EFRAG

European Financial Reporting Advisory Group

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 21 August 2009

XX September 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Credit Risk in Liability Measurement

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Discussion Paper *Credit Risk in Liability Measurement* ('the DP'). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

We are very pleased that the IASB has taken the decision to prepare and issue a discussion paper on one of the more contentious aspects of the fair value measurement debate: whether, and if so to what extent, own credit risk should be reflected in liability measures.

Although we have considered the arguments for and against the inclusion of own credit risk in the measurement of liabilities, we think the key issue is what approach would result in the most useful information. Using this test, we concluded that:

- Own credit risk should only be taken into account in the initial measurement of a liability if own credit risk is priced into the transaction that gave rise to the initial recognition of a liability. In all other circumstances it should not be included.

- Changes in own credit risk should not be taken into account in subsequent measurements of liabilities.

Our detailed comments are set out in the appendix. We will also be discussing the issue of own credit risk in our response to the IASB ED *Fair Value Measurement*.

If you would like to discuss our comments further, please do not hesitate to contact Gregory Hodgkiss or myself.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
EFRAG's detailed comments

GENERAL COMMENTS

Notes for EFRAG's constituents

1 *The IASB has recently issued an exposure draft* Fair Value Measurement *which proposes that the fair value of a liability is the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. It further proposes that that fair value should reflect the effect of non-performance risk, which includes own credit risk (credit standing).*

2 *The discussion paper* Credit Risk in Liability Measurement *(the DP) explores this aspect of the ED's definition of fair value further. It notes also that the issue—of whether own credit risk and the effects of changes in own credit risk*[1] *should be included in the measurement of a liability—is not an issue that arises only when liabilities are measured at fair value; it can apply to other measures of liabilities.*

3 *The DP makes it clear that, as it is a specific liability that is being measured, the relevant own credit risk is the risk associated with that liability. A well-collateralised liability has less own credit risk than an entity's other liabilities.*

4 *The DP briefly discusses the three arguments it considers to be the most commonly cited arguments in favour of including own credit risk in the measurement of a liability. Those arguments are:*

(a) *Consistency*

(b) *Wealth transfer*

(c) *Accounting mismatch*

The DP also briefly discusses the three arguments it considers to be the most commonly cited arguments against including own credit risk. They are:

(d) *Counter-intuitive results*

(e) *Accounting mismatch*

(f) *Realisation*

These arguments are summarised and discussed immediately below.

[1] Hereafter to keep things simple, we generally use the phrase 'including own credit risk' to mean "including own credit risk and the effects of changes in own credit risk".

EFRAG's comments

Arguments in favour of including own credit risk in liability measurement

Consistency

5 The IASB paper points out that the initial measurement of a liability incurred in exchange for cash (usually a borrowing) includes the price put on the borrower's own credit risk (adjusted for collateral etc). The paper also points out that, barring evidence to the contrary, the cash exchange amount usually represents the fair value in that market on the transaction date. In the case of a bond issued at market rate, the proceeds of the bond represent the transaction date fair value of the future payments promised to bond holders. Thus, the transaction price and day one fair value of such a liability will reflect own credit risk.

6 The paper goes on to explain that a commonly-heard argument is that there is no conceptual reason why:

(a) the initial measurement of only some liabilities should include own credit risk. Either it should be included in all initial measures or in none; and

(b) subsequent measurement of a liability should include the effect of changes in only some of the factors that were included in the initial measurement.

7 EFRAG believes that it is over-stating the case to say that there is "no conceptual reason" for there to be differences in the way own credit risk is treated on initial recognition and subsequently. In our view, such an argument overlooks the need for information to be relevant.

(a) We agree that, if there is to be consistency of treatment between different instruments and at different times, either own credit risk needs always to be included in the measurement of liabilities or it needs always to be excluded. However, it is our understanding, based on the discussions we have had with users, that users do not place great value on consistency in this area.

(b) On the other hand, it is very important to users that the information they are provided with is as relevant as possible. It is our understanding that users do not consider the changes in liability amounts arising from changes in own credit risk to be relevant information; furthermore, they believe its inclusion in profit and loss and in the statement of financial position can actually obscure information that is relevant. That is, for example, why they tend to adjust those primary financial statements to remove the effect of changes in own credit risk.

Wealth transfer

8 As the paper explains, liabilities and equity represent two classes of claims against the entity. The total of the two sets of claims equals the assets of the entity. Lenders' interests are usually senior to those of equity holders. As an entity's ability to pay its liabilities diminishes, the effect on owners' claims is limited to the amount of their investment and so there is in effect a transfer of wealth between the two classes. Some argue that recognising changes in own credit risk is a way of acknowledging that wealth transfer.

9 One explanation of this is based on financial economic theory. The equity owners are assumed to have been granted an option by the debt holders to put the entity to

the debt holder for an amount equal to the liabilities. The value of that option increases as the value of the equity's assets decreases.

10 EFRAG is not convinced by this reasoning. We do not think the equity owners really have an option to put the entity to the debt holders, and in any case do not believe that the change in the value of the hypothetical option would the same as the change in the fair value of liabilities caused by changes in own credit risk, except by coincidence. Furthermore, any option that the equity owners do have would be their option, and not an option of the reporting entity. Finally, we do not think that the financial statements of an entity should reflect the theoretical transfers of wealth between the owners of the entity's debt and its owners.

Accounting mismatch

11 The paper explains that it is often argued that the failure to include own credit risk of liabilities can result in an accounting mismatch between the measurement of assets and liabilities. If an entity's financial assets are measured at fair value, changes in credit spreads on those assets will affect their fair value. If the measurement of liabilities does not incorporate changes in credit spreads, there will be an accounting mismatch which will distort profit or loss or other comprehensive income.

12 EFRAG does not find this reasoning convincing for several reasons.

(a) The credit risks inherent in the financial assets held by the entity and in its own liabilities are unlikely to be identical, as the credit risks of the former relate to the underlying investee and the latter relate to the reporting entity. There is therefore an economic mismatch.

(b) Although we agree that credit risk is included in the fair value from the perspective of those that hold an entity's liability as an asset, we think the perspective of holders of those instruments and the perspective of those obligated to settle the instruments are fundamentally different.

(c) Finally, there are many assets which are not held at fair value and it could be argued that including own credit risk in the measurement of all liabilities would introduce a further mismatch.

Arguments against using own credit risk in liability measurement

Counter-intuitive results

13 The paper states that the most common objection to liability measurements that reflect own credit risk is that an entity reports a gain when the credit quality of its liabilities declines. This is, some argue, counter-intuitive—because gains should result from improvements in an entity's financial situation, not deteriorations—and potentially misleading—because such "gains" can hide a deteriorating financial situation in the entity.

14 We agree with this argument. An entity whose credit standing declines is worse-off—for example, its future borrowings will be more expensive—so it is counterintuitive to report increases in net assets and income.

15 Having said that, we note that some might argue that the inclusion of own credit risk would allow one to account for interest expense on a fair value basis (by applying the current market interest rate to the fair value of the liability). Furthermore, including own credit risk would mean that, for example, a 10-year borrowing that is five years

from maturity would be shown in the statement of financial position at the same value as a newly issued 5-year loan with the same contractual terms, which sounds appealing. However, most users that EFRAG has discussed this with believe that the inclusion of the effects of changes in own credit risk in liability measurement does not result in useful information; indeed, they see its inclusion as misleading and will generally adjust reported figures to remove the effect from the statement of financial position and profit and loss account. Furthermore, they do not appear to find fair value interest expense a useful number.

16 Another aspect of this issue is that the Framework tells us that general purpose financial statements should be prepared on a going concern basis. Of course, not all changes in own credit worthiness threaten that assumption (for example, improvements in own credit risk do not) but nevertheless there appears to be some sort of contradiction between the going concern assumption and measuring liabilities at amounts that reflect the risk that the entity will be unable to settle those liabilities.

<u>Accounting mismatch</u>

17 As explained above, one argument sometimes used in favour of including the effects of changes in own credit risk is that including them would prevent an accounting mismatch arising. However, some argue that <u>excluding</u> changes in own credit risk is necessary to prevent an accounting mismatch. They argue that a decline in credit standing of an individual entity is often the result of a decline in the value of assets that are either not recognised at all—such as unrecognised intangible assets and confidence in the entity's management—or are not measured on a current value basis, such as goodwill. A mismatch would occur, it is argued, if the liabilities are reduced to reflect the effect of a decline in own credit risk but no corresponding, 'offsetting' adjustment is made.

18 However, we do not find this argument convincing for the same reason we did not find the earlier accounting mismatch argument convincing; credit risk affects assets and liabilities differently anyway, so there will be an economic mismatch.

<u>Realisation</u>

19 The paper explains that an argument used by some to justify the use of current values (including fair value) and recognising changes in those values in profit or loss is that realisation is not an economically significant event if it is easy to sell something whenever one wishes to do so; and, if realisation is not an economically significant event, it should not drive the accounting. "Furthermore, unless a financial asset is pledged or otherwise restricted, an entity can sell an asset whenever management wishes to do so."

20 However, as the paper notes, although assets are frequently sold, transfers of liabilities are much rarer, as this usually requires the permission of the counterparty. Indeed, some liabilities cannot be transferred in practice. As a result, realisation can be an economically significant event in the case of liabilities. And, if that is the case, although the measurement of some liabilities requires the inclusion of current information[2], it does not follow that the measurement of all liabilities should precisely mirror that of assets.

21 As the IASB paper goes on to explain, there is a second aspect to the realisation argument, which is that some believe that the effect of changes in own credit risk

[2] For example, asset removal obligations or pension obligations require a current interest rate to enable the cash flows involved to be expressed as present value amounts.

should not be reflected in the financial statements because the entity cannot benefit or suffer from such changes as they generally find it very hard to redeem or settle their borrowings at amounts that are discounted at a rate that reflects changes in own credit risk. We agree with this observation and think that it means that, if changes in own credit risk are reflected in the financial statements, one of the principal groups of users of the financial statements—the shareholders—will receive misleading messages about their investment and the returns they can expect over the long term.

22 We note that there have been several recent examples of entities repurchasing their debt when this has become advantageous following a change in the credit premium demanded by the market. However, we do not think that this relatively small number of cases is sufficient to justify requiring all financial liabilities to be measured at amounts that reflect changes in credit spreads. In our view, such gains should be recognised only when an actual transaction has taken place. This has the advantage of differentiating between those entities that have actively managed their borrowing costs in this way and those that have not. We think this is more relevant information for users than putting all entities on the same basis irrespective of the decisions management makes.

EFRAG'S RESPONSES TO THE QUESTIONS ASKED IN THE DISCUSSION PAPER

Question 1—When a liability is first recognised, should its measurement (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why? If the answer is 'sometimes', in what cases should the initial measurement exclude the price of the credit risk inherent in the liability? And, if the answer is 'never': (i) what interest rate should be used in the measurement? and (ii) what should be done with the difference between the computed amount and cash proceeds (if any)?

Notes for EFRAG's constituents

23 *See notes under 'General comments' above.*

EFRAG's comments

- EFRAG agrees that, if own credit risk is priced into the transaction giving rise to the initial recognition of a liability, that risk should be included in that liability's initial measurement. Otherwise, own credit risk should <u>not</u> be included in the initial measurement of the liability.

24 We think we need first to clarify what we understand the question to be. Our understanding is that the word 'inherent' in this context means that the price of credit risk is incorporated in an actual transaction. For example, the terms of a deal providing cash in exchange for a bond or borrowing agreement will include a price for the credit rating of the entity which becomes the obligor. On the other hand, where there is no transaction with an identified counterparty that can put a price on credit risk, our understanding is that there is no inherent price of credit risk. Thus, under our interpretation, there is no inherent price in a provision for asset removal, for a warranty provision or for a post-retirement obligation.

25 While we are familiar with, and understand, the argument that including the effect of own credit risk in the initial recognition amount in all cases leads to consistency and enhanced comparability, users tell us that they do not value that consistency and

comparability. They are aware of the different measurement methods that are applied to the different parts of the statement of financial position and are content that these are appropriate to the various categories of asset and liability. We think this is a very important message, because we think that the ultimate test of what is the appropriate accounting is whether the approach provides the user with the most useful information.

26 Furthermore, we think that inclusion of an estimate of the effect of own credit risk where this is not actually priced in the terms of the transaction is onerous. Similarly, the exclusion of the own credit risk from a transaction price that includes it is not always straight-forward. We think the costs involved in both cases could be justified only if users found the result useful—which, as we have said, they seem not to.

27 For those reasons, we think that:

(a) where there is an inherent price of credit risk in the transaction—such as in the case of an obligation taken on in exchange for cash proceeds—the initial measurement of the liability should include the price of credit risk. This means that the liability will be measured at an amount equal to the cash proceeds; and

(b) where there is no inherent price for credit risk in a liability, the discount rate used to reduce the liability to present value should <u>not</u> include a factor for own credit risk.

Question 2—Should current measurements following initial recognition (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why? If the answer is 'sometimes', in what cases should subsequent current measurements exclude the price of the credit risk inherent in the liability?

Notes for EFRAG's constituents

28 *See notes under 'General comments' above.*

EFRAG's comments

- EFRAG does not agree with the inclusion of the effects of changes in own credit risk in the subsequent measurement of liabilities.

29 As we have already explained, we think that the ultimate test of what is the appropriate accounting is whether the approach provides users with the most useful information. And users tell us those not do that; indeed, if the effects of changes in own credit risk are reflected in the subsequent measurement of liabilities, they will generally adjust the financial statements to remove those effects if the amounts are material.

30 Given the users' apparent belief that the effect of changes in own credit risk is not useful information, we think that, even if the initial measure for a liability reflects the initial own credit risk, subsequent measurement should not be adjusted to reflect any subsequent change in the price of own credit risk.

31 In our view, subsequent measurement should be made on the basis of changes in market rates other than those resulting from own credit standing since the previous reporting date. We also think that it would be best not to require preparers to try to remove an estimate of the inherent effect of a change in credit spreads from the change in observable market interest rates as this would necessarily be an arbitrary amount and might not be deemed by users to have any real value.

32 Having said that, we are aware that some entities take own credit risk into account when measuring liabilities held at fair value in their trading book. Because of the short-term nature of such items, we believe that the effect of taking this into account in the measurement will be negligible and does not need to be adjusted for.

Question 3—How should the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability be determined?

Notes for EFRAG's constituents

33 *See notes under 'General comments' above.*

EFRAG's comments

- If own credit risk were to be included, we think the change in market rates attributable to the change in the entity's credit rating could be estimated by comparing the change in high-quality bond rates with the change in the entity's recent borrowing costs or information about the sector's credit standings.

34 As we have already explained, we do not support the inclusion of changes in own credit risk in liability measurement and do not believe that own credit risk should be included in the initial measures unless it is already inherent in the liability.

35 However, putting that aside, we think that an estimate of the change in market rates attributable to the change in the entity's credit rating could be made by comparing the change in high-quality bond rates with the change in the entity's recent borrowing costs or information about the sector's credit standings. We recognise that this would necessarily involve a great deal of judgement and result in fairly arbitrary prices. Although estimation and judgement are essential parts of accounting measurement techniques, we wonder whether the results would be sufficiently reliable to warrant the effort involved in arriving at them in this case.

Question 4—The paper describes three categories of approaches to liability measurement and credit standing. Which of the approaches do you prefer, and why? Are there other alternatives that have not been identified?

Notes for EFRAG's constituents

36 *The discussion paper describes and discusses the following three alternatives to the inclusion of own credit risk in liability measurement:*

(a) *Measure all liabilities using the risk-free rate of interest and expected future cash flows, including the risk of default. Any difference between the resulting amount and the cash proceeds (if any) should be charged to income immediately.*

(b) *Measure all liabilities using the risk-free rate of interest and expected future cash flows, excluding any expectations about default. Any difference between the resulting amount and cash proceeds (if any) should be charged to equity and amortised over the life of the liability.*

(c) *Initially measure borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds; and initially measure liabilities that do not have a cash exchange at the present value of expected future cash flows, discounted at market rates that exclude the effect of own credit risk. Subsequent current measurements should incorporate changes in market* *interest rates. Changes arising from the entity's credit quality or the price of its credit should be excluded from the market interest rates. The paper states that this would have the effect of fixing the credit spread at the original amount and incorporating all changes in the risk-free rate.*

EFRAG's comments

- EFRAG prefers the approach described in (c) above.

37 We do not support the proposal that a risk-free discount rate should be applied to all liabilities (ie approaches (a) and (b)). While this might seem like a simple method that would result in comparability between entities, we think it would in fact lead to complexity because the difference between the initial amount measured using the risk-free rate and the cash proceeds received would need to be accounted for (and we do not like the suggestions in the paper as to how this is done).

38 EFRAG thinks that the approach described in (c) above (and in paragraph 62(c) of the DP) is probably the simplest to apply, as it requires the use of discounting based on data which is almost entirely directly observable. We also think that approach would result in decision-useful information.

39 However, we also think that the reference in paragraph 62(c) to the need to exclude the changes arising from the entity's credit quality is misleading, as we think that use of a risk-free rate observed in the market will automatically exclude the entity-specific effects that should be removed.