June 2009

Discussion Paper DP/2009/2

Credit Risk in Liability Measurement

Comments to be received by 1 September 2009

International Accounting Standards Board®

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Enquiries about this publication should be addressed to:
IASC Foundation Publications Department,
1st Floor, 30 Cannon Street,
London EC4M 6XH,
United Kingdom.
Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
Email: publications@iasb.org Web: www.iasb.org

Credit Risk in Liability Measurement

Introduction

1 At its meeting in May 2009, the International Accounting Standards Board decided to publish the attached staff paper and to invite comments on the issues examined. Arguably, questions about the role of credit risk in liability measurement have generated more comment and controversy than any other issue in fair value. This paper examines those questions. In particular it asks: should current measurements of liabilities (including fair value) incorporate the chance that an entity will fail to perform as required? If not, what are the alternatives?

2 The paper was written by Wayne S Upton, Jr, who is the IASB Director, International Activities. The Board decided that publishing this paper as a staff document and asking for comments on the issues raised would be the most efficient way to place the document into the public domain.

3 The Board invites readers to respond to the questions set out below and to make any other comments they consider relevant to the issues raised. Comments should be submitted in writing so as to be received no later than 1 September 2009.

4 Commentators frequently refer to the role of credit risk as 'own credit'. An entity's credit standing affects the credit risk of its liabilities, but the effect may be different from one liability to another. For example, a well-collateralised liability has less credit risk than an entity's other liabilities. For other liabilities, the credit risk of the entity translates directly to the credit risk of the liability. The Board has stressed that it is the particular liability that is being measured, and the relevant credit risk is the risk associated with that liability.

5 A number of the Board's consultative documents have included some discussion of credit risk in liability measurement, including the recent exposure draft *Fair Value Measurement* and the following discussion papers:

(a) *Fair Value Measurements*, November 2006;

(b) *Preliminary Views on Insurance Contracts*, May 2007;

(c) *Preliminary Views on Amendments to IAS 19 Employee Benefits*, March 2008; and

(d) *Reducing Complexity in Reporting Financial Instruments*, March 2008.

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6 Many of the respondents to those documents have disagreed with proposals that liability measurements should include the effects of credit risk. However, their responses tended to be brief, perhaps because credit risk was one of many questions posed. Recent developments in financial markets have led to increased attention to, and criticism of, gains that result from changes in the value of an entity's liabilities. The Board decided that the standard-setting process would benefit from a discussion paper concentrating on the role of credit risk in liability measurement. The Board expects that the comments received will be useful in its deliberation of several of its projects.

7 This paper outlines the three most often-cited arguments in favour of including credit risk and the three most often-cited arguments against. It is not an exhaustive recitation of all that has gone before. Instead, the Board hopes that an even-handed presentation of those arguments and identification of the key issues will result in a more focused discussion that will enhance the debate.

8 This paper includes within its scope all current measurements of liabilities. Standard-setters have concluded that the fair value of a liability is a price and, thus, necessarily includes the credit standing of that liability. It does not follow that other current measurements of the liability should do so. Alternative current measurements of liabilities might include, for example:

(a) fulfilment value, as it is being developed in the Board's joint project with the US Financial Accounting Standards Board (FASB) on insurance contracts;

(b) the value at which the liability could be settled with the counterparty;

(c) fair value, but excluding the effects of credit risk, and

(d) the value at which the liability could be transferred in a transaction permitted by industry regulators.

9 Just as there are several alternative current measures of a liability, there are several reasons why the reported amount of a liability might change. Some of those changes do not involve changes in credit risk, for example, changes in expected cash flows or currency exchange rates.

10 The objective of financial statements is to provide financial information that is useful in making economic decisions. The arguments for and against including credit risk in liability measurement tend to be about why credit risk *should*, or *should not*, be decision-useful. The Board is

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especially interested in the views of analysts and other users of financial statements about *whether* and *how* this information is used by them. With that in mind the Board plans to seek out the views of financial analysts on this topic.

Questions for respondents

Question 1

When a liability is first recognised, should its measurement (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why?

(a) If the answer is 'sometimes', in what cases should the initial measurement exclude the price of the credit risk inherent in the liability?

(b) If the answer is 'never':

   (i) what interest rate should be used in the measurement?

   (ii) what should be done with the difference between the computed amount and cash proceeds (if any)?

Question 2

Should current measurements following initial recognition (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why? If the answer is 'sometimes', in what cases should subsequent current measurements exclude the price of the credit risk inherent in the liability?

Question 3

How should the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability be determined?

Question 4

The paper describes three categories of approaches to liability measurement and credit standing. Which of the approaches do you prefer, and why? Are there other alternatives that have not been identified?

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