Project **Fair Value Measurement**

Topic **Non-performance risk**

Purpose of this paper

1. This paper addresses the effect of non-performance risk on the fair value of a liability.

2. This paper asks the boards to:

   (a) decide whether the fair value of a liability includes the effect of non-performance risk

   (b) clarify what non-performance risk represents.

3. The boards have agreed to work toward publishing converged fair value measurement guidance. Although most of the focus will be on eliminating differences, the IASB needs to discuss some of the fundamental issues proposed in its exposure draft. One of those issues is whether the fair value of a liability includes the effect of non-performance risk. The staff is asking the boards to discuss this topic jointly to ensure that a difference does not arise during the deliberations.

4. This paper does not address whether or which liabilities should be recognised at fair value. Any concerns about recognising liabilities at fair value will be addressed in a scope assessment, to be discussed at a future meeting.

5. Agenda Paper 10A (IASB)/28A (FASB) for the January meeting addresses the measurement of financial liabilities as part of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*.

Summary of differences between the IASB's exposure draft and Topic 820

6. Both the IASB's exposure draft *Fair Value Measurement* and FASB Accounting Standards Codification Topic 820 (Fair Value Measurements and Disclosures) state that the fair value of a liability includes the effect of non-performance risk.

7. The appendix to this paper compares the proposals about non-performance risk in the IASB's exposure draft with the requirements in Topic 820.

8. The boards have already had detailed technical discussions on this topic in developing the IASB's exposure draft and FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157).[1] As a result, the meeting will focus on analysing the differences between those two documents, the comments received on the IASB's proposals and feedback received about the implementation of Topic 820. This paper does not replicate the analyses already discussed by the boards in developing the IASB's exposure draft and SFAS 157/Topic 820. Board members should contact the staff for the relevant background materials if needed.

Overview of comments received on the IASB's exposure draft

9. The invitation to comment for the IASB's exposure draft asked interested parties whether the proposed guidance for measuring the fair value of liabilities is appropriate. In particular, it asked whether the fair value of a liability should reflect the risk that an entity will not fulfil the obligation (non-performance risk).

10. The comments on the exposure draft were similar to those in the IASB's discussion paper *Credit Risk in Liability Measurement*. In fact, many respondents for the exposure draft referred directly to their comment letters for that discussion paper.[2]

11. Respondents generally agree that the fair value of a liability should include non-performance risk, both at initial recognition and at subsequent measurement. However, there are concerns about when liabilities should be measured at fair value, particularly for subsequent measurement.

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[1] FASB Accounting Standards Codification Topic 820 codified SFAS 157.

[2] The comment letter summary for the discussion paper is in Agenda Papers 13 and 13A from the September 2009 IASB meeting and is available to board members upon request.

12. Many respondents think it is counter-intuitive to recognise a gain when an entity's credit standing deteriorates and vice versa. Some of these respondents suggest recognising such gains or losses in other comprehensive income rather than in profit or loss/earnings. Some would prefer a measurement that 'freezes' the credit spread at initial recognition so that changes in credit standing and interest rates do not affect the value of the liability subsequently. Other respondents suggest that liabilities should not be measured at fair value for subsequent measurement.

13. Some respondents suggest including the effect of non-performance risk only when an entity can realise the effect of a change in its credit risk (eg when it can repurchase its own debt). Respondents differ in whether the entity must have the intention *and* ability to do so, or if only having the ability to do so is sufficient.

14. Some respondents wonder what, in addition to credit risk, is included in non-performance risk and how it relates to non-financial liabilities.

Staff analysis and recommendation

Fair value reflects non-performance risk

15. In developing its exposure draft, the IASB concluded that a fair value measurement reflects the effect of an entity's non-performance risk because those who hold the entity's obligation as assets would consider the effect of the entity's non-performance risk when pricing those assets.[3] The FASB reached the same conclusion in developing SFAS 157.

16. Furthermore, the IASB noted the concerns of respondents about the decision-usefulness of an entity reporting gains when its credit deteriorates and losses when it improves, but conclude that addressing those concerns is beyond the scope of the fair value measurement project. The IASB believed that a measurement that does not consider the effect of an entity's non-performance risk is not a fair value measurement (this led to the issuance of the discussion

[3] Agenda Paper 2G discusses whether the fair value of a liability equals the fair value of the corresponding asset.

paper *Credit Risk in Liability Measurement*). The FASB had the same view in SFAS 157.

17. Therefore, the staff recommends that the fair value of a liability includes the effect of non-performance risk. Any concerns about the counter-intuitive results in subsequent measurement should be addressed in other projects.

What is included in non-performance risk?

18. The glossary to Topic 820 defines non-performance risk as ‘the risk that the obligation will not be fulfilled’. It states that non-performance risk includes, but may not be limited to, credit risk.

19. For a financial liability, non-performance risk equals credit risk. Credit risk takes into consideration the entity’s ability and willingness to pay.[4]

20. For a non-financial liability, non-performance risk relates to the risk the entity will not be able to perform. For a decommissioning liability or asset retirement obligation, this is the risk that the entity will not do what it has promised (eg legally or contractually) it will do at the end of the operations. Part of this risk relates to the entity’s ability and willingness to perform the work needing to be done. Part relates to the entity’s ability to finance the ‘clean up’ operations.

21. The staff recommends clarifying what non-performance risk represents (see paragraphs 19 and 20). For a non-financial liability, this could be done by including a description of non-performance risk in the asset retirement obligation (decommissioning liability in IFRSs) example in Topic 820 (see Case A of Example 9 in Appendix B of Agenda Paper 2G). The example could state that the entity adjusts the risk-free rate to reflect the risk that it will not be able to fulfil the obligation (its risk of non-performance).

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[4] Non-performance risk does not include the risk that there may be a change in the obligation, eg from a change in the terms of the contract. The terms of a contract are a characteristic of the liability. A change in terms effectively results in a different liability. To the extent that the terms could change, and market participants would take that into account in pricing the liability, there would be an effect on the fair value measurement.

Question 1 – Fair value reflects non-performance risk
Do you agree with the staff recommendation that the fair value of a liability includes the effect of non-performance risk? If not, what do you propose and why?

Question 2 – What non-performance risk represents
Do you agree with the staff recommendation to clarify what non-performance risk represents? If not, what do you propose and why?

Appendix – Non-performance risk in the IASB’s exposure draft and Topic 820

Issue	Reference	Proposal in the IASB’s exposure draft	Reference	Requirement in Topic 820
Description of non-performance risk	Paragraph 29 Appendix A Paragraph 30	The fair value of a liability reflects the effect of non-performance risk, which is the risk that an entity will not fulfil an obligation…. Non-performance risk is the risk that an entity will not fulfil an obligation. Non-performance risk includes, but may not be limited to, an entity’s own credit risk. When measuring the fair value of a liability, an entity shall consider the effect of its credit risk (credit standing) and any other risk factors that might influence the likelihood that the obligation will not be fulfilled. That effect may differ depending on the liability, eg whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a non-financial liability), and the terms of credit enhancements related to the liability, if any.	820-10-35-17 Glossary 820-10-35-18	The fair value of the liability shall reflect the nonperformance risk relating to that liability. Nonperformance risk refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. Nonperformance risk includes but may not be limited to the reporting entity’s own credit risk. The reporting entity shall 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. That effect may differ depending on the liability, for example: a. Whether the liability is an obligation to deliver cash (a financial liability) or an obligation to deliver goods or services (a nonfinancial liability) b. The terms of credit enhancements

Issue	Reference	Proposal in the IASB's exposure draft	Reference	Requirement in Topic 820
				related to the liability, if any.
Non-performance risk is the same before and after the transfer	Paragraph 29	… Non-performance risk is assumed to be the same before and after the transfer of the liability. This is because market participants would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price. For example, a creditor would not generally permit a debtor to transfer its obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor (debtor) if those terms reflect the transferor's lower credit standing.	820-10-35-16	A fair value measurement assumes both of the following: … b. The nonperformance risk relating to that liability is the same before and after its transfer.