

List of Submissions to ITC 21 *Request for Comment on IASB Discussion Paper DP/2009/2
Credit Risk in Liability Measurement*

- 1 Grant Thornton
- 2 Representatives of the Australian Accounting Profession
(CPA Australia, The Institute of Chartered Accountants in Australia and National
Institute of Accountants)
- 3 HoTARAC



Mr Kevin Stevenson
Chairman
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7 August 2009

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Dear Kevin

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on ITC 21 which is a re-badged copy of the International Accounting Standards Board's Discussion Paper DP/2009/2 (the DP). We have considered the DP along with the accompanying Staff Paper and set out our comments below.

Grant Thornton's response reflects our position as auditors and business advisers both to listed companies and privately held companies and businesses, and this submission has benefited with some initial input from our clients, Grant Thornton International which is working on a global submission to the IASB, and discussions with key constituents.

The views expressed here are preliminary in nature, and a more detailed Grant Thornton's global submission will be finalised by the IASB's due date of 1 September 2009.

We welcome the Board's decision to seek views on the role of 'own credit risk' in measuring liabilities. As noted in the DP, this issue has generated considerable comment and controversy. It is also relevant to several of the Board's current projects.

We believe the DP and Staff Paper set out a clear and balanced summary of the main arguments for and against the inclusion of the effects of own credit risk in measuring liabilities. These arguments demonstrate that there is probably no perfect solution that will address all criticisms. Accordingly, to move forward the Board will need to decide which factors are most important (for example, consistency on initial recognition, income statement effects and so on). In doing so, we suggest that the decision-usefulness of the information produced (by including or excluding the effect of own credit risk) is paramount.

We therefore welcome the DP's call for views from analysts and other users of financial statements about whether and how this information is used by them.

We are not necessarily convinced that the same approach to own credit risk is necessary or appropriate for all types of liability. At standards-level the usual range of factors, including practicality and cost-benefit considerations, should be assessed. Conclusions may justifiably

differ for different classes of liability.

Our other main comments on the DP are as follows:

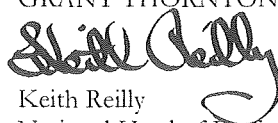
- In general we believe that the objective of measuring a liability should be to portray the 'burden' of the liability rather than the obligor's ability (or perceived ability) to meet honour the obligation. We acknowledge that this line of argument does not resolve how to arrive at a discount rate. At a conceptual level we believe that the discount rate should reflect the nature of the obligation rather than the entity's ability to meet the obligation. At an operational level, selecting a rate currently requires judgement and will probably continue to do so.
- We also share the concerns of many constituents that reporting gains (or losses) as a result of changes in an entity's own credit standing is counter-intuitive. These concerns are well articulated in paragraphs 48 to 52 of the Staff Paper. We have our doubts as to whether these reported gains (losses) represent useful information in practice - and indeed suggest that they are simply 'noise' in many cases. Having said that, we recognise that this is primarily a matter for investors and other users.
- Nonetheless, we acknowledge and agree that the *fair value* of a liability reflects the effect of non-performance risk if that risk alters the amount the obligor would have to pay to transfer its obligation to a market participant at the measurement date. (We are not however convinced that this hypothetical transfer price should be estimated on then assumption that non-performance risk is the same both before and after the transfer - we will consider this in more detail in responding to ED/2009/5 *Fair Value Measurement*).
- Linking these two points, we believe that the key concern is to address the circumstances in which a fair value measure produces useful information for liabilities. Although addressing this question is beyond the DP's scope, we suggest that a general starting point is that a transfer value is not likely to be relevant for liabilities which are rarely transferred. We would therefore characterise fair value as a basis to be used in special cases when a transfer value provide the most relevant information.

Where liabilities are measured other than at fair value, we believe that discount rate used to determine a measurement date carrying value should not incorporate an explicit adjustment for 'own credit'

Appendix 1 contains our more detailed preliminary responses to both the IASB's and the AASB's questions.

If you require any further information or comment, please contact me.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED



Keith Reilly
National Head of Professional Standards

Appendix 1: Responses to ITC 21 Questions

Invitation to comment 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?

- 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

Where a liability is incurred in exchange for cash (or other consideration whose value is observable) we believe that it should be recorded initially at the amount of the proceeds. This amount will normally reflect the price of credit risk inherent in the liability, although exceptions will arise in situations such as related party transactions. This is generally consistent with current practice and we see no persuasive reason to change. We are not particularly concerned that this can result in similar cash obligations being measured at different amounts depending on the issuer's credit status - the difference will be reflected in future interest charges.

For other types of liabilities that do not have a cash exchange, such as many provisions, the question becomes one of selecting an appropriate discount rate. As noted in the main body of this letter, we believe that the discount rate should reflect the nature of the obligation rather than the entity's ability to meet the obligation.

Discounting is of course a long-standing challenge in financial reporting, and existing requirements are diverse. Making operational a requirement to discount based on the nature of the liability is of course far from straightforward. We envisage a continued role for the use of appropriate judgement.

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

With the exception of fair value measurements, our general view is that current measurements of liabilities should not reflect changes in the entity's own credit standing. This is because we believe:

- the effect of incorporating changes in credit risk is to create 'noise' (ie non-useful information) in the income statement
- the burden of the obligation has not changed unless the effect of change in credit risk is that the entity has the practical ability to extinguish the liability for a different amount.

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?

Response

As noted in the main body of this letter, we suggest that the effects of own credit risk should be included in the measurement only in the context of fair value (and then only when credit risk affects the estimated price that would need to be paid to transfer the liability). Accordingly, this issue is not generally applicable under our suggested approach.

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?

Response

Of the alternatives presented, our preferred starting point is approach (c) in paragraph 62 of the Staff Paper. This approach involves:

- measuring borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds
- measuring 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 credit risk
- subsequent current measurements incorporating changes in market interest rates, but excluding changes arising from the entity's credit quality or the price of credit.

This approach seems simplest to apply of those presented and is consistent with our preference for measuring the liability in a way that is not affected by the obligor's ability to meet the obligation.

However, we note that this proposal involves re-measuring liabilities for changes in market rates. This is not therefore consistent with amortised cost using the effective interest rate as

applied to most financial liabilities (which we would also describe as a current measurement).

For other types of (non-financial) liability, we believe that further work is needed on whether and when discount rates should be revised after initial recognition.

Specific AASB Questions

- 1 Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
 - a not-for-profit entities; and
 - b public sector entities.

Response

Apart from our earlier comments, we are not aware of any regulatory issues that may effect the implementation of the proposals.

- 2 whether, overall, the proposals would result in financial statements that would be useful to users; and

Response

Apart from our earlier comments, we are not aware of any regulatory issues that may effect the implementation of the proposals.

- 3 Whether the proposals are in the best interests of the Australian economy.

Response

Apart from our earlier comments, we are not aware of any regulatory issues that may effect the implementation of the proposals.

7 August 2009

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

Via email: standard@asb.gov.au

Dear Mr Stevenson

Comments on ITC 21 Discussion Paper DP/2009/2 Credit Risk in Liability Measurement

Thank you for the opportunity to comment on the AASB ITC 21 Discussion Paper (DP) Credit Risk in Liability Measurement. CPA Australia, The Institute of Chartered Accountants in Australia, and the National Institute of Accountants (the Joint Accounting Bodies) have considered the above discussion paper (DP) and our comments follow.

The Joint Accounting Bodies represent over 180,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia throughout Australia and internationally.

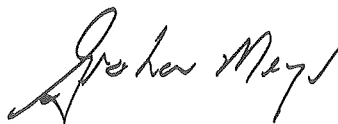
Our response to matters on which specific comment is requested is included in the attached Appendix. Also attached is our submission to the IASB.

If you have any questions regarding this submission, please do not hesitate to contact either Kerry Hicks (the Institute) at kerry.hicks@charteredaccountants.com.au, Mark Shying (CPA Australia) at mark.shying@cpaaustralia.com.au or Tom Ravlic (NIA) at tom.ravlic@nia.org.au.

Yours sincerely



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Chief Executive Officer
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Andrew Conway
Chief Executive Officer
National Institute of Accountants

Representatives of the Australian Accounting Profession



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The Institute of
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in Australia

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Appendix - Matters on Which Specific Comment Requested

The AASB would particularly value comments on whether:

- (a) **there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:**
 - (i) **not-for-profit entities; and**
 - (ii) **public sector entities;**

Because we do not agree with approach in the DP for the private sector, we are similarly unable to support them for not-for-profit and public sector entities.

- (b) **overall, the proposals would result in financial statements that would be useful to users; and**
- (c) **the proposals are in the best interests of the Australian economy.**

Given our concern about which of the different measurement models available should apply to the measurement of liabilities, we do not consider the DP would result in useful financial statements or would be in the best interest of the Australian economy.

7 August 2009

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Via "Open to comment" page on www.iasb.org

Dear Sir David

Comments on Discussion Paper DP/2009/2 Credit Risk in Liability Measurement

Thank you for the opportunity to comment on the IASB Discussion Paper (DP) Credit Risk in Liability Measurement. CPA Australia, The Institute of Chartered Accountants in Australia (the Institute) and the National Institute of Accountants (the Joint Accounting Bodies) have considered the above DP and our comments follow.

The Joint Accounting Bodies represent over 180,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia throughout Australia and internationally.

The Joint Accounting Bodies appreciate the concerns expressed in the DP about the place of 'own credit risk' in liability measurement and support the need for guidance and clarity on this issue. However, it is our view that these concerns cannot be resolved before addressing measurement models. In particular, the issue of credit risk in liability measurement must be addressed in conjunction with the fair value measurement project and not in isolation of it, as the credit risk issue can only be resolved once fair value has been defined. We think this fundamental issue is more appropriately addressed within the conceptual framework and definition of fair value, rather than the approach taken in the DP.

Our understanding of fair value measurement, consistent with the IASB *Fair Value Measurement* exposure draft on issue, is that credit risk is included in the fair value measurement of a liability. However, fair value is not the only measurement model on which the International Financial Reporting Standards are established. The IASB *Financial Instruments: Classification and Measurement* exposure draft currently on issue proposes two measurement models for financial liabilities – amortised cost and fair value. Other mixed measurement models currently used to measure liabilities on and following initial recognition under other accounting standards (for example, IAS 17 *Leases* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) do not include 'own credit risk'.


With all the different measurement models available to measure liabilities, the Joint Accounting Bodies think that the attention of the Board should be focused on resolving how liabilities are to be measured and when is it appropriate to use fair value, given that liabilities measured at fair value includes 'own credit risk'. We therefore strongly suggest that the Board carefully consider which of the different measurement models available should apply to the measurement of liabilities.

In the context of the comments above we do not provide responses to the matters on which specific comment was requested.

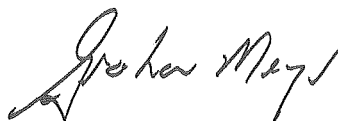
Representatives of the Australian Accounting Profession

If you have any questions regarding this submission, please do not hesitate to contact either Mark Shying (CPA Australia) at mark.shying@cpaaustralia.com.au, Kerry Hicks (the Institute) at kerry.hicks@charteredaccountants.com.au or Tom Ravlic (The National Institute of Accountants) at tom.ravlic@nia.org.au.

Yours sincerely



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Mr Kevin Stevenson
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PO Box 204
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Dear Mr Stevenson

**ITC 21 REQUEST FOR COMMENT ON IASB DISCUSSION PAPER DP/2009/2 CREDIT
RISK IN LIABILITY MEASUREMENT**

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to provide comments to the Australian Accounting Standards Board on the International Accounting Standards Board's Discussion Paper 2009/2: *Credit Risk in Liability Measurement*.

HoTARAC does not consider that the concept of fair value has been developed enough and the issues sufficiently clearly enunciated for this Discussion Paper to be progressed. In particular, the issue of whether the fair value of a liability should be based on its settlement (as in the current fair value definition) or its transfer (as in the proposed fair value definition in IASB ED 2009/5 Fair Value Measurement) requires further explanation. As the issue of fair value measurement is a conceptual issue, impacting on multiple standards, HoTARAC believes it should be dealt with at the conceptual framework level.

HoTARAC is of the opinion that, fundamentally, the inclusion of an entity's own credit risk in the measurement of its liabilities, following initial recognition, would not reflect the true nature of the liability as it could result in an amount being less than the amount the entity actually owes. Further, as the credit risk deteriorates, the Balance Sheet improves with the reduction in value of the liability. While this might be appropriate for marketable financial instruments, which the entity could purchase back at the discounted price, if it had the resources to do so, the majority of liabilities are not marketable. It also seems perverse that a reduction in credit rating should have a positive effect on the entity's operating result.

As a general observation, HoTARAC believes the clarity of the Paper is poor and overly implies a focus on financial instruments where market price can be readily determined.

HoTARAC is not aware of any regulatory impediments to implementation of the changes. HoTARAC offers no comment about whether the changes are in the best interests of the Australian economy.

Comments by HoTARAC on questions from the Discussion Paper are attached.

If you have any queries regarding HoTARAC's comments, please contact Peter Gibson from the Australian Department of Finance and Deregulation on 02 6215 3551.

Yours sincerely



D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

14 August 2009

Contact: Amy Huxley
Phone: 6233 3411
Our Ref: D/14418 AH/DC

IASB DP 2009/2 Credit Risk in Liability Measurement**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)?

When fair value is used for initial measurement, the price of credit risk inherent in the liability should always be incorporated [refer option (a)].

HoTARAC considers that an entity's own credit risk is usually already incorporated into the initial fair value assessment along with other risks, where an exchange gives rise to the liability. Further work is required for other types of liabilities such as provisions and employee entitlements, for example, long term workers' compensation and personal injury insurance liabilities for which there are no effective market.

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?

Explicit recognition should never be given to an entity's own credit risk following initial recognition. Credit risk should already be incorporated, along with other relevant risks, in discount rates used for the initial measurement of liabilities.

- HoTARAC considers that the costs of attempting to subsequently identify and measure changes in credit risk would outweigh the perceived benefits;
- as noted in the Paper, it may be difficult to separately determine credit risk with any objectivity, particularly for liabilities where there is no market reference point (what is the credit risk on an unlisted entity's trade payables or post-employment health plan liabilities?). HoTARAC would not support an approach which could require complicated models to be developed for measurement of every liability, and HoTARAC does not believe many users will understand the results;

- unless the debtor's financial obligation would change according to changes in its credit risk, HoTARAC cannot determine any logical reason for the measurement of liabilities to be adjusted for changes in the entity's credit risk; and
- the Discussion Paper does not appear to indicate whether the IASB has consulted with market analysts, and other users, as to whether they want this type of information to be included.

HoTARAC agrees with the arguments presented in Paragraphs 48 and 58 of the Discussion Paper as reasons for the non-inclusion of credit risk in liability measurement following initial recognition:

- Paragraph 48 (Counter-intuitive results) explains that, when liability measurement includes credit risk, an entity reports a gain from a decline in the credit quality of its liabilities. This is counter-intuitive, as gains should result from improvements not declines. Such reporting is potentially misleading and could mask a deteriorating situation. Such reporting would not provide useful information to users and should not be considered, particularly during situations such as the current Global Financial Crisis.
- Paragraph 58 (Realisation) explains that, unless assets are restricted, an entity can sell them whenever management wishes to do so, but liabilities are rarely transferred as it would require the permission of the counterparty. Thus, some liabilities cannot be transferred in any practical way, and the accounting measurement of the liabilities should, therefore, not mirror that of the measurement of assets.

Also, IAS 39.60/AASB 139.60 states that, a downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. Therefore, with the exception of "other available information", it is the opinion of HoTARAC that an entity's credit risk should not be considered in measuring its liabilities, as it is not viewed as being impaired.

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?

HoTARAC considers that liabilities can be unique and the use of a generic approach would not be suitable.

As discussed in the response to Question 2, HoTARAC believes it will be impracticable to attempt to separately identify and measure changes in interest rates attributable to credit risk of an entity. In this respect, HoTARAC agrees with the views presented in Paragraphs 18 and 19 of the Discussion Paper.

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?

HoTARAC does not support the proposal. Of the options presented, the frozen spread is preferable (Paragraph 62(c)).

HoTARAC is of the view that the frozen spread option best represents the measurement of liabilities because it better relates to the characteristics of differing types of liabilities as well as not incorporating an entity's credit quality.

HoTARAC is of the opinion that the "borrowing penalty" (Paragraph 62(a)) option is inappropriate due to the recognition of gains and losses. HoTARAC considers the "shareholder put" (Paragraph 62(b)) option to be inappropriate because amortising the differences between the resulting amount and cash proceeds over the life of the liability is illogical.