

IAS Plus Update.

IASB seeks views on the role of credit risk in liability measurement

On 18 June 2009, the International Accounting Standards Board (IASB) issued a discussion paper DP/2009/2 *Credit Risk in Liability Measurement*. The aim of the DP and the accompanying staff paper (together 'the DP') is to invite comments about the role of credit risk in liability measurement. The principal issue under consideration is whether current measurements of liabilities (including fair value) should incorporate the probability that the entity will fail to perform as required. If not, what are the alternatives?

Background

The role of credit risk in liability measurement has generated more interest in recent years because of the general deterioration in credit quality as evidenced in the global financial markets. The issue has been particularly acute when fair valuing financial liabilities subsequent to initial recognition, because a deterioration in an entity's own credit quality (leading to a lower fair value for its liabilities) results in the entity reporting a gain in profit or loss.

The DP focuses on the role of credit risk in current measurement of all liabilities, not just financial liabilities, but does not conclude whether changes in credit quality (sometimes referred to as 'non-performance risk') should be included or not. The DP sets out the main arguments for and against including credit risk in the measurement of liabilities, and illustrates the different approaches with examples.

Current requirements

The DP recognises that the treatment of credit risk in liability measurement varies within the IASB's existing literature. For example, if an entity measures a liability at fair value subsequent to initial recognition under IAS 39 *Financial Instruments: Recognition and Measurement*, the measurement incorporates the effect of credit risk and, therefore, as the probability of the entity failing to meet its obligation varies, the fair value of the liability changes. In contrast, a high quality bond rate is used for discounting pension liabilities under IAS 19 *Employee Benefits*, even though that rate will not necessarily reflect the credit risk of the employer. In other cases, a risk-free rate or the original effective interest rate may be used.

The DP addresses whether these inconsistencies are justifiable and, more broadly, whether the probability of failing to meet the obligation inherent in the liability should be recognised as part of the measurement.

Arguments both for and against

The DP sets out a brief discussion of three of the main arguments both for and against including credit risk in liability measurement. The following is a summary of the key arguments in the DP.

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The case for incorporating credit risk

Consistency at initial recognition When a borrowing is initially recognised, the probability of non-payment is factored into the contractual interest rate on the borrowing. The borrowing is recorded at its fair value – being the net proceeds received by the entity. Because credit risk is included in initial measurement, it can be argued from a consistency standpoint that it should be included for subsequent measurement. If the treatments were to be brought into line by excluding credit risk from all liability measurements then, at initial recognition, the liability would be recognised at a premium to net proceeds and a net debit would arise for the difference between the cash proceeds and the initial measurement of the liability; but where would the debit go?

Wealth transfer Long-standing economic theory recognises that there is a dynamic relationship between holders of instruments that have different claims against the entity. The equity holders' claim against the entity (being the subordinate claim) is affected by the claims of others having a more senior claim (e.g. holders of the entity's liabilities). One view of this relationship is that the equity holders have a right to put the net assets of the entity to the liability holders for the face amount of the liabilities (i.e. by repaying the liabilities). When the value of the net assets of the entity decreases, the value of the option held by the equity holders (written by the liability holders) increases. It is the change in the value of this option that it is argued should be reflected in the measurement of the liability.

Accounting mismatch It is also argued that failing to include credit risk in liability measurement creates a mismatch with asset measurement where the probability of non-payment is included. If payment is not received on assets, there is a greater probability that the entity cannot meet its payment obligations on its liabilities. Including credit risk in measurement on both sides of the statement of financial position would ensure consistency and avoid accounting mismatches.

The case against incorporating credit risk

Counterintuitive results The main argument cited in recent years against incorporating credit risk in liability measurement is that the effects of doing so are counter-intuitive. Recognising gains from declining credit quality in profit or loss is argued to be misleading, because the entity's reported financial performance has improved as a result of remeasuring its liabilities when its ability to continue as a going concern has reduced. The recognition of a gain when the entity is under-performing does not make intuitive sense.

Accounting mismatch Those who argue against incorporating credit risk believe that the accounting mismatch argument cited above in support of including credit risk in liability measurement is not compelling.

As most assets are not measured in a way that includes credit risk (e.g. at fair value), and much of the ability to meet future obligations is derived from assets and transactions not necessarily recognised in the financial statements (e.g. internally generated goodwill and future sales), recognising credit risk in liability measurement does not provide an offset to asset measurement. Including credit risk in liability measurement creates or exaggerates, rather than eliminates, an accounting mismatch.

Realisation The inability of the entity to realise the gain generated from declining credit worthiness is used as a further argument against incorporating credit risk in liability measurement. If credit risk has declined significantly, is it possible for the entity to borrow new funds in order to buy back its existing liabilities cheaply? If a borrowing is bought back cheaply, would not the cost of the new borrowing be higher because of the falling credit quality? In other words, a gain from buying back the borrowing in one period is replaced by a higher interest cost in the following periods. Similarly, if the credit risk was less than when the funds were originally borrowed, why would the entity bother borrowing new funds to buy back its existing borrowing at a premium to what it contractually owes? It is argued that realisation is hypothetical, not actual.

Illustrative examples

The DP includes in its appendix some examples of including and excluding credit risk in fair value measurement and what the accounting entries would be as a result of applying different approaches:

- the 'base case' approach includes credit risk in fair value measurement of a borrowing (such as a liability that is held for trading under IAS 39);
- a second approach (the 'borrowing penalty' approach) discounts the borrowing at the current risk-free rate and recognises a debit in profit or loss at inception, ignoring credit risk in subsequent measurements;
- a third approach (the 'shareholder put' approach) is the same as the second, except that the debit at inception is recognised in shareholders' equity and amortised to profit or loss over the life of the borrowing; and
- a fourth approach (the 'frozen spread' approach) is the same as the base case except that the value of credit risk inherent in the borrowing at inception (as reflected in the interest rate) is frozen and is never updated when credit risk changes.

The IASB identified the four approaches described above from comment letters and published studies and recognises that there may be other approaches. The IASB would welcome views on these approaches.

Comment deadline

The IASB has invited comments on a series of questions contained in the DP by 1 September 2009.

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