30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **19 September 2006, London**

Project: **Fair Value Measurements**

Subject: **Non-performance Risk (Agenda Paper 10A)**

Introduction

1 The FASB's draft Fair Value Measurements (FVM) statement observes that non-performance risk (ie, the risk that the obligation will not be fulfilled) affects the value at which the liability is transferred. As a result, the draft FVM statement indicates the fair value of a liability shall reflect the non-performance risk relating to that liability. The draft FVM statement clarifies that non-performance risk includes the reporting entity's own credit risk, thereby requiring an entity to consider its credit risk (credit standing) on the fair value of a liability.

2 IFRSs currently do not discuss non-performance risk in relation to the fair value of liabilities. However, IAS 39 requires the fair value of a financial liability reflect the credit quality of the instrument. Reflecting credit quality in the fair value measurement of a financial liability effectively causes the fair value measurement to reflect the risk that the obligation will not be fulfilled. The wording in the draft FVM statement extends this principle to the fair value measurement of both financial and non-financial liabilities.

3 The staff agrees with the Board's conclusion in IAS 39 that the fair value of a financial liability should reflect the credit risk of the liability. However, the

staff reasons the risk of default is not limited only to the credit quality of the liability. Further, the staff believes there should be no conceptual difference between the fair value measurement objective for financial and non-financial liabilities. Therefore, if the risk of default (as indicated by credit quality) should be reflected in the fair value measurement of financial liabilities, the staff concludes the risk of default (or non-performance) should similarly be reflected in the fair value measurement of non-financial liabilities. The staff therefore agrees with the wording in the draft FVM statement, which indicates the fair value of a liability should reflect the non-performance risk relating to that liability. Also, because of the strong views of some constituents on this matter, the staff recommends including a discussion and preliminary view in the Invitation to Comment regarding the wording in the draft FVM statement and the comparable IFRS guidance.

Discussion

4 The FASB's FVM Statement states the fair value of a liability shall reflect the non-performance risk relating to that liability. Non-performance is the risk that an obligation will not be fulfilled and includes (but is not limited to) the reporting entity's own credit risk. Therefore, a reporting entity is required to consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value. This effect may differ depending on the liability and the terms of credit enhancements related to the liability, if any.

5 The staff interprets this guidance to relate to the risk of default specific to the liability. As such, a change in an entity's credit standing might (or might not) affect the fair value of a liability of the entity, depending on the terms of credit enhancements related to the liability (such as collateralisation or third-party guarantees). The staff concludes this is generally consistent with IAS 39, which requires the credit quality or credit risk of a liability be reflected in the fair value of a financial liability, except that the FASB's FVM Statement extends this principle:

(a) to all fair value measurements of liabilities (not just financial liabilities as in IAS 39), and

(b) to all risks of default or non-performance (not just credit risk).

6 Having said this, the staff understands there may be diversity in practice in US GAAP in defining 'the liability.' As the FASB's FVM Statement does not address unit of account, others might interpret the wording differently: [Remainder of this paragraph omitted from observer note].

7 [Paragraph omitted from observer note].

Current IFRS requirements to consider credit quality

8 IFRSs currently do not discuss non-performance risk beyond the requirements of IAS 39 to reflect the credit quality of a financial liability when measuring its fair value:

(a) IAS 39.AG69: 'Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.'

(b) IAS 39.AG73: 'If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.'

9 The Basis of Conclusions of IAS 39 provides the rationale for the Board's views on reflecting credit risk in the fair value of a financial liability. IAS 39.BC89 states:

'However, 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 for the following reasons:

(a) entities realise changes in fair value, including fair value attributable to the liability's credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives;

(b) changes in credit risk affect the observed market price of a financial liability and hence its fair value;

(c) it is difficult from a practical standpoint to exclude changes in credit risk from an observed market price; and

(d) the fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects its credit risk. The Board believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.'

10 This concept was reaffirmed during the Board's discussion of credit characteristics of insurance liabilities in May. While the exit value concept being developed in insurance is not necessarily 'fair value', it is a current value measurement with conceptual similarities to fair value. During the May discussion of insurance liabilities the Board tentatively concluded:

(a) the initial measurement of an insurance liability should reflect its credit characteristics; and

(b) the subsequent measurement of an insurance liability should reflect changes in the effect of its credit characteristics (ie changes in the probability of default or changes in the price for possible default).

11 Agenda Paper 4C for the May Board meeting argued credit characteristics should be reflected in the exit value of an insurance liability, in part, because:

(a) The transferor would not willingly pay the price that a willing transferee would require for a transfer that improves those characteristics.

(b) The policyholder (and regulator, if any) would not consent to a transfer that impairs those characteristics.

Credit risk versus non-performance risk

12 Credit risk is not defined in IFRSs. *Options, Futures, and Other Derivatives (6th Edition)* by John C. Hull defines the credit risk for a derivative as 'The risk that a loss will be experiences because of a default by the counterparty.' The staff reasons this definition is generally consistent with the intended definition of credit risk in IFRSs.

13 The staff observes that credit risk therefore provides a measure of the likelihood a financial liability will be satisfied in accordance with its contractual terms (ie, the risk of default). However, certain liabilities are not settled financially, including product warranties, asset retirement obligations and obligations to perform environmental clean-up activities. Conceptually, the staff reasons default risk should not be considered only in terms of credit risk. Rather, if credit risk should be reflected in the fair value measurement of a liability, it would also seem appropriate to for the fair value measurement to reflect other risks of default or non-performance. The staff therefore concludes the wording in the FASB's draft FVM statement more appropriately establishes the concept that the fair value of a liability should reflect the risk that the obligations of that liability will not be performed, and that credit risk is one component of this risk.

Staff Recommendation

14 The staff concludes the wording in the draft FVM statement is an extension of the concept established in IAS 39 to include fair value measurements of both financial and non-financial liabilities. The staff therefore recommends the Board include a preliminary view in the invitation to comment agreeing with the concept that the fair value of a liability should reflect the non-performance risk relating to that liability.

15 As the Board has already established in IAS 39 the concept that the credit risk of a liability should be considered when measuring the fair value of that liability, the staff considered whether the Board should remain silent in the invitation to comment regarding the use of the term non-performance risk in the FASB's FVM statement. However, the staff observes this issue will likely receive significant comment given previous objections from some constituents in the exposure draft to IAS 39 and in recent Insurance Working Group

discussions. As such the staff concludes a discussion, preliminary view and question should be included in the invitation to comment in order to explain this matter along with the Board's basis for their views. Do Board members agree with the staff recommendation?