Federation of European Accountants
Fédération des Experts comptables Européens

Sir David Tweedie
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Ref.: BAN/HvD//LF/SR

Dear Sir David,

Re: FEE Comments on IASB Discussion Paper *Credit Risk in Liability Measurement*

(1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the IASB Discussion Paper *Credit Risk in Liability Measurement* (the "DP").

(2) As a founding organisation of EFRAG we have also contributed to the EFRAG consultation process by submitting on 31 August 2009 the FEE comments on EFRAG's Draft Comment Letter of 23 July 2009. EFRAG has issued its final comment letter on 23 September 2009. We have considered the EFRAG Final Comment Letter in our response and made reference to the EFRAG comments where relevant.

(3) A summary of our position is presented below, whereas some further observations and the responses to the questions are included in the appendix to this letter.

(4) As a general remark, we wish to observe that it is in our view important to highlight that this DP involves the discussion of two separate issues: on the one hand the discussion of the definition Fair Value of a liability - always including own credit risk - and on the other hand when and how the Fair Value of the liability should be recognised. Another perspective could be to see inclusion of credit risk as a classification issue.

(5) Like EFRAG, we welcome the decision of the IASB to issue a discussion paper on own credit risk since it is one of the most, if not the most, controversial issue in the debate on liability measurement: whether, and if so to what extent, own credit risk should be reflected therein.

(6) We note that the issue of credit risk and the DP are related to the IASB ED *Fair Value Measurement.* We may make further observations on own credit risk in our response to that ED.

(7) We agree with EFRAG that the relevance and the usefulness of information should be the key driver to decide on a principle to guide whether credit risk should be included in the measurement of liabilities. It would be helpful if a clear principle could be developed. It would in particular be helpful to obtain users' views in this respect.

(8) FEE supports EFRAG's suggestions that credit risk should only be taken into account in the initial measurement of a liability if an entity's own credit risk is priced into the transaction that gave rise to the initial recognition of a liability. Changes in own credit risk should not be taken into account in subsequent measurement of liabilities with the exception of financial liabilities (and possibly also insurance liabilities) which, in accordance with the business model, are expected to be disposed of at Fair Value.

(9) We also wish to note that a discussion paper on the measurement of assets and liabilities is expected to be published in the near future as part of Phase C of the Conceptual Framework project. Accordingly, the views expressed in our response to the DP are tentative, and we may wish to revisit these questions in due course in responding to the consultation on measurement of assets and liabilities.

For further information on this letter, please contact Ms. Saskia Slomp, Technical Director.

Yours sincerely,

Hans van Damme
President

Appendix - Responses to the questions in the IASB Discussion Paper *Credit Risk in Liability Measurement*

GENERAL COMMENTS

(10) We have considered the arguments pro and contra raised in the DP concerning including own credit risk in liability measurement. We support the EFRAG's analysis of those arguments.

Arguments in favour of including own credit risk in liability measurement

<u>Consistency</u>

(11) We agree with EFRAG that consistency in treatment between different instruments and at different times is needed. However, consistency between initial and subsequent measurement should not override the relevance and the usefulness of information. We share EFRAG's view that consistency in isolation is not a convincing argument.

(12) The IASB, in some of its other projects, attached lower importance to the consistency argument, for example in the Discussion Paper on Leases.

<u>Wealth transfer</u>

(13) In our opinion, financial reporting should not be affected by wealth transfers between the shareholders and creditors with no explicit involvement of and by the entity. We share the view of EFRAG in this respect.

(14) While transactions that represent transfer of wealth involving shareholders are recognised under IFRS 2, there is a significant difference between wealth transfer transactions that are reflected in the financial statements under IFRS 2 and the situation contemplated herein (implicit wealth transfers from the debt holders to the shareholders through non-payment of liabilities). Under IFRS 2, the recognition of wealth transfer in the financial statements of an entity is justified by the fact that the entity is presumed to have received actual goods or services from employees or suppliers that are remunerated by its shareholders. Since non-payment of a liability represents a hypothetical transaction as opposed to an actual receipt of goods or services by the entity, recognition of the wealth transfer in the entity's financial statements does not appear justified. This further supports EFRAG's position that wealth transfer is not a convincing argument in the present situation.

<u>Accounting mismatch</u>

(15) We agree with EFRAG's view that the credit risk inherent in the financial assets held by the entity and its own liabilities – even though in certain cases assets and liabilities may be related – are unlikely to be identical, as the credit risk of the former relates to the underlying investee and the credit risk of the latter relates to the reporting entity.

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(16) We also share the opinion of EFRAG that, although the credit risk is included in the fair value from the perspective of those that hold an entity's debt instrument as an asset, the perspective of holders of those instruments and the perspective of those obligated to settle the instruments are fundamentally different.

(17) Moreover, we agree that the existing mismatch does not relate solely to the treatment of credit risk. Many assets are not measured at fair value and including an entity's own credit risk in the measurement of liabilities may introduce a further mismatch rather than solve the mismatch. An accounting mismatch will remain since not all assets and liabilities are measured at fair value.

Arguments against including own credit risk in liability measurement

<u>Counter-intuitive results</u>

(18) We agree with EFRAG and support the argument in the DP that the inclusion of "own credit risk" in the fair value has a counter-intuitive effect of reporting an increase in earnings when the entity's credit rating is lowered and that it does not provide useful information to users.

(19) Recognition of a gain as an entity's own credit risk deteriorates would in fact be misleading because it is not probable that economic benefits will flow to the entity as a result of the decrease in its credit-worthiness. Indeed, the entity is able to settle the liability for a lower amount only in very specific situations (typically, it can do so only if it can buy back its debt instrument from the holders or if the lender accepts to renegotiate its terms). Even in these situations, no economic benefit will result from the settlement to the extent it requires refinancing at costs that will necessarily be higher (to the extent that refinancing is even possible).

<u>Accounting mismatch</u>

(20) We refer to our earlier comments on the accounting mismatch. We agree with EFRAG that the accounting mismatch does not constitute a convincing argument.

<u>Realisation</u>

(21) We share the view expressed by EFRAG that, although assets are frequently sold, transfers of liabilities are much rarer, as this usually requires the permission of the counterparty. Consequently, we agree that economic realisation can be an economically significant event in the case of liabilities even though this is not the case for financial assets. In most cases, the liabilities will not be transferred and own credit risk will therefore not be realised. Accordingly, the lack of realisation constitutes a convincing argument to <u>exclude</u> an entity's own credit risk from the measurement of all liabilities with the exception of those financial liabilities (and possibly insurance liabilities) which, in accordance with the business model, are expected to be disposed of at Fair Value.

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Additional issues

(22) In relation to paragraphs 26 to 31 of the DP, we refer to our observations on the PAAinE paper on the Financial Reporting of Pensions that the discount rate should not incorporate the entity's own credit risk. "In the perspective of the going concern of the entity, the liability will be settled over time through the payment of pension benefits. Of course, where there is a tradable market, the factors to be taken into account in valuations could be different. However, the current infrequency of "buy-outs" would suggest that credit risk is not an appropriate generic approach to valuation. Secondly, to the extent that funds have been set aside in a bankruptcy-remote entity, we fail to understand how the credit rating of the sponsoring entity would be relevant."

RESPONSES TO QUESTIONS

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? If the answer is 'sometimes', in what cases should the initial measurement exclude the price of the credit risk inherent in the liability? And, if the answer is 'never': (i) what interest rate should be used in the measurement? and (ii) what should be done with the difference between the computed amount and cash proceeds (if any)?

(23) We agree with the observations of EFRAG in its final comment letter in paragraphs 22 to 25 and support EFRAG's conclusion that if an entity's own credit risk is priced into the transaction giving rise to the initial recognition of the liability, that credit risk should be included in the initial measurement of the liability. Otherwise, credit risk should not be included in the initial measurement of the liability.

(24) To better appreciate what this would mean in IFRSs, it may be useful to consider the application of the above conclusion to the nature of the liabilities addressed in the various Standards. Based on the principles in IAS 39, one would expect that credit risk would be included in the initial measurement of financial liabilities. This would also be the case for insurance liabilities and deferred income (IAS 18). In all of these cases, the liability arises from a transaction with a counterparty that would have considered the risk that the entity will not perform in determining the price at which it is willing to transact.

(25) On the other hand, credit risk is unlikely to be included in IAS 19 obligations and IAS 37 provisions. In the case of IAS 19, under the going concern assumption, employees can expect that their benefits will be paid and do not typically demand higher or lower salaries based on the credit-worthiness of an entity (except in rare circumstances). Under IAS 37, provisions are measured at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. IAS 37 indicates that this is the amount that an entity would rationally pay to settle the obligation or transfer it to a third party. To the extent that a present obligation exists at the end of the reporting period, under the going concern assumption, the possibility that the entity would not have the resources necessary to meet its obligations in case of bankruptcy would not be expected to be factored in the measurement of the provision.

(26) The application of the conclusion stated in paragraph 23 of this letter to liabilities with a demand feature (e.g. bank demand deposit) requires further investigation. Given the demand feature and the fact that these deposits usually carry 0% interest rate it is difficult to assess how credit risk should be reflected in determining the valuation of bank deposits. It may be that the fact that the deposits are due on demand would render this impact negligible.

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?

(27) We support EFRAG's position and we disagree with the inclusion of the effects of changes of own credit risk in the subsequent measurement of financial liabilities with the exception of those financial liabilities (and possibly insurance liabilities) which, in accordance with the business model, are expected to be disposed of at Fair Value.

(28) Financial Statements are prepared based on a going concern basis. Therefore it would not be appropriate to make different assumptions for fair value measurement.

(29) On the same basis that credit rating does not affect the initial measurement when the liabilities are not priced to reflect an issuer's credit rating, it would not be appropriate to reflect changes in an entity's credit risk unless this reflects an economic reality (i.e. the capacity and the ability for the entity to realise the gain/loss). In our view, for subsequent measurement, when liabilities do not result from an exchange for cash, the effect of credit risk should not be taken into account; when liabilities result from an exchange for cash, the credit spread should be fixed at the original amount.

(30) As already mentioned, in our opinion changes in own credit risk should not be taken into account in subsequent measurement of liabilities with the exception of financial liabilities (and possibly also insurance liabilities) which, in accordance with the business model, are expected to be disposed of at Fair Value. If this is not the case, the cash flows that are expected to arise in settlement of the liabilities are those that are contractually agreed in the term of the instruments and, even for derivatives that are measured at fair value, are not impacted by changes in the entity's credit risk unless there is a contractual indexation within the instrument to the entity's own credit risk. Accordingly, adjusting the carrying amount of liabilities for changes in credit risk in these circumstances is considered meaningless.

(31) If the debt instrument in accordance with the business model is expected to be disposed of at Fair Value contractually indexed to the entity's own credit risk, its subsequent measurement should reflect changes in the issuer's credit rating since this reflects a pricing of the obligation that is expected to be realised.

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?

(32) As already mentioned, in our opinion, changes in own credit risk should not be taken into account in subsequent measurement of liabilities with the exception of financial liabilities (and possibly also insurance liabilities) which, in accordance with the business model, are expected to be disposed of at Fair Value. Accordingly, we do not believe that there is always a need to isolate the changes in interest rates attributable solely to the price of the credit risk.

(33) In addition, we believe that the costs and benefits of determining the changes in interest rates attributable solely to the price of the credit risk should be considered when own credit risk is not taken into account and could be separately be disclosed.

(34) We believe that methods that could be considered, if the IASB maintains its position to integrate the credit component in the fair value measurement, include (i) the method described in paragraph IG11 of IFRS 7, (ii) deriving the credit spread from the credit rating attributed to the entity and adjusting the measurement of the liability for changes in the credit spread each time there is a change in the credit rating of the reporting entity and (iii) deriving the credit spread from the credit default swap curve that is available for the considered entity and the considered maturity of the issued instrument.

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?

(35) Like EFRAG, FEE supports Approach (c): Initially measure borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds; and initially 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 own 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, with the exception of financial liabilities that are expected (meant) to be bought back on the market. For these liabilities, it would appear consistent to include the effect of the changes in credit risk in profit or loss as they occur.

(36) This is the only method that would be consistent with the position expressed in our response to Questions 1 and 2.

(37) We do not believe that Approach (a) appropriately reflects the economic reality of borrowing transactions. As noted in our response to Question 1, liabilities resulting from transaction that are priced to reflect an entity's own credit risk should be measured to reflect the price established in the transaction. We believe that it would be inappropriate for an entity to immediately recognised a gain (or loss) when it has borrowed funds at the prevailing interest rate.

(38) Similarly, we do not believe that Approach (b) reflects an economic reality either. Application of this method would imply that borrowing at the prevailing interest rate results in a reduction to the entity's equity, akin to a distribution to its shareholders of a shareholders' put. As we explained earlier in this letter, we do not believe that debt borrowings result in a wealth transfer that should be reflected in the entity's financial statements.

(39) However, were Approach (b) adopted, we question why under such an approach the shareholders' put would be amortised to profit or loss. Equity instruments are normally not remeasured and normally do not subsequently effect profit or loss.