Australian Government

Australian Accounting Standards Board

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Sir David Tweedie
Chairman
International Accounting Standards Board
1st Floor
30 Cannon Street
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UNITED KINGDOM

Dear David

Discussion Paper *Credit Risk in Liability Measurement*

The Australian Accounting Standards Board (AASB) is pleased to submit its comments on the abovenamed Discussion Paper. In formulating these comments, the AASB sought and considered the views of Australian constituents. The comment letters received are published on the AASB's website.

The AASB found the Discussion Paper and Staff Paper to contain a useful 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 concerns in a mixed measurement model. Indeed, the AASB is of the view that the question about credit risk in measuring liabilities can only be definitely addressed in the context of a specified measurement attribute.

The Staff Paper itself provides evidence that concerns about the manner in which credit risk impacts on financial reporting stem from the measurement attribute adopted. For example, paragraph 50 refers to the view that an entity is no better off when the fair value of its debt falls, because it would be more costly to replace the debt in any case. This touches on the issue of maintaining an entity's capital and the notion that gains can only arise if there is a net increase in that capital. Also, the Staff Paper discusses the various liability measurement attributes under the existing IFRSs and the respective treatments of the impact of credit risk, which seems to prove the point that the measurement attributes themselves drive the outcome as regards credit risk. The Paper could equally have discussed whether liquidity risk should always, sometimes or never be included in liability measurement.

A possible framework that the IASB may adopt is that on initial recognition, liability measurement should always include credit risk. Measurement attributes where this is not the case would be eliminated. On subsequent measurement, whether credit risk is included should depend on the nature of the measurement attribute. The AASB considers that two broad attributes exist:

(a) a fair value attribute where credit risk is always adjusted for in subsequent measurement; and

(b) a cost attribute where credit risk is not adjusted for in subsequent measurement (unless current market variables impact on the carrying amount through an impairment test).

Any further 'mixing' of measurement attributes (such as fair value with the impact of credit risk removed) should be avoided.

It should be noted that the AASB is not promoting any particular measurement attribute, and its comments are made in the context of the existing mixed measurement attribute environment.

If this project is progressed, the AASB is of the view that it would be useful if the IASB details how this project interacts with Exposure Draft *Fair Value Measurement* and the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*.

The AASB's comments on the specific questions in the Discussion Paper are attached.

If you have queries regarding any matters in this submission, please contact Raymond Yu (ryu@aasb.gov.au) or me.

Yours sincerely

K.M. Stevenson

Kevin M. Stevenson
Chairman

AASB's Specific Comments on IASB Discussion Paper DP/2009/2 *Credit Risk in Liability Measurement*

The AASB's views on the questions in the Discussion Paper are as follows:

> Question 1
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> 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)?

Consistent with the general comments in the covering letter, the AASB considers that:

- if a fair value measurement attribute is selected for application by the IASB, it is implicit that credit risk is included initially and subsequently in the measurement of the liability. The AASB notes that there is no basis for specifically seeking to remove credit risk on initial recognition and leaving other market risk, for example, liquidity risk in the measurement;
- if the measurement attribute selected for application by the IASB to a liability involves a price initially established in an exchange transaction, it is explicit that credit risk is included initially. If, in subsequently measuring that liability, there is no further reference to market variables (for example, under a cost attribute when cost is expected to be settled), it is implicit that changes in credit risk will not be part of that liability's measurement; and
- if a measurement attribute is selected for application by the IASB that involves no reference to market variables, it is implicit that credit risk is not included initially or subsequently in the measurement of the liability, unless the IASB explicitly makes reference to a need to incorporate credit risk.

Accordingly, the AASB considers that credit risk is **sometimes** incorporated into liability measurement, depending on the measurement attribute.

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?

The AASB views current measurements as those listed in paragraph 8 of the Discussion Paper. The AASB is of the view that specifically removing the impact of credit risk from a measurement attribute that inherently includes credit risk is conceptually incorrect and therefore could not support certain measurements in paragraph 8 (for example, fair value but excluding the effects of credit risk).

Consistent with the general comments in the covering letter, the AASB believes that credit risk is **sometimes** incorporated into current measurement of liabilities, depending on the objective of the measurement attribute. An example of where credit risk is excluded from current measurement is fulfilment value, which might exclude credit risk, depending on the interest rate chosen.

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?

Even for a deep and liquid secondary market, credit risk for a liability can generally only be inferred (paragraph 14 of Staff Paper). Based on discussions with AASB constituents, there is currently no precise way to separate credit risk from other components of the spread between the risk-free rate and the rate relevant to the transaction when there is a change in market interest rates.

Reference to credit default swaps (CDSs) may provide good evidence in some cases. However, it is difficult to obtain such information from CDSs, as they are only available for a small portion of the market (mainly large companies, and even CDSs for those are usually thinly traded).

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?

The AASB does not support deliberately setting out to exclude credit risk from liability measurement. Accordingly, the AASB cannot support any of the approaches outlined.