EFRAG

European Financial Reporting Advisory Group

23 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 measurement debate: whether, and if so to what extent, own credit risk should be reflected in liability measures. We note that this discussion paper has been produced and published on the initiative of the IASB alone, and does not form part of the work done under the Memorandum of Understanding. We would urge the IASB to try to ensure that the FASB is appropriately included in any future deliberations and decisions on the subject so that a converged approach can be developed.

Our detailed comments are set out in the appendix. However, to summarise, 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 that liability. In all other circumstances it should not be included.

- Changes in own credit risk should be taken into account in the subsequent measurement of a liability only if it is a financial liability that is both held by the entity for trading purposes and actively traded. In all other circumstances, changes in own credit risk should not be taken into account unless and until they are 'realised' in the form of cash flows.

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

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
EFRAG's detailed comments

GENERAL COMMENTS

Fair value measurement

1 The IASB is currently consulting on an Exposure Draft *Fair Value Measurement* which asks, inter alia, whether the fair value of a liability should reflect non-performance risk (including own credit risk). In responding to the Discussion Paper *Credit Risk in Liability Measurement* (the DP) we have tried to avoid commenting on whether fair value includes credit risk; instead, we have focused on discussing whether a liability is best measured at an amount that takes into account own credit risk.[1]

Arguments in favour of including own credit risk in liability measurement

2 The DP starts by briefly discussing 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 summarised and discussed below.

Consistency

3 The DP 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).

4 The DP 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.

5 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

[1] Hereafter to keep things simple we generally use the phrase 'including own credit risk' to mean "including a premium to reflect own credit risk on initial recognition and the changes in own credit risk subsequently."

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

6 As the DP 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.

7 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.

8 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, except by coincidence, be the same as the change in the fair value of liabilities caused by changes in own credit risk. Furthermore, any option that the equity owners do have would be their option rather than 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

9 The paper explains that it is often argued that the failure to include own credit risk in the measurement 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 that will distort profit or loss or other comprehensive income.

10 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 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 that 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

11 The DP also briefly discusses the three arguments it considers to be the most commonly cited arguments against including own credit risk. Those arguments are summarised and discussed below.

Counter-intuitive results

12 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.

13 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.

14 Having said that, we note that some might argue that the inclusion of own credit risk in the fair value measurement of a liability would allow entities 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 effect 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.

15 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.

Accounting mismatch

16 As explained above, one argument sometimes used in favour of including the effects of changes in own credit risk is that it prevents 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 entity is often the result of a decline in the value attributed to things 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.

17 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.

Realisation

18 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."

19 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, in practice some liabilities cannot be transferred. 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.

20 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 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.

21 We note that there have been several recent examples of entities repurchasing their debt when this has become advantageous to do following a change in the credit premium demanded by the market. In our view, the time to recognise such gains is when an actual transaction has taken place and the gains have been 'realised'. 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 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)?

Summary of EFRAG's view:

- 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

[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.

measurement. Otherwise, own credit risk should not be included in the initial measurement of the liability.

22 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 risk of the entity that 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 of credit risk in a provision for asset removal, for a warranty provision or for a post-retirement obligation.

23 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, most users that we have discussed this with tell us that they do not value that consistency and comparability. We think this is a very important message, because we think the ultimate test of whether a change in accounting is appropriate is whether the new approach provides the user with more useful information.

24 Furthermore, we think that inclusion of an estimate of the effect of own credit risk where it is not actually priced in the terms of the transaction is onerous. Similarly, the exclusion of the effect of 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 an improvement—which, as we have said, they seem not to.

25 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 not 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?

Summary of EFRAG's view:

- EFRAG believes that, as a general rule, the effects of changes in own credit risk should not be taken into account in the subsequent measurement of a liability. However, we believe there should be an exception to this general rule for financial liabilities that are both held by the entity for trading purposes and actively traded.

26 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 most users we have spoken to on the subject tell us that, 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.

27 Given users' apparent belief that the effect of changes in own credit risk is not useful information, we think the general rule should be 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. Subsequent measurement should be made on the basis of changes in market rates other than those resulting from own credit risk since the previous reporting date. The 'gains' and 'losses' arising from changes in own credit risk should be recognised as and when they are realised.

28 We would however make one exception to this general rule: we think it is appropriate to take changes in own credit risk into account when measuring financial liabilities that are both held for trading and actively traded. It is widely agreed that financial assets and financial liabilities that are both held for trading and actively traded are best measured at the value at which they can be traded (ie marked-to-market). This value will include the effects of changes in own credit risk. Indeed, it is our understanding that many entities already take own credit risk into account when measuring such financial liabilities.

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?

Summary of EFRAG's view:

- If changes in own credit risk were to be included in the subsequent measurement of a liability, we think the IASB should not be prescriptive as to how the amount attributable to such changes should be determined. More than one approach could be used to measure the effects of the changes reliably, and we think the IASB should allow entities to use the most appropriate model to reflect their specific circumstances.

29 As we have already explained, we think that generally changes in own credit risk should not be included in liability measurement and we do not believe that own credit risk should be included in the initial measure of a liability unless it is priced into the transaction giving rise to the initial recognition of the liability.

30 However, putting that aside, we think that there is more than one approach that could be used to measure reliably the effects of changes in own credit risk. For example, in some circumstances the effects can 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. However, in other circumstances there could be better methods to use. Our view therefore is that the IASB should not prescribe the method to be used. Instead, the measurement objective should be clearly stated and some guidance could perhaps be provided, but entities should be allowed to determine the value based on a range of acceptable approaches. We note that this would be a similar approach to that adopted in IFRS 2 *Share based Payments*, which also does not require the use of any particular pricing model.

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?

Summary of EFRAG's view: • EFRAG prefers the approach described in (c) below.

31 The discussion paper describes and discusses the following three alternatives to including 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.

32 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 might be done).

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

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