IASB Meeting Agenda reference **6**

Staff Paper Date **October 2009**

Project **Credit Risk in Liability Measurement**

Topic **Comment letter analysis**

Introduction

1. In June 2009 the Board published the discussion paper *Credit Risk in Liability Measurement* (DP). The comment period ended on 1 September 2009 and, by that date, the IASB had received 82 comment letters.

2. The DP and accompanying staff paper outlined the three most often-cited arguments in favour of including credit risk in liability measurement and the three most often-cited arguments against including it. The DP sought respondents' views on when and how credit risk should be included in liability measurement.

3. The staff presented a preliminary analysis of the 102 comment letters that had been received through 2 September at the September Board meeting.

4. A note on terminology before continuing. The staff paper focused on "credit risk," which might be defined as the possibility that an entity will fail to pay an obligation according to its terms. FASB Statement 157, *Fair Value Measurements,* introduced the term "nonperformance risk." The FASB intended the term to include credit risk, but also to include other failures to meet an obligation. Many of the respondents treated the terms as if they meant the same thing. The terms are interchangeable in many, but not all situations. We will describe one such in the final section of this paper.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Purpose of this paper

5. This paper provides a more detailed analysis of the 123 comment letters that were received by 5 October, along with staff recommendations on how the Board should address credit risk in other projects.

Overview of the comments received

6. Respondents agreed that Credit Risk is a complex and controversial issue which has to be addressed. However some respondents had concerns about looking at this issue in isolation and maintained that it should be addressed as a part of the Conceptual Framework project. Other respondents said that it was difficult to respond on this issue before the Fair Value (FV) project and the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* have been completed. Respondents however generally supported the Board's effort to address this issue.

7. Respondents generally said that liabilities can or should be measured differently on initial measurement than on subsequent remeasurement. They also argued that a consistent measurement approach for different types of liabilities is not needed. In their view, different liabilities can or should be measured differently.

8. Respondents most often argued that decision usefulness should be the driver in liability measurement rather than consistency.

> When assessing whether current measurements, subsequent to initial recognition, should incorporate the price of credit risk inherent in the liability, the objectives of quality of information and decision usefulness should be the guiding principles. (CL#71)

9. Respondents also seem to be more interested in eliminating obvious day one gain/loss than having a consistent approach to measuring liabilities. We use the word "obvious" here because any measurement on initial recognition that excludes credit risk builds in a "borrowing penalty" (see paragraph 30 of the

staff paper). The penalty is obvious when the transaction includes a debit to cash, because debits have to equal credits.

10. A majority of the respondents addressed all types of liabilities, other respondents limited their answers to financial liabilities. A few of the respondents limited their answers to either pension or insurance liabilities.

11. The respondents who limited their responses to financial liabilities seemed to be more inclined to favour including credit risk both on initial measurement and on subsequent remeasurement. However, their answers were often limited further to financial liabilities measured at FV. We will return to the interaction between comments about credit risk and fair value later in the paper.

12. Very few respondents identified the difference between a change in credit rating and a change in spread as an issue.

13. One of the objectives of the DP was to get users' opinions on credit risk. Only three responses can be classified users, so the DP did not meet that objective. Whether this was due to the timing of the DP, the short comment period or the traditional pattern of receiving few comment letters from users is not clear.

14. We would summarize the respondents' general conclusions in the following table (borrowed from the Ernst and Young comment letter):

	Measurement	**Include own credit risk?**	
		Initial recognition	Subsequent remeasurement
Financial liabilities	Fair value	Yes	Yes
	Other than fair value	Yes	No
Non-financial liabilities	Fair value	Yes	Yes
	Other than fair value		
	- inital consideration exchanged	Yes	No
	- no initial consideration exchanged	No	No

15. The comment letters are summarized below by type of respondent and geographic region:

Respondent Type	**Number of respondents**	**Percentage**
Preparer	48	39%
Professional bodies	29	24%
National standard-setters	15	12%
Regulator	8	7%
Others eg NFPs, public sectors	8	7%
Accounting firms	6	5%
Individuals	4	3%
Investor/ Analyst/ User	3	2%
Academic	2	2%
Total	123	100%

Geographic region	**Number of respondents**	**Percentage**
West Europe	61	50%
North America	21	17%
International	14	11%
Asia Pacific ex ANZ	11	9%
Australia/NZ	11	9%
Africa	2	2%
East Europe	1	1%
Central/South America	1	1%
Total	122	100%

16. In addition to responding to the questions in the DP, most respondents provided general comments about credit risk. First we will summarize those general comments and then we will address the responses to the questions in the DP.

Summary of general comments

17. Some respondents have concerns about this DP and credit risk being taken on as a separate project. They are especially concerned about the interaction between this project and other ongoing projects on the Board's agenda.

Conceptual Framework

18. Some respondents said that this issue should not be addressed in isolation and should be addressed in the measurement phase of Conceptual Framework Project. They also said generally that more work is needed on liability measurement before the issue of credit risk can be addressed.

> The Joint Accounting Bodies appreciate the concerns expressed in the DP about the place of 'own credit risk' in liability measurement and support the need for guidance and clarity on the issue. However, it is our view that these concerns cannot be resolved before addressing measurement models. In particular, the issue of credit risk in liability measurement must be addressed in conjunction with the fair value measurement project and not in isolation of it, as the credit risk issue can only be resolved once fair value has been defined. We think this fundamental issue is more appropriately addressed within the conceptual framework and definition of fair value, rather than the approach taken in the DP. (CL #6)

Fair Value

19. The staff found respondents' views on the interaction between fair value and credit risk difficult to analyse. Some respondents:

    (a) Appeared to be opposed to fair value measurement of liabilities in general, and used credit risk as a basis for arguing against fair value, or

    (b) Agreed that the Board's definition of fair value includes credit risk, and therefore would rarely favour its application to liabilities, or

(c) Would like a definition of fair value that does not include credit risk.

20. Many respondents said that it is difficult to answer the questions on the use of credit risk when the FV project has not been completed.

> We would like to note that it is difficult to comment on the issue of when financial liability measurement should include consideration of credit risk separately to the related issues of how fair value should be determined and when financial instruments should be measured at fair value. The Board's conclusions on this DP clearly have potential impacts on exposure drafts already in issue, ED/2009/7 *Financial Instruments: Classification and Measurement* and ED/2009/5 *Fair Value Measurement*, which we will be commenting on separately. (CL #17)

21. Many respondents said that FV should only be used in limited circumstances on subsequent remeasurement, namely for trading liabilities and other similar liabilities, or if the entity has the possibility to realise the changes in FV.

22. Some respondents suggest using adjusted FV on subsequent measurement, in which effects of changes in own credit risk would be separated from other changes.

> Therefore, we believe that it is premature to include subsequent changes in an entity's creditworthiness in the income statement. Such effects would be better suited to disclosure in the footnotes to the financial statements. (CL#99)

> For fair value measurements of non-trading liabilities, as a practical solution rather than due to any conceptual argument, we support the recognition of gains or losses arising from changes in own credit risk through OCI. We believe that this approach would reduce volatility in the income statement and also meet the demands of various stakeholders. (CL#90)

The main argument raised here was that reporting changes in own credit risk in the income statement is misleading and the "counterintuitive" nature of recognized gains and losses when they cannot be realised. Many also argued that the gains and losses are not useful information, except when the entity can realise the gain by buying back its own debt.

23. A few respondents suggested separating the FV changes into changes for own credit risk which should not be presented in the income statement and all other

changes which would be presented in the income statement. The changes related to own credit risk would be reported in Other Comprehensive Income.

24. Some letters remarked on the difficulties in separating credit risk from other elements of an interest rate. Some observed that extracting effects of own credit risk in level 1 FV measurement is very hard as the credit risk is implicit in the price used. They observed the opposite problem when inserting credit risk in level 3 FV measurement.

> Conceptually, we do not disagree with the inclusion of credit risk where liabilities are measured at fair value but we do not believe that a single approach can be applied to all such liabilities. For example, from a practical point of view it may be appropriate to distinguish liabilities measured at fair value between those categorised at different levels of the fair value hierarchy. Accordingly, one would expect to reflect credit risk in the measurement of those at level 1 whereas this would not be the case for those at level 3 in the hierarchy. It would be practically difficult to exclude credit risk from a fair value determined higher up the hierarchy whereas a "mark to model" level 3 valuation would potentially experience the same difficulties including the credit risk element. (CL 63)

The project to replace IAS 39

25. Many respondents also said that while the project to replace IAS 39, especially the first phase, *Financial Instruments: Classification and Measurement* has not been completed it is hard to give a definite answer now on credit risk without knowing when and to what extent FV will be used in measurement.

26. There are also some concerns about using FV especially on subsequent remeasurement as discussed above.

Other projects

27. The use of credit risk in the measurement of liabilities in other projects was also mentioned, especially the insurance and pension projects. There was little support for including own credit risk in the measurement of these liabilities. Respondents said that credit risk should only be included in measurement of a liability when it is priced into the (usually cash) transaction that gives rise to the

liability. They also said that it is very difficult or even impossible to measure amount attributable to credit risk for these liabilities.

> In the case of non-financial liabilites we do not believe it is possible for an entity to measure non-performance risk for no observable market price exists. Therefore non-performance risk should not be included in both initial and subsequent measurement. (CL 101)

Respondent also said that the same applies to liabilities within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the leases project.

Other comments

28. Many respondents said that decision usefulness of information on liabilities presented in financial statement should be the driver for measurement. Their view of decision usefulness overcomes any argument for a consistent measurement approach applied to all liabilities. They also said that measurement of the same liability should not necessarily include credit risk both on initial measurement and subsequent remeasurement.

The going concern assumption

29. Many respondents argued against the inclusion of own credit risk, especially on subsequent remeasurement, because it violated their notion of the going concern basis.

30. The staff has heard this argument many times, applied to many topics. We find it useful to revisit what the term "going concern" means in an IFRS context. Paragraph 23 of the *Framework for Preparation and Presentation of Financial Statement* reads as follows:

> The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

31. Paragraph 23 of the Framework does not include or exclude any measurement objective, although going concern is often raised in objection to current measurements. We agree that most entities expect to pay their obligations when they are due. We also agree that adjustments for fair value and credit risk reverse when an obligation is paid according to its terms. Neither of those truisms has anything to do with the going concern notion described in the Framework. In the staff's view, there are strong arguments against including credit risk in liability measurements. An appeal to the going concern notion is not one of them.

Summary of the responses to the questions in the DP

Initial measurement

32. On initial measurement a majority of the respondents said that credit risk should *sometimes* be included in the measurement of liabilities. However, some of the respondents said that credit risk should *always* be included. It should however be noted that majority of those that support *always* including credit risk limit their answers to financial liabilities. Only four respondents said that credit risk should *always* be included in initial measurement of all liabilities. Very few respondents said that credit risk should *never* be included on initial measurement. As discussed earlier, most respondents equated "sometimes" with "cash transaction."

Subsequent remeasurement

33. There are more divided views on subsequent remeasurement. The majority of the respondents said that credit risk should *sometimes* be included in subsequent measurement of liabilities. However, a substantial part of the respondents said that credit risk should *never* be included. Only a small number of the respondents said that credit risk should *always* be included. Again the majority of those which favoured *always* including credit risk limit their answers to

financial liabilities measured at FV. Only two respondents said that credit risk should always be included in subsequent remeasurement of all liabilities.

Methods to determine the amount of change in market interest rates attributable to the price of credit risk

34. Many respondents concluded that this question was not relevant as they would not measure this change. For others, the staff has concluded that this question was not clear. Given the number of respondents who opposed including credit risk in subsequent measurement, we expected more attention to the process of extracting credit risk from observed prices.

35. A majority of those who answered this question thought that difference between the entities borrowing rate (or issuance rate) and a relevant market rate should be used, without explaining further what they meant by relevant rate.

36. A few respondents pointed to the guidance in IFRS 7 *Financial Instruments: Disclosures* on how to determine this amount.

37. There were also suggestions that a panel of industry experts should be convened to develop guidance on how the effect of changes in the price of own credit should be calculated.

Preferred approach to measure liabilities and credit standing

38. Approaches a) and b) suggested in paragraph 62 of the staff paper accompanying the DP did not get any support from the respondents. They were dismissed on the grounds that they would increase complexity and not provide decision useful information.

39. Most respondents favored approach c), that is the “frozen spread” approach, of the approaches presented in the paper to measure liabilities and credit standing in question 4 of the DP.

> Measure borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds. 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 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. This would have the effect of fixing the credit spread at the original amount and incorporating all changes in the risk-free rate.

40. More than half of the respondents favoured approach c). However many respondents rejected all the approaches suggested without recommending an alternative.

41. Those respondents who rejected all the proposed approaches did so in most cases on the grounds that credit risk would have to be included in fair value measurement. They said that this approach would therefore not work for financial liabilities measured at FV, such as liabilities held for trading. They seemed to conclude that liabilities measured at FV would have to include changes in the entity's own credit risk. It is not clear whether most of these respondents a) rejected the idea of an "adjusted fair value," or b) did not see the proposed alternatives as appropriate adjustments.

Analysis and recommendations

General Recommendation

42. The natural first question following the Discussion Paper is "what next?" Neither the Board nor the staff started this exercise with a plan that it would follow a normal project's trajectory. Instead, we wanted to focus our constituents' attention on a crosscutting issue. We hoped that their comments would provide useful input to a number of projects.

43. In the staff's view, the answer to "what next?" should be "nothing," at least in terms of continuing work on a quasi-project called Credit Risk. The discussion paper accomplished the Board's objective. Several respondents contended that the issues surrounding credit risk cannot be solved apart from a general concept of liability measurement. We agree with them, to a degree. It would be a mistake for the Board to try and articulate a principle on credit risk without

having a principle on liability measurement. Any further work on credit risk as a general proposition should be part of the conceptual framework measurement phase.

44. But the Board still needs to make decisions about liability measurement in individual projects. We have some recommendations about how to approach that need.

Fair value

45. The credit risk team does not recommend any change in the role of credit/performance risk in the **definition** of fair value for liabilities. The staff proposed a different approach last December, and the Board rejected that proposal. Moreover, a fundamental change to the definition of fair value would be a major impediment to IASB/FASB convergence.

46. We recommend that the Board explicitly consider modifications to the **application** of fair value in every project. There is precedent for adopting a modified fair value, notably the use of "fair value less costs to sell," and "fair value less costs to distribute," in IFRS 5, *Noncurrent Assets Held for Sale and Discontinued Operations.* The Board's 2008 Discussion Paper on employee benefits adopted the phrase "fair value assuming the terms of the benefit promise do not change."

47. For example, the Board might decide that a particular class of liabilities should be measured:

    (a) At fair value on initial recognition, with a presumption that the cash proceeds of the liability approximate fair value. That measurement would include credit/performance risk to the extent that it is captured in the cash price, as one would expect it would be.

    (b) Using an approach similar to the "frozen spread" method described in the Credit Risk paper for subsequent measurements. The result might be described as "fair value excluding changes in credit risk."

48. We expect that defining the population of the class of liabilities to which this approach would apply will be difficult. It always is. We learned little from the comment letters that will help us with that. Many respondents said that subsequent measurement of liabilities should never include changes in credit standing. Their scope appears to have been all liabilities. Others allowed that fair value should include credit/performance risk when measuring some liabilities. Derivatives and liabilities in trading portfolios were common suggestions.

Other measurements

49. In IFRS, most applications of fair value to liabilities occur in financial instruments. We have several other standards that *do not* require fair value but *do* require current information to be incorporated in liability measurement, including IAS 37 on provisions, IAS 19 on pensions, and potentially, standards on revenue recognition and insurance. Board decisions in those projects suggest that IFRS will have measurements that could be described as "current (or fresh-start) measurements that are not fair value" for the foreseeable future. All of those measurements are going to be based, to one degree or another, on the present value of future cash flows.

50. 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. We are in a different position on this point than is the FASB. FASB Concepts Statement No 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* mandates fair value in paragraph 25, which says:

> The only objective of present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value. Stated differently, present value should attempt to capture the elements that taken together would comprise a market price if one existed, that is, fair value.

51. The FASB members who voted for Concepts Statement 7 intended that language to be absolute. Indeed, the two dissenters raised only this point in their dissent. In its entirety, the dissent reads:

> Messrs. Larson and Trott dissent from this Statement because of its adoption of fair value as the sole objective of using cash flow information and present value in accounting measurements at initial recognition and fresh-start measurements. They agree with the guidance in the Statement for using cash flow information and present value if the objective is to estimate fair value. However, they believe that cash flow information and present value used in cost-accumulation and other measurements also produces relevant information.

52. A considerable majority of the respondents maintained that credit risk should not be incorporated in either initial or subsequent measurement of nonfinancial liabilities. Few, if any, commented on the inconsistency between this view and their views on initial measurements that result from cash transactions. That is, excluding credit standing at initial recognition builds a "borrowing penalty" into any liability measurement (refer to paragraph 30 of the staff paper). Most argued instead that credit risk should not be incorporated when it is not explicitly priced in a transaction.

Credit risk meets performance risk

53. There is another dimension to the role of credit (or performance) risk in liabilities with uncertain cash flows; a dimension that we should have spent more time describing in the staff paper. We usually think of credit risk as the possibility that a borrower will fail to pay a fixed amount on a fixed or determinable date. That is a two-dimensional problem. But nonfinancial liabilities usually have more dimensions of uncertainty.

54. Consider a liability with possible cash outflows that range from CU 5,000,000 to CU 5,000,000,000. Any cash outflow that exceeds CU 1,000,000,000 will bankrupt the entity. The company knows that if the cash outflow nears CU 1 billion, it will either default or attempt to renegotiate its contract. Do the expected cash flows for a measurement other than fair value include the possibilities exceeding CU 1 billion? The fair value exposure draft seems to define a market participant as one with the same capacities as the entity, so possible outcomes exceeding CU 1 billion are assigned a probability of zero. It

is not clear whether the same analysis applies in measurements that are not targeted on fair value.

55. A similar problem, though not of the same black-swan[1] magnitude, caused the Board to adopt a modified fair value (fair value assuming the terms of the benefit promise do not change) in its discussion paper on employee benefits.

56. We think that this is an (admittedly extreme) example of what the FASB was thinking about when they described performance risk. The distinction between credit and performance is important only because it reveals something that respondents may not have considered, and that we did not ask them to consider. Many respondents took the view that measurement of nonfinancial liabilities should never include credit risk. Many went a step farther and used the term performance risk. If we follow their argument, then a present value measurement of a nonfinancial liability must use:

    (a) All of the cash flow scenarios, including the black-swan possibilities. Excluding the cash flow scenarios over CU 1 billion would incorporate performance risk in the measurement.

    (b) A risk free interest rate. Any rate other than risk free would incorporate some credit risk in the measurement.

57. We suspect that many of the constituents who objected to credit risk in their comment letters would also object to the measurement that applying (a) and (b) would produce. However, the problem illustrates that any present value measurement is a product of assumptions about cash flows and interest rates. Variability in possible outcomes can be incorporated in either, but should only be counted once. We tend to focus too often on the interest rate when describing credit risk.

58. We recommend that the Board acknowledge that it will consider the question of credit (and performance) risk in every project that involves a current

[1] A *black-swan* event is one with low probability but very large magnitude. The name comes from a popular 2007 book by Nassim Nicholas Taleb.

measurement of liabilities that is not fair value. We should not ask constituents to answer it on their own.

Staff recommendations and question for the Board
The staff recommends: (a) That the Board stop work on credit risk as a free-standing work stream; (b) That the Board not reach a general conclusion on credit risk at this time, but instead incorporate the topic in the conceptual framework measurement project; (c) That the Board not change the role of credit/performance risk in the definition of fair value; (d) That the Board consider the application of that definition in measurements that would otherwise be at fair value, and (e) That the Board state that it will consider the question of credit risk in every project that involves a current measurement of liabilities that is not fair value. Do you agree?