



# Accounting Standards Board

Aldwych House, 71-91 Aldwych, London WC2B 4HN

Telephone: 020 7492 2300 Fax: 020 7492 2399

[www.frc.org.uk/asb](http://www.frc.org.uk/asb)



International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH

28 July 2009

Dear Sirs

## **Discussion Paper: Credit Risk in Liability Measurement (DP/2009/2)**

I am responding on behalf of the Accounting Standards Board (ASB) to the Discussion Paper: Credit Risk in Liability Measurement (DP).

The ASB welcomes the International Accounting Standards Board (IASB) decision to issue the discussion paper and agrees that the standard-setting process will benefit from a discussion concentrating on the role of credit risk in liability measurement.

In agreeing with this the ASB notes that credit risk in liability measurement needs to be considered in the context of the objective of financial reporting and that the DP is a very specific discussion of credit risk in liability measurement. The paper does not discuss the measurement objective for liabilities more generally. In the ASB's view it is important that different measurement methods are applied to different categories of liabilities so that objectives of financial reports are achieved. The ASB agrees that where fair value is an appropriate measurement method it will incorporate own credit risk – however it is important to first determine if fair value is the appropriate measure.

Having considered the arguments set out in the DP the ASB is of the view that:

- (i) when a liability is initially recognised its measurement should incorporate the price of credit risk only where there is an observable market transaction. In the ASB's view the price of credit risk can only be measured reliably when there is an observable market transaction; and

- (ii) current measurement of liabilities should not include changes in credit risk. In forming its view that credit risk should only be included on initial recognition where there is an observable market transaction the ASB has considered whether financial reporting is impeded by inconsistent treatment this approach brings. The ASB could find no evidence that financial reporting is impeded by the inconsistent treatment.

The ASB's responses to the invitation to comment are set out in Appendix to this letter. In forming its views the ASB gave due consideration to respondents views to the 'Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper: The Financial Reporting of Pensions' which invited comments on the inclusion of credit risk in the measurement of pension liabilities.

Should you have any queries regarding our response please contact me or Michelle Sansom, Project Director, on 020 7492 2432 or by email [m.sansom@frc-asb.org.uk](mailto:m.sansom@frc-asb.org.uk).

Yours sincerely



**Ian Mackintosh**  
**Chairman**

DDI: 020 7492 2434

Email: [i.mackintosh@frc-asb.org.uk](mailto:i.mackintosh@frc-asb.org.uk)

## Appendix: Response to the 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)?

### Response

1. **The ASB considers that when a liability is first recognised its measurement should incorporate the price of credit risk only where there is an observable market transaction. In the ASB's view the price of credit risk can only be measured reliably when there is an observable market transaction.**
2. In forming its view the ASB considered the example set out in the IASB staff paper accompanying the discussion paper of an entity issuing a bond at market rates in contrast to an asset removal obligation, both arising on the same date. The paper makes the point that the interest rate on the bond incorporates the price of credit risk and asks, implicitly, whether the asset removal obligation should similarly incorporate credit risk.
3. The ASB gave consideration to the distinguishing features between these two liabilities and noted that risk relating to liabilities can be divided in two:
  - (i) risk as to the size of the liability; and
  - (ii) risk that there are insufficient cash flows in the entity to settle the liability (credit risk).
4. The ASB noted for non-financial liabilities the risk associated with the size of the liability is often greater due to the assumptions that are required to measure the liability; this is particularly true of liabilities such as asset removal obligations and pensions. The ASB is of the view that for risk relating to the size of the liability a distinction can be made between financial and non-financial liabilities.

5. The ASB does not, however, consider there is a distinguishing feature between financial and non-financial liabilities in relation to credit risk. The ASB agrees that credit risk differs between individual liabilities but cannot identify a distinguishing feature between the two types of liabilities that would cause the price of credit risk to differ. Consequently, the ASB accepts that on initial recognition there is inconsistency in the measurement of liabilities relating to the price of credit risk.
6. The ASB has sought to identify why this inconsistency arises and what its consequences might be.
7. In identifying why the inconsistency arises the ASB noted that there is a difference between the two liabilities discussed in the staff paper. The measurement of a liability arising from issuing a bond issue (financial liability) is derived from the cash inflows to the entity. The cash inflows are an observable market transaction and include the price of credit. This is not the case for an asset removal obligation where the liability is measured using expected cash flows. In this instance there is no market transaction on which to price credit.
8. As regards the consequences, the ASB has considered whether financial reporting is impeded through the inconsistent treatment of credit risk on initial recognition. The ASB believes that financial reporting is impeded where users' needs are not met. The ASB is not aware of any evidence that users consider that the inconsistent treatment of credit risk on initial recognition of liabilities impedes financial reporting.
9. Consequently, the ASB has concluded that in the absence of evidence that users' needs are impeded by the inconsistency on initial recognition of liabilities the price of credit risk should be included only where there is an observable market transaction.

## **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?

## **Response**

10. **The ASB considers that current measurement of liabilities should not include changes in credit risk.**
11. In developing its view the ASB has considered:
  - (i) the arguments set out in the IASB staff paper;

- (ii) the views of respondents to its discussion paper 'Pro-active Accounting Activities in Europe (PAAinE) Discussion Paper: The Financial Reporting of Pensions' (pensions DP); and
  - (iii) the objective of the statement of financial position.
12. As regards the arguments set out in the IASB staff paper the ASB has the following comments:

(i) *Consistency on initial recognition*

The ASB's view on this argument is discussed in its response to question 1.

(ii) *Wealth transfer*

The ASB, although accepting the economic and financial theory that underlies this argument, is not convinced that the theory is consistent with the entity concept. In its view the 'put option' referred to in the argument is that of the equity holders rather than that of the entity – the entity concept (which has been adopted in IFRS) does not distinguish between the owners of the entity. Consequently the ASB does not consider this argument is consistent with the IASB's current thinking in other areas of financial reporting.

The ASB also does not support the inclusion of hypothetical transactions in financial reporting and we do not think that an entity's financial statements should reflect the theoretical transfers of wealth between its debt holders and its equity owners.

(iii) *Accounting mismatch*

The ASB does not consider that there is necessarily a symmetrical change in the valuation of assets when an entity's credit risk changes. It notes that internally generated intangible assets are not recognised and that a change in credit risk may relate to unrecognised assets; in which circumstances reflecting credit risk is inappropriate as the corresponding asset may not be recognised. The ASB therefore supports the views expressed in paragraphs 53-57 of the IASB staff paper that including changes in credit risk is likely to increase the accounting mismatch.

The ASB is also not convinced that this argument clearly reflects the objectives of financial reporting or the going concept as the basis of preparation. These points are discussed below.

(iv) *Counter-intuitive results*

In considering this argument the ASB has taken into consideration the fact that some UK banks have chosen to specifically highlight, in financial reports, the gains arising from the changes in credit risk in the measurement of liabilities and that such gains are likely to reverse. The

ASB considers the decision by banks to highlight and discuss these gains is related to the concerns regarding counter-intuitive results. It further considers that the inclusion of such disclosures raises a question regarding the usefulness of the information provided by including changes in credit risk in the subsequent measurement of liabilities. In addition the ASB is concerned including such gains increases the complexity of financial statements.

(v) *Realisation*

The ASB agrees with this view and further notes that the pensions DP referred to the fact that where pension liabilities are transferred there is often a credit enhancement to the recipient which has a cost to the entity.

13. In forming its views, the ASB has also taken into account the responses it received to the pensions DP<sup>1</sup>. The ASB notes that the majority to respondents to the question asked in the pensions DP regarding whether credit risk should be included in the measurement of pension liabilities did not support inclusion of credit risk. Respondents to the DP noted that, in their view, the inclusion of credit risk in the measurement of liabilities is inconsistent with the going concern assumption. The ASB agrees with respondents that that the going concern assumption requires an entity to assume that it will settle its liabilities in full over time. As financial statements are prepared on the going concern basis it is inappropriate to assume the entity will not settle its liabilities in full over time.
14. The ASB has also considered the objective of the statement of financial position. In its view the objective of the statement of financial position is to provide information about the assets and liabilities of the entity at a specified date – inclusion of credit in the measurement of liabilities would not provide information about an entity's liabilities. The inclusion of credit risk provides information about the amount a market expects an entity to pay rather than the amount it is required to pay.
15. The ASB does not support the arguments for inclusion of credit risk (consistency on initial recognition, wealth transfer and the accounting mismatch) set out in staff paper. In addition the ASB supports the views of respondents to its pension discussion paper that inclusion of credit risk is inconsistent with the going concern concept. Consequently the ASB does not consider the inclusion of credit risk is consistent with its view as to the objective of the statement of financial position.

### 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?

---

<sup>1</sup> The responses to this discussion paper are available at [EFRAG /PA/AinE /Pensions](https://www.efrag.org/PA/AinE/Pensions)

16. The ASB does not support the inclusion of credit risk in the subsequent measure of liabilities. In the pension DP the ASB noted that in its view:

*The objective of a current value measure of future payments of pension benefits is to reflect today's value of the future cash outflows expected to settle the liability when it falls due.*

...

*It is inappropriate for an entity's liability for pensions to be reduced to reflect its credit risk.*

Having given due consideration to the matters raised in relation to subsequent measure of liabilities the ASB retains the view that credit risk should not be reflected in the subsequent measurement of liabilities and not just those relating to pensions.

#### **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?

17. The ASB prefers view C; as discussed above the ASB does not consider that the inconsistent treatment of credit risk in the measurement of liabilities on initial recognition impedes the usefulness of financial reporting.