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Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
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
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Attachment 1

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 identity 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.