on terminology to clarify for the purposes of this discussion what we assume is included in a discount rate and, further, what we think the components of credit risk are. A market discount rate for a liability will include the time value of money (the appropriate risk free rate for the maturity/duration of the cash flows), the expectation for inflation, and provisions for credit risk, liquidity risk, currency risk and possibly other risks specific to the liability as appropriate. Credit risk is the possibility that the entity will fail to satisfy the obligation fully and on time and can include the risk related to some or all of the following:

(a) the class of borrower in the market (i.e., the difference between the risk free rate and the rate applicable to an issuer with similar characteristics, or sector spread)

(b) the entity (i.e., the credit quality of the issuer relative to others, as indicated by rating agencies or credit default swap spreads, or the difference between the sector spread and the rate the entity pays); and

(c) the instrument (i.e., the effect of the provision of a credit enhancement, such as a guarantee or collateral).

A8. Again, some or all of these components of credit risk may be relevant to the liability being measured.

Formatted: Bullets and Numbering

A9. There is guidance in Appendix A of IAS 36 *Impairment of Assets* on "Using Present Value Techniques to Measure Value in Use." Although the guidance is from the perspective of an asset and not a liability, it should be relevant for the measurement of provisions. In paragraph A1 of this guidance, other elements that are not noted in paragraph 5 above but that are identified as items that should be included in cash flow measurements are the "expectations about possible variations in the amount or timing of those cash flows" and "the price for bearing the uncertainty inherent in the asset." In IAS 37, both of these factors are subsumed into the discussion of risks and uncertainties in paragraphs 42 and 43.

A10. ***Support for Inclusion of Credit Risk***

A11. Those who support the inclusion of credit risk in the determination of a provision look to the factors that the IASB took into consideration when deciding to include credit risk in

Formatted: Bullets and Numbering

the fair value measurement of financial liabilities, set out in paragraphs BC87 to BC92 of the Basis for Conclusions on IAS 39 *Financial Instruments: Recognition and Measurement*. In particular, "the Board noted that because financial statements are prepared on a going concern basis, credit risk affects the value at which liabilities could be repurchased or settled. Accordingly, the fair value of a financial liability reflects the credit risk relating to that liability. Therefore it decided to include credit risk relating to a financial liability in the fair value measurement of that liability …." IAS 37 provisions are current measurements rather than fair value measurements. However, as the discussion in IAS 39 makes clear, credit risk affects the amount at which a liability could be repurchased or settled. As IAS 37 requires a provision to be measured at the best estimate of the expenditure required to settle it, those who support the inclusion of credit risk believe it must be included to satisfy that objective.

A12. The effect of credit risk on the amount "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" can be illustrated as follows. The purchaser/transferee may not care about the entity's credit risk in agreeing to assume a liability such as an asset retirement obligation. However, the counterparty to the entity's liability will certainly be concerned. For example, in an asset retirement obligation the counterparty could be the lessor of the property to which the asset retirement obligation relates. The lessor will have an interest in ensuring that the obligation is not transferred to a party that has a greater credit risk than the entity trying to transfer it. Thus, the entity's credit risk effectively creates a cap on the credit risk the counterparty will accept. On the other hand, if the best estimate must consider what the entity would *rationally* pay to settle the obligation, the entity would not pay any extra amount to reduce its counterparty's credit risk, that is, it would not pay a premium to transfer the obligation to a party with a better credit standing. Therefore, the entity's credit risk has a bearing on both the amount to settle and the amount to transfer the provision and should be included in the determination of the best estimate.

A13. In addition, supporters of the inclusion of credit risk in the discount rate think that the phrase "risks specific to the liability" simply acknowledges that not all of an entity's liabilities necessarily have the same credit risk. The Basis for Conclusions on IAS 39 referred to previously states, "The Board decided to clarify that this issue relates to the credit risk of the financial liability, rather than the creditworthiness of the entity." This view is reinforced by the discussion in paragraph 2 of the IASB's Discussion Paper "Credit Risk in Liability Measurement" (the Credit Risk DP) which notes that "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 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."

Support for Exclusion of Credit Risk

A14. As noted earlier, the discount rate used in a current, but not fair value, measure of a liability may include some but not all of the factors listed in paragraphs 5 and 6 above. Those who do not support the inclusion of credit risk in the discount rate note that there are important differences between financial liabilities and non-financial liabilities such as those covered by IAS 37. Paragraphs 23 and 24 of the Credit Risk DP outline the major differences including:

(a) the absence of an exchange transaction that establishes the liability on initial recognition, and

(b) the possible absence of an individual counterparty.

Formatted: Bullets and Numbering

A15. The Credit Risk DP concludes this discussion by stating, "Some have suggested that liabilities [with these characteristics] are different from traditional borrowings. Without an explicit price for credit risk in the transaction, the best measure is one that represents the entity's 'obligation'." The analysis of the responses received on the Credit Risk DP noted that respondents commented on the difficulties of separating out the credit risk, especially in the case of non-financial liabilities when there was no observable market price. In support of the exclusion of credit risk, that analysis notes that "In the credit risk staff's view, there is no conceptual imperative in IFRS that requires a current measurement of a liability (other than fair value) to include credit risk."

Formatted: Bullets and Numbering

A16. Those who support excluding an adjustment for credit risk also refer to the June 2005 ED of proposed amendments to IAS 37. Paragraph 36 of that ED states, "A risk adjustment typically increases the amount at which a liability is measured relative to a measurement that does not include a risk adjustment, all other things being equal." Paragraph 40 states, "When an entity reflects the effects of risks and uncertainties by adjusting the discount rate rather than by adjusting the estimated cash flows, the resulting discount rate is typically lower than a risk-free rate."

A17. However, it is worth noting that the IASB's January 2010 re-ED *Measurement of Liabilities in IAS 37* clarified this point. In Appendix B, paragraph B15 states: "An entity shall consider *the risk that the actual outflows of resources* might ultimately differ from those expected. A risk adjustment measures the amount, if any, that the entity would rationally pay in excess of the expected present value of the outflows to be relieved of *this* risk. (emphasis added)" This seems to imply that the risk adjustment that would result in a reduction of the discount rate below the risk free rate is related to the variability of the expected cash flows, not to the credit risk of the obligation.

Reasons for IFRIC to Address the Issue

Formatted: Bullets and Numbering

A18. *Is the issue widespread and practical?*

A19. Yes. The issue was raised as a problem for X entities transitioning to IFRS, but the Appendix A of Agenda Paper 7 prepared for the September 2010 IASB meeting, summarizing the main issues raised by respondents to the IASB's Re-Exposure Draft on *Measurement of Liabilities in IAS 37* indicates that there currently is a problem for existing IFRS users elsewhere in the world. In paragraph 3.6.1 discussing the discount rate, the paper states that "some respondents – including two of the large audit firms – note that the different interpretations of IAS 37 requirements at present are causing material differences in liability measurements."

Formatted: Bullets and Numbering

A20. *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*

A21. There appears to be existing diversity in the interpretation of IAS 37. Some interpret this standard to prohibit the inclusion of credit risk in the discount rate used to measure provisions under IAS 37. Others believe that the standard is unclear and therefore think either approach is acceptable, that is, the discount rate may be adjusted for credit risk.

Formatted: Bullets and Numbering

A22. *Would financial reporting be improved through elimination of the diversity?*

A23. Yes. Financial reporting would be significantly improved if there were clarity as to whether the discount rate should be adjusted to reflect credit risk. The inclusion or exclusion of credit risk can cause material differences in the liability measurement reducing the comparability among entities within the same industry. For example, the increase in an asset retirement obligation caused by using a discount rate not adjusted for credit risk is included in the measurement of the related asset. That increase may cause the asset to be impaired because the asset cash flows will be discounted using a rate that reflects the return the market would demand for cash flows with the same risks. Consequently, using the long term discount rate can have immediate income effects even for asset retirement obligations.

A24. For X oil and gas entities transitioning to IFRS the issue is both more significant and more urgent. These entities often have significant asset retirement obligations and many of them are using the exemption in paragraph D8A of IFRS 1 *First-time Adoption of International Financial Reporting Standards* to measure their producing properties at an allocation of the previous carrying amount. Thus, in accordance with paragraph D21A of IFRS 1, on transition any difference in the measurement of the asset retirement obligation from existing X GAAP, which required a fair value measurement, to IAS 37 is an adjustment to opening retained earnings. The discount rate difference can increase the asset retirement obligation by 100% to 125%. Consequently, even if the IFRIC concludes that it cannot resolve the question of whether credit risk should be included in the discount rate, at a minimum, clarification as to whether its inclusion is prohibited would remove the significant practice problems imposed by the current diversity.

A25. *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretations process?*

Formatted: Bullets and Numbering

A26. Yes. The issue requires interpretation of whether the phrase "risks specific to the liability" prohibits the inclusion of a provision for credit risk in the discount rate.

A27. *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IAS1B project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process.)*

Formatted: Bullets and Numbering

A28. The IASB started redeliberations on the measurement requirements of the project Liabilities – amendments to IAS 37 in September 2010 to discuss the comments received. The exposure draft did not clarify this issue and a number of comment letters requested that it be addressed in finalizing the amendments to the standard.

A29. The Conceptual Framework measurement project is supposed to be addressing the inclusion of credit risk in liability measurement. Even though the decision to address credit risk in liability measurement was allocated to the Conceptual Framework project, the IASB staff in their staff analysis recommended that "the Board acknowledge that it will consider the question of credit (and performance) risk in every project that involves a current measurement of liabilities that is not fair value. We should not ask constituents to answer it on their own."

A30. The IFRS Interpretations Committee could address the problem on a faster basis than either of these projects and, as noted above, the proposal in the revised version of IAS 37 has not addressed this issue. If the IFRIC were to recommend that, because of the existing diversity in practice the issue be explicitly clarified by the IAS 37 project, we believe that would be extremely helpful to the Board's further deliberations on that project. In the interim, acknowledgement of the current diversity (the acceptance of both interpretations of IAS 37) would be of significant assistance to entities in those jurisdictions in the process of transitioning to IFRS.