

IASB issues Discussion Paper on 'own credit risk'

Background

The International Accounting Standards Board (IASB) recently published a Discussion Paper (the DP) based on an IASB staff paper on the role of credit risk in liability measurement (often referred to as 'own credit risk'). The developments in the financial markets have increased focus on, and criticism of, gains that result from changes in the fair value of an entity's financial liabilities, including changes resulting from credit risk. The DP raises the question of credit risk on a much broader basis and addresses its role in liability measurement in general. The scope of the DP is unclear, but seems to focus on all current measurements of liabilities, both financial and non-financial.

If the Board concludes that the measurement of all liabilities must include the consideration of credit risk, this will represent a fundamental change and require extensive effort by most entities. In contrast, if the Board concludes that measurement of liabilities should not include credit risk, this will be a significant change for entities that currently carry financial instruments at fair value.

Measurement of liabilities

IFRS provides several different measurement bases for measuring liabilities in several different standards. These include, but are not limited to, the following:

- ▶ Fair value
- ▶ Fulfilment value on insurance contracts¹
- ▶ Realisable (settlement) value, which is the value at which a liability could be settled with the counterparty, equal to the undiscounted cash flows expected to be paid
- ▶ Present value, equal to the discounted cash flows expected to be paid
- ▶ Fair value, but excluding the effect of credit risk
- ▶ The value at which a liability could be transferred in a transaction permitted by industry regulators.

Of these measurement bases, only fair value currently takes into account the issue of own credit risk.

¹ This is currently being developed as part of the Board's joint project with the US Financial Accounting Standards Board (FASB).



The role of 'own credit risk' in fair value

The IASB's Expert Advisory Panel was formed in May 2008 in response to recommendations made by the Financial Stability Forum to address questions related to fair value. The Panel recommended that own credit risk be included when determining fair value.

In May 2009, the IASB published an Exposure Draft (ED) *Fair value measurement*, which incorporates the views of the Expert Advisory Panel. The ED is clear that the effect of an entity's non-performance risk (i.e., the risk that an entity will not fulfil an obligation) is considered in measuring the fair value of a liability and that non-performance risk includes own credit risk. This would apply to financial and non-financial liabilities measured at fair value.

However, the Board recognises that there is some diversity in current practice and acknowledges that there are concerns regarding the decision-usefulness of reflecting the non-performance risk of a liability after initial recognition. This is because recognition of own credit risk could lead to counter-intuitive and potentially confusing financial reporting, (i.e., 'gains' for credit deterioration and 'losses' for credit improvements). Therefore, the Board has decided to consider these concerns in a separate DP for public comment. The comments received on this DP are expected to be considered when the Board issues the replacement standard on financial instruments.

Questions posed by the Discussion Paper

The DP poses the question whether current measurements of liabilities (including fair value) at inception and, subsequently, should incorporate the chance that an entity will fail to perform as required. It also asks how a liability's credit risk should be measured.

Even though the questions are raised in relation to all liabilities, the DP seems to focus on liabilities that are measured on a 'current measurement basis'. The arguments for and against the inclusion of credit risk seem to focus primarily on financial instruments, and are outlined in Table 1.

Arguments for and against including own credit risk

In order to help commentators, the DP outlines the three most often-cited arguments for and against incorporating own credit risk, summarised as follows:

² The ED *Fair Value Measurements* is largely based upon SFAS No. 157 *Fair Value Measurements*, issued by the US Financial Accounting Standards Board. See IFRS Outlook, Issue 43, for additional information on the ED.



Table 1

Arguments for incorporating credit risk	Arguments against incorporating credit risk
<p>Consistency at initial recognition</p> <ul style="list-style-type: none"> ▶ Accountants accept that the initial measurement of a liability incurred in an exchange of cash includes the effects of the borrower’s credit risk, adjusted for collateral, guarantees, etc. Therefore, there is no reason why subsequent current measurements should exclude changes in factors that were included in the initial measurement. ▶ Similarly, there is no reason why the initial recognition of some liabilities should include the effects of credit risk and others should not. Therefore, liabilities that do not arise from straightforward borrowing transactions (such as for asset removal or decommissioning, product warranty, employee benefits, insurance claims, etc.) should also include credit risk. This is necessary to achieve consistent accounting among liabilities and to avoid overstating non-financial liabilities by excluding the effects of credit risk. <p>Wealth transfer</p> <ul style="list-style-type: none"> ▶ An entity’s balance sheet includes its recognised assets and two sets of claims against the assets—those of owners and those of lenders. A change in the credit risk of the entity’s liabilities represents a transfer of wealth between owners and lenders. ▶ The owners’ relative share of the claims would increase or decrease as the value of the entity’s total assets increase or decrease, in the absence of additional borrowing or other new liabilities. <p>Accounting mismatch</p> <ul style="list-style-type: none"> ▶ If an entity’s assets are measured at fair value, then changes in credit spreads on those assets will affect their fair value and either profit or loss or other comprehensive income. If the measurement of liabilities does not incorporate changes in credit spreads, then there is an accounting mismatch and the amount of profit or loss or other comprehensive income will be distorted. The extent of the mismatch will vary, depending on the recognition and measurement of assets. 	<p>Counter-intuitive results</p> <ul style="list-style-type: none"> ▶ When liability measurement includes credit risk, an entity reports a gain from the decline in the credit quality of its liabilities. This gain (or loss, in the case of improving credit quality) is counter-intuitive. ▶ When the entity’s credit standing is downgraded, the entity and its shareholders are not better off. Future borrowings, if possible at all, will be more expensive. The entity’s obligation has not declined; it still must pay the same amounts. ▶ Gains should result from improvements in an entity’s financial position, not declines. Reporting a gain from a decline in credit quality is potentially misleading and can mask a deteriorating situation. Some constituents (e.g., regulators) are concerned that it could mask an underlying weakness or insolvency and may forestall their ability to take regulatory action. <p>Realisation</p> <ul style="list-style-type: none"> ▶ An entity can sell an asset whenever it wishes to do so (unless pledged or otherwise restricted), whereas liabilities are seldom transferred. A transfer usually requires the permission of the counterparty, and some liabilities cannot be transferred in any practical way. ▶ An entity may be able to realise the benefits of decreased credit quality by repurchasing its bonds. However, an entity with decreased credit standing will find it difficult or impossible to do so. ▶ Any gain is hypothetical and is unlikely to be realised. <p>Accounting mismatch</p> <ul style="list-style-type: none"> ▶ A decline in an entity’s credit quality usually signals: a decline in the value of assets that may not be measured on a current basis (like fixed assets and goodwill); unrecognised intangible assets; and confidence in the entity’s management. Because changes in those items are not recognised in the financial statements, changes in credit quality should be similarly excluded.

Alternatives to including own credit risk

If the IASB concludes that credit risk should not be included in measuring all liabilities, the IASB staff identified three other alternatives:

1. Measure all liabilities using the risk-free rate of interest and expected future cash flows, excluding any expectations about default. Any difference between the resulting amount and cash proceeds (if any) should be charged to income immediately.
2. Similar to (1) except that the difference between the resulting amount and cash proceeds (if any) should be charged to equity and amortised over the life of the liability.
3. 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 an exchange of cash upon initial recognition (e.g., asset retirement obligations, product warranty liabilities) 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, excluding changes arising from the entity’s credit quality or the price of its credit. This would have the effect of fixing the credit spread at the original amount and so the fair value will rise or fall only with changes in the risk-free rate.

Potential implications

In issuing this DP, the Board is exploring a fundamental question: should credit risk be included at all in the measurement basis of liabilities, and if so, would this apply to all liabilities or some categories?

If the Board decides that credit risk should be considered in all measurements of liabilities, it could achieve a greater degree of harmonisation in the measurement of non-financial and financial liabilities, as well as address any current diversity in practice for financial liabilities. However, this will result in significant implementation issues for non-financial liabilities, because most measurements of non-financial liabilities do not currently include own credit risk.

For financial liabilities, there is usually a market providing an explicit price for credit risk and it is generally possible to sell or transfer an instrument based on these prices (including the effects of own credit risk). Therefore, for many financial liabilities, it should be possible to determine the own credit risk adjustment, although the argument does remain whether or not such an adjustment 'should be' made.

The issue of whether or not own credit risk should be adjusted in measuring financial liabilities could have further ramifications based on the current proposals to replace IAS 39 *Financial Instruments: Recognition and Measurement*. Under the current proposals on IAS 39, for hybrid financial instruments, it will no longer be possible to separate embedded derivatives and record the host instrument at amortised cost - instead, the entire hybrid will have to be at fair value through profit or loss (FVPL) and, hence, will have to include own credit risk in the liability measurement.

For insurance contract liabilities (other than those recorded at fair value under IAS 39), the question of whether or not own credit risk should be incorporated is rather more complex. From a policyholder's perspective, a change in the credit standing of the insurer could be decision-useful information, as the policyholder may want to ensure that future claims or payouts are secured. However, the argument to include credit risk for insurance liabilities may not be viable if there are regulatory restrictions (e.g., the liability may only be transferred to another insurer with the same credit standing as the transferor).

If the Board decides that an entity must consider credit risk in measuring all liabilities, an entity would have to reconsider its approach to measuring:

- ▶ Trade payables and other payables (e.g., staff wages)
- ▶ Provisions for warranties, refunds and legal settlements
- ▶ Income taxes payable
- ▶ Contingent consideration payable related to business combinations
- ▶ Cash-settled share-based payment transactions
- ▶ Asset removal obligations and decommissioning liabilities
- ▶ Liabilities related to disposal groups held for sale

Typically, non-financial liabilities are not settled in such a way that a variation in credit risk is reflected in the price. If the Board requires measurement of own credit risk for the above non-financial liabilities, it is not clear how an entity would measure such credit risk, given that there is rarely, if ever, an active market for such liabilities.

Next steps

The objective of financial statements is to provide financial information that is useful in making economic decisions. The arguments for and against including own credit risk in liability measurement (as summarised in Table 1) tend to be about why credit risk should, or should not, be decision-useful. The Board has stated that it is especially interested in the views of analysts and other users of financial statements about whether and how they use this information.

Constituents should carefully consider the pros and cons of including 'own credit risk' in liability measurement and provide comments to the IASB by 1 September 2009. It is expected that the Board will deliberate the comments received and consider any implications for the comprehensive project to replace IAS 39.

Comments are due by 1 September 2009

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