**IASB Meeting** | Agenda reference **13**

Staff Paper | Date **September 2009**

Project **Credit Risk in Liability Measurement**

Topic **Comment letter analysis**

## Purpose of this paper

1. This paper summarizes responses to the Boards' Discussion Paper, *Credit Risk in Liability Measurement* ("DP"). 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.

2. The purpose of this paper is to communicate the main themes of respondents' comment letters based on the staff's preliminary analysis. The staff will provide a more detailed analysis on the responses at the Board meeting in October.

## Overview of the comment letters

3. The three-month comment period on the DP ended on September 1, 2009. As of September 2, 2009, which is the cut-off date for this comment letter analysis, the Board had received 101 comment letters which are summarized below by type of respondent and geographic region.


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.

| **Respondent Type** | **Number of respondents** |
|---|---|
| Preparer | 43 |
| Professional bodies | 22 |
| National standard-setters | 10 |
| Regulator | 7 |
| Accounting firms | 6 |
| Investor/ Analyst/ User | 4 |
| Individuals | 4 |
| Others eg NFPs, public sectors | 3 |
| Academic | 2 |
| **Total** | 101 |

| **Geographic region** | **Number of respondents** |
|---|---|
| West Europe | 46 |
| North America | 19 |
| International | 11 |
| Asia Pacific ex ANZ | 10 |
| Australia/NZ | 10 |
| Africa | 2 |
| East Europe | 1 |
| Central/South America | 1 |
| **Total** | 100 |

4. The Board has continued to receive comment letters. Late arrivals will be included in the more detailed analysis for the Board in October.

5. For this paper, respondents' comments are summarized as follows:

   (a) Main conclusions (paragraphs 5-10)

   (b) Other comments on the DP (paragraphs 11-12)

   (c) Financial liabilities vs. non-financial liabilities (paragraphs 13-15)

   (d) Initial measurement (paragraphs 16-18)

   (e) Subsequent remeasurement (paragraph 19)

(f) Methods to determine the amount of change in market interest rates attributable to the price of credit risk (paragraph 20)

(g) Preferred approach to measure liabilities and credit standing (paragraphs 21-24).

## Overall views

### *Main conclusions*

6. The main conclusion that can be drawn from the comment letter is that on initial recognition, measurement of financial liabilities should incorporate the price of credit risk inherent in an exchange transaction. For most non-financial liabilities the price of credit risk should not be incorporated into the measurement of those liabilities. Measurement of non-financial liabilities should therefore not incorporate the price of credit risk unless they result from an exchange transaction or are required to be carried at fair value.

7. On subsequent remeasurement some respondents would incorporate credit risk in measurement of liabilities, financial or non-financial, that are required to be carried at fair value. Others would never incorporate changes in the price of credit risk.

8. Many respondents argued that the decision usefulness of information on liabilities presented in financial statement should be the driver for liability measurement. Their view of decision usefulness overcomes any argument for a consistent measurement approach applied to all liabilities. Nor do they conclude that measurement of the same liability should necessarily include credit risk both on initial measurement and subsequent remeasurement.

9. The most often-cited argument against is the “counterintuitive” nature of recognized gains and losses. Many argued that the gains and losses are not useful information, except when the entity can realise the gain by buying back its own debt. Situations in which entities are able to realise these gain are also considered very rare.

10. The main conclusion that can be drawn from the comment letters are summarised in the following table.

| | **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 |

***Other comments on the DP***

11. Some respondents objected to considering the question of credit risk in isolation. In their view, more work has to be done generally on the measurement objectives in liability measurement, especially in fair value measurement.

> 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)

12. Some respondents also said that they can only submit a tentative view as the outcome of other projects such as the project to replace IAS39 might affect their final view on the matter.

> 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)

***Financial liabilities vs. non-financial liabilities***

13. Those respondents which limited their comments to financial liabilities seemed more inclined to favor including own credit risk in both initial measurement and subsequent remeasurement than those who did not limit their comments to financial liabilities.

14. Most respondents argued that own credit risk should be excluded from the measurement of non-financial liabilities such as pensions and insurance, and liabilities that fall under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

15. This difference between those who limit their comments to financial liabilities and others will be explored in more detail in the October Board paper.

***Initial measurement***

16. On initial measurement a large majority of the respondents say that credit risk should be included in the measurement sometimes or always. Only few respondents say that credit risk should never be included in initial measurement of liabilities.

17. Nearly all respondents say that is appropriate to include credit risk in the initial measurement of liabilities which are measured at fair value. Most respondents also say that the initial measurement of a financial liability, whether measured at fair value or not should include credit risk.

18. As for non-financial liabilities most respondents say that credit risk should not be included in initial measurement. However, in the instances when a non-financial liability is the result of exchange of consideration, credit risk should be included in initial measurement in order to prevent day one gain or loss. Some respondents would exclude credit risk by using a default risk-free rate of interest

to discount cash flows. Others called for "an appropriate market rate" without defining what that term might mean.

***Subsequent remeasurement***

19. There are more divided views on subsequent remeasurement; nearly quarter of the respondents said that own credit risk should never be included in subsequent remeasurement of liabilities. However nearly half of the respondents said that credit risk should sometimes be included in subsequent remeasurement.

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

20. On the methods to determine the amount of change in market interest rate attributable to the price of credit risk respondents came up with number of ways to determine the amount. A few respondents pointed to the guidance in IFRS 7 *Financial Instruments: Disclosures* on how to determine this amount. One respondent suggested 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. This issue will be explored in more detail in the Board paper for October.

***Preferred approach to measure liabilities and credit standing***

21. Most respondents favored approach c) 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.

22. The were however concerns that this approach would not work for financial liabilities held for trading, which should be measured at fair value and would therefore have to include changes in the entity's own credit quality.

23. Those respondents which 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 on remeasurement.

24. The two other approaches 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.