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16 September 2009

Dear Kevin

**AASB ED 184 and ED 186, Invitation to Comment ITC 21 and Discussion Paper AASB 139 DP**

I am enclosing copies of the PricewaterhouseCoopers responses to the following International Accounting Standards Board's papers:

- IASB Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement* [AASB ED 184]
- IASB Exposure Draft ED/2009/9 *Classification of Rights Issues (Proposed amendments to IAS 32)* [AASB ED 186]
- IASB Discussion Paper DP/2009/2 *Credit Risk in Liability Measurement* [AASB ITC 21], and
- IASB Request for Information *Impairment of Financial Assets: Expected Cash Flow Approach (Expected Loss Model)* [AASB Discussion Paper - AASB 139 DP]

The letters reflect the views of the PricewaterhouseCoopers network of firms and as such include our own comments on the matters raised in the exposure drafts and the discussion papers.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (02) 8266 8350 if you would like to discuss this further.

Yours sincerely



Regina Fikkers  
Partner  
Assurance

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
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1 September 2009

Dear Sir

**Credit Risk in Liability Measurement: Discussion Paper**

We are responding to the invitation of the IASB ("the board") to comment on the above-mentioned Discussion Paper on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on the Discussion Paper. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Conceptually, we believe that nonperformance risk, including credit risk, should be considered in measuring the fair value of any liability. We believe, however, that fair value may not provide the most decision-useful information about certain financial and non-financial liabilities.

We understand that many commentators on financial reporting standards question whether fair value is the most appropriate measurement basis for most non-derivative financial and non-financial liabilities. These commentators believe that current measurements which incorporate changes in the price of credit risk (i.e. changes in an entity's own credit that affect the risk of default of the liability) do not provide the most decision useful information. They believe that users of financial statements are primarily interested in information about the discounted value of future cash flows that reflect the assumption that the liability will be extinguished through performance in accordance with its terms. However, we also understand that fair value is the accepted and preferred measurement basis by many users for some financial liabilities such as derivative instruments.

Incorporating changes in the price of default risk is inconsistent with the assumption that the liability will be extinguished through performance in accordance with its terms. The goal of financial information is to provide the decision useful information that users most want. Therefore changes in the price of (own) credit risk should be incorporated into the current measurement of liabilities in circumstances where the external or "market" value of the liability is more relevant to users.

We have not performed a survey of users to determine whether they are primarily interested in information about future cash flows that reflects an assumption that the liability will be extinguished through performance in accordance with its terms. There is nevertheless a strong belief by some within our network that this is the case and our comments are based on this belief. Accordingly, as we believe fair value measurements incorporate changes in the price of credit, we also believe that fair value should be used as a measurement basis for financial and nonfinancial liabilities only when the incorporation of credit in measurement is relevant to users. We urge the board to

continue its efforts to ascertain users' true preferences in this regard and the circumstances that support the use of fair value when measuring liabilities.

We believe there are circumstances in which measurement of the liability at fair value is appropriate. These apply primarily to financial liabilities, and as noted in our answers to the specific questions in the Discussion Paper, will be discussed in our response to the exposure draft on Financial Instruments: Classification and Measurement.

Finally, we note as well that, as the Discussion Paper describes, the debate about the usefulness of including changes in the price of own credit in the current measurement of liabilities is often closely intertwined with debates about the presentation of the performance statement. We therefore also urge the board to ensure that the discussion of own credit risk does not pre-empt any of the debate that rightly belongs in the financial statement presentation project, and to revisit any arguments and conclusions as is appropriate in the context of that project and any future consideration of specific types of liabilities.

\* \* \* \* \*

Our answers to the specific questions in the Discussion Paper are attached in the appendix to this letter.

We would be pleased to discuss our comments or answer any questions that the board may have. Please contact Richard Keys, PwC Global Chief Accountant (+44 20 7802 4555), or John Althoff (+44 20 7213 1175) regarding our submission.

Yours faithfully

*PricewaterhouseCoopers LLP*

PricewaterhouseCoopers LLP

## APPENDIX

### Detailed responses to the questions in the Discussion Paper

#### 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 a liability is first recognised, its measurement should sometimes incorporate the price of the credit risk inherent in the liability.

Liabilities can be divided into two categories:

- a. Those that are recognised upon an exchange transaction that reflects the price of credit risk
- b. Those that are not recognised upon an exchange transaction that reflects the price of credit risk

An example of a liability that is recognized upon an exchange transaction, which reflects the price of credit risk, is an arm's length borrowing. The amount of cash received and the timing and amount of contractual cash flows required to settle that borrowing reflect the entity's price of credit at the time of the initial transaction. The effect of the price of credit risk is therefore relevant to users that require cash flow information that reflects an assumption that the liability will be extinguished through performance in accordance with its terms. Accordingly, when a liability of this type is first recognized, its measurement should incorporate the price of credit risk inherent in the liability.

When the liability does not arise from an exchange transaction that reflects the price of credit risk, the amount and timing of future cash flows are not determined by the price of credit risk. The amount and timing of future cash flows required to satisfy a decommissioning liability, for example, is not dependent upon the entity's price of credit risk at the time when it recognises the obligation. In these situations, the effect of the price of credit risk is not relevant to users that require cash flow information that reflects an assumption that the liability will be extinguished through performance in accordance with its terms. When a liability of this type is first recognised, its measurement should not incorporate the price of credit risk inherent in the liability.

We note that to the extent that liabilities are initially recognised at transaction amount, credit risk is necessarily included in that initial recognition when it is part of the transaction—and this is consistent with the principles described above.

#### 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?*

We believe that current measurements following initial recognition should sometimes incorporate changes in the price of credit risk.

We believe that users of financial statements generally look to the current measurement of liabilities to obtain information about the present value of future cash flows, assuming performance according to the terms of the liability. Only the risk-free rate (since it represents the risk-free time value of money), and factors which affect the timing and amount of future cash flows required for performance according to the terms of the liability should be included in a current measurement which assumes performance. (These factors could include the risk of variability due to factors other than non-performance, and could be captured in the measurement of the liability either through the use of multiple probability-weighted scenarios, or a risk-adjusted discount rate. Of course, in the latter case the discount rate would only be adjusted for risks other than non-performance.) Changes in the price of credit risk do not affect the timing or amount of cash flows required to perform according to the terms of the liability, and so incorporating such a change into a current measurement would not provide the most decision useful information to those users who want information about future cash flows assuming performance according to the terms of the liability.

However, we believe that there are additional considerations which might make it appropriate to record certain types of financial liabilities at fair value subsequent to initial recognition, notwithstanding the principle we have just articulated. These considerations will be discussed in our comment letter on the Exposure Draft Financial Instruments: Classification and Measurement, which we consider the proper forum for that full discussion.

### **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?*

The discussion paper notes that the price of credit risk is seldom, if ever, directly observable. It can only be estimated indirectly in a manner that requires significant judgment. (For example, it might be identified as the residual when other components of market interest rates are determined and deducted from an observable rate.) We do not think it appropriate therefore to provide detailed guidance on how the amount of change attributable to the price of credit risk inherent in the liability should be determined. Guidance along the lines already included in IFRS 7 is sufficient.

### **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?*

Of the approaches described we prefer the third alternative. The first two methods ignore the fact, discussed in our answer to question one, that the price of credit risk is relevant to the initial measurement of liabilities which arise from an exchange transaction which itself reflects the price of credit risk. The third approach is consistent with our answers to questions 1 and 2.