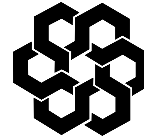

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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **Fair Value Measurement**

Subject: **Credit standing (Agenda paper 3I)**

Introduction

1. The first paper on credit standing discussed an issue in the measurement of credit standing. This note explores another set of questions. Should the IASB continue to hold the view that the fair value of a liability includes the credit standing of that liability? Alternatively, should the IASB develop a different current measurement of liabilities that excludes changes in the entity's or the instrument's credit standing? There is a distinction between the effect of a change in an entity's credit standing (for example from A to BB) and a change in the price of a credit spread relative to risk-free rates. Few of the IASB's constituents draw a distinction between the two, and this paper includes both under the general heading of "changes in credit standing."

Where We Are Now

2. The conclusion that the fair value of a liability includes the effects of an entity's credit standing rests on a series of logical propositions that, with one exception, form a complete and coherent package. The internal logic is hard to refute. I've attached an article that I

wrote with Mike Crooch during my time at the FASB that describes a lot of that thinking (agenda paper 3J).

3. In summary, the IASB and FASB arguments have rested on four principles:

    a. ***Consistency with initial measurement.*** With the exception of a few actuaries, most agree that the initial proceeds of a liability represent its entry value and that this amount is the most useful depiction of the liability at initial recognition. The proceeds represent the market's assessment of the adjustment, relative to assets free of default risk, required for the entity's credit standing. If that amount represents fair value at initial recognition (FAS 157's exit value requirement notwithstanding), then subsequent measurements of fair value should include a similar adjustment and reflect changes in credit standing.

    b. ***Measurement independent of timing.*** Fair value measures identical assets at identical amounts, without regard to when those assets were acquired. A share of common stock, say Fannie Mae, purchased today should be measured at the same amount as one purchased last year. Failure to do so omits information from the financial statements and is misleading, especially in the case of Fannie Mae. Entities that borrow at different times should similarly report those liabilities independent of when the amounts were borrowed.

    c. ***Avoiding mismatches.*** Changes in the value of an entity's assets, both recognized and unrecognized, are the major cause of changes in the credit standing of its liabilities. If the measurement of liabilities locks in the credit standing on initial recognition, and the measurement of assets includes changes in their value, then there is a mismatch.

    d. ***View of the entity.*** A change in credit standing of liabilities represents a transfer of wealth between classes of claimants to the entity's assets. Every downgrade in credit standing increases the value of the shareholders' claims and decreases the value of the lenders' claims. The reverse is true for credit upgrades. Within the limits of financial reporting, we should capture those wealth transfers.

4. And the exception? FASB Statement 157 and Concepts Statement 7 stipulate that fair value measurement represents an amount at which the entity could transfer the liability to

an entity of similar credit standing or, in the case of Concepts Statement 7, to settle with the counterparty. That isn't a principle. It's a device required to implement the four principles in a particular way. More specifically, it defines the market that we look to for measurement. As outlined in the first note on credit standing, using this device creates some possible inconsistencies with asset measurement in FASB Statement 157.

5. The FASB might have chosen other devices to implement the fair value of liabilities, but each had problems. For example, they could have looked to:

    a. The amount that the entity would receive in a current transaction if it promised to pay the same principal amount at the same time. That would work for borrowings, but Concepts Statement 7 was developed at the same time as the FASB standard on asset removal obligations and IAS 37. The FASB recognized that those liabilities don't have a counterparty and there are no proceeds to which the entity could refer.

    b. The amount that the entity could invest today that would accumulate to an amount needed to retire the liability when it becomes due. Stated differently, the amount required to defease the liability. This approach has two disadvantages. First, it defines the measurement in terms of its calculation rather than stating a consistent approach to the fair value objective. Second, it introduces the idea that the measurement of a liability might be based on the investment strategy of the entity rather than the characteristics of the liability in question.

And the Problem Is?

6. Despite several years of trying, we have failed to convince a significant number of our constituents that including credit standing in subsequent measurement of liabilities produces decision-useful information. (See also paragraphs 3.73 to 3.77 of the March 2008 Discussion Paper, *Reducing Complexity in Reporting Financial Instruments*.) Those who disagree tend to fall into several camps:

    a. Some argue that fair value, with or without credit standing, is not a relevant measurement attribute for liabilities.

    b. Some complain about the effects of changes in the credit spread without changes in the credit standing of the entity.

c. Some maintain that remeasurements resulting from changes in credit standing produce income statement effects that are counterintuitive. This is probably the most common objection. There are two effects that many find counterintuitive:

    i. The entity reports a gain when its financial strength deteriorates and a loss when its financial strength increases.

    ii. If an entity's financial strength deteriorates, it will report a gain at the time. Assuming the entity doesn't actually default, that gain reverses automatically in later periods. This effect arises from both changes in the expected value of defaults and changes in the entity's credit spread. This latter effect has fallen under the spotlight in the credit crisis.

d. In some circumstances, the effect may be difficult to measure. This may cause concerns of possible bias and subjectivity.

e. The credit standing effect can be viewed as a put option held by the equity holders. Some would report this as a separate asset of the entity (rather than a reduction in the liability). Others view it as an asset of the equity holders and believe it does not belong in the entity's financial statements.

f. Some users like to compare an entity's assets with its liabilities and assess how much headroom there is. This task is more difficult if the liability measurement shifts in response to credit spreads and expected defaults. Although the transfer of wealth from creditors to equity holders is real, it would be more useful to deal with those effects outside the financial statements.

g. Some argue that subsequent measurements that include changes in credit standing are not useful (at best) or misleading (at worst). This is the common view of regulators, preparers and, of greater concern, of an apparent majority of financial statement users.

7. The balance of this discussion focuses on the last and most serious objection. Opinion is not unanimous. For example, the CFA Institute, commenting on the fair value option, said:

> We are also not concerned about recognition of gains or losses in earnings from changes in an issuer's creditworthiness. Such affects are only counterintuitive when financial statements are (incorrectly) viewed as reflecting some sort of amorphous view of an entire entity. If financial statements are viewed as presenting the position of existing shareholders, a decrease in creditworthiness is effectively a wealth transfer from bondholders to stockholders (or vice versa for an increase), which is exactly what the income statement should communicate.

8. However, a recent Standard and Poor's report, *Credit FAQ: Accounting Ramifications Of The Recent Mortgage-Lending Disruption For Financial Institutions*, included the following observation:

> Although we expect to see a company's election to mark its own obligations to fair value within the context of an asset/liability matching, risk management, or hedging program, we do not view changes in equity and earnings resulting from changes in the institution's own credit standing as "real" for the purpose of our credit analysis, unless realized. Accordingly, when these gains (or losses, should conditions change) are material, we will reverse them in our analysis of earnings and capital.

9. Fitch Ratings has made a similar comment in recent reports. Their comment letter on the IASB fair value discussion paper said:

> Again, please refer to our answer to question 3 above. We urge the IASB to try to think about the practical implications of how the value of a company's own debt should be determined. *It is very difficult for us, as credit analysts to conceptualise how there can be any added value to our understanding of financial statements by reporting a company's loans and debt at the values at which they would be willing and able to transfer them and a third party would be willing and able to buy.* We accept that many companies do buy back their own debt in the market from time to time, or pay for this to be guaranteed, but this is not common, and would certainly not be a realistic basis for the valuation of all a company's financial obligations. It would be more helpful accounting practice to recognise and value such arrangements as they occur. [Emphasis added.]

10. I was unable to find anything on point from Moody's, CRUF, or the Council of Institutional Investors. The Basel Committee, IOSCO, and the International Association of Insurance Supervisors have long argued that including changes in credit standing in subsequent measurement of liabilities is potentially misleading.

11. But what about the argument, "If you leave out the entity's credit standing, you have something, but it isn't fair value." Logicians refer to this as a fallacy of circular definition. We standard setters defined the fair value of a liability to include credit standing, so, yes, leaving out credit standing would be inconsistent with our definition. It would also be inconsistent with a notion of the fair value of a liability as the price that

others are willing to pay to hold the entity's liability as an asset, but we didn't adopt that notion.

12. If we are going to make an argument about credit standing, we have to demonstrate that the result is decision-useful. Interestingly, others who support including credit standing haven't made a usefulness argument. The CFA Institute comment referred to earlier presents an argument for internal consistency, not for usefulness. The two ought to be subsets of the total construction of an argument, but many of our constituents do not agree. They seem to argue that internal consistency is not necessary and perhaps not sufficient for decision usefulness.

13. Unfortunately, I have been unable to find any significant empirical research, beyond the article co-authored by Mary Barth, Leslie Holder, and Stephen Stubben[1], to help us. The authors describe their findings as follows:

> Our findings link and empirically document the existence of two countervailing equity value effects associated with increases in credit risk: (i) decreases in equity value, presumably arising from decreases in asset value or increases in systematic asset risk, and (ii) increases in equity value attributable to decreases in debt value, presumably arising from decreases in asset value or increases in systematic or unsystematic asset risk.

14. I hesitate to further characterize the conclusion at the risk of getting it wrong. I think the conclusion is, among other things, that critics of including credit standing are looking at only half of the picture. An entity's credit standing does not change in isolation from other things that are captured by changes in the fair value of its recognized and unrecognized assets.

15. To review, our current exposure draft on objectives and quantitative characteristics describes decision-usefulness as follows:

> Capital providers are interested in financial reporting because it provides information that is useful for making decisions. The decisions that capital providers make include whether and how to allocate their resources to a particular entity (that is, whether and how to provide capital) and whether and how to protect or enhance their investments. When making those decisions, capital providers are interested in assessing the entity's ability to generate net cash inflows and management's ability to protect and enhance the capital providers' investments.

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[1] *Fair Value Accounting for Liabilities and Own Credit Risk,* May 2006 draft, (http://www.nd.edu/~carecob/Paper%20Links/Su'06%20Conf/Hodder%206-06.pdf)

16. That description encompasses two questions for capital providers. Should I invest in or lend money to this entity, and is management properly managing my existing investment? So the question for us to answer is the following: does a subsequent measurement of liabilities that includes changes in credit standing enhance a capital provider's ability to answer those two questions?

17. Fair value information about assets provides useful information by telling users about the consequences of past decisions to buy an asset (through recognized gains and losses) and the implications of current decisions to hold an asset rather than selling it (through the effects on future reported earnings). Decisions have opportunity costs, and despite the old arguments that accounting should not try to deal with opportunity costs, fair value does just that. It does not directly provide information about future cash flows and isn't designed to do so. Rather, it provides information about the value that the market attaches to particular cash flows. As Jim Leisenring has observed, it is the ultimate stewardship attribute.

18. But does a measurement of liabilities that includes changes in the entity's credit standing provide the same sort of information about a liability? Here we have two problems.

    a. Entities usually have more freedom to exit from assets than to exit from liabilities, so the fair value of liabilities often does not communicate as much information about choices and decisions as the fair value of assets. That freedom isn't unconstrained in assets, especially if they are pledged against particular liabilities. However, exiting a liability almost always requires permission from the counterparty or some other entity (like a governmental body).

    b. Changes an entity's credit standing are often influenced by changes in unrecognized assets – intangible assets and goodwill. Recognizing changes in credit standing of liabilities exacerbates, rather than diminishing, an accounting mismatch. This was one of the arguments made, if I recall correctly, by the German participants in the Joint Working Group on Financial Instruments in the late 1990s. Our only argument in refutation is that there are limits to financial statements. The absence of some assets and liabilities from the financial statements is not a reason to omit information about the assets and liabilities that are recognized.

19. I am persuaded that we should examine the decision usefulness of including changes in credit standing in computing the carrying amount of liabilities. Note here that I didn't say "in computing fair value." Standard setters might well conclude, as they have before, that any computation of the fair value must include the borrower's ability to repay. In my view, that conclusion addresses only part of the issue – the "how" part. The bigger question is whether doing so provides decision useful information and, if so, under what circumstances.

20. The upcoming Exposure Draft on fair value is all about "how" to compute fair value and not about "when" or "whether" to do so. Discussing whether it is useful to include changes in credit standing is arguably out of place. Many of our constituents, including many who are well informed and thoughtful, do not accept the distinction. Moreover, we will not have another opportunity to consider the issue for some time. I propose that we include questions about credit standing in the invitation to comment to the Exposure Draft. The questions might include the following:

    a. Does a measurement described as fair value necessarily include the credit standing of a liability, both on initial recognition and in subsequent measurement? If not, what measurement do you support and how is it consistent with your notion of fair value?

    b. Does a measurement of liabilities that includes the effects of changes in credit standing enhance users' ability to make investment and stewardship decisions? If so, how do users employ the information? If not, what alternative do you propose and how would it provide more useful information?

    c. Is it possible to isolate and compute the effects of (a) changes in the credit standing of a liability from (b) changes in the credit spread unaccompanied by a change in credit standing from the total change in the fair value of a liability? If so, how would you propose that the computation be made?