



Credit Risk in Liability Measurement

Discussion Paper DP/2009/2

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DP/2009/2 – Background and timetable

Background

- Financial Crisis related project

Timetable

- Published 18 June 2009
- Comments on this Discussion Paper to be submitted by 1 September 2009



DP/2009/2 – Objective of the Discussion Paper

In particular the Discussion Paper asks:

Should current measurements of liabilities (including fair value) incorporate the chance that an entity will fail to perform as required?

If not, what are the alternatives?



DP/2009/2 – Scope

- The Discussion Paper includes within its scope all **current** measurements of liabilities.
- Alternative **current** measurements of liabilities are, for example:
 - fulfilment value on insurance contracts
 - settlement with the counterparty
 - fair value excluding the effects of credit risk
 - transfer value permitted by industry regulators



DP/2009/2 – Illustrative Example (1)

- An entity **issues bonds** at market rates on 31 December 20X1. The interest rate on the bonds certainly incorporates the market's view of credit risk. The entity would record the cash proceeds from the bonds and a liability for the same amount.
- Assumption: The entity measures the financial liability 'at fair value through profit or loss'.¹⁾

¹⁾ According to the proposals in the Exposure Draft ED/2009/7 Financial Instruments: Classification and Measurement financial assets and financial liabilities shall be measured at fair value, if the conditions of 'basis loan features' and 'managed on a contractual yield basis' are not met and there is no accounting mismatch.



DP/2009/2 – Illustrative Example (2)

- The same entity also recognises an **asset removal obligation** on the same date. It will have to use estimated cash flows and a discount rate to measure the liability.

Should the measurement of the asset removal obligation also incorporate credit risk?



DP/2009/2 – Arguments in favour (1)

Consistency at initial recognition

- Accountants accept that the initial measurement of a liability incurred in an exchange for cash includes the effects of the borrower's credit risk. The cash exchange represents fair value in that market.
- There is no reason why subsequent current measurements should exclude changes in factors that were included in the initial measurement.
- Similarly, there is no reason why the initial measurement of some liabilities should include the effects of credit risk and others should not.



DP/2009/2 – Arguments in favour (2)

Consistency at initial recognition

- Many liabilities do not arise in straightforward borrowing transactions, for example:
 - asset removal or decommissioning liabilities
 - product warranty liabilities
 - performance obligations arising from sales to customers
 - employee benefit obligations
 - insurance claims liabilities.
- Some have remarked that the listed liabilities are different from traditional borrowing, because there is no **explicit** price for credit risk in the transaction.



DP/2009/2 – Arguments in favour (3)

Consistency at initial recognition

- The difficulty with this line of argument is that it does not answer the **question of discount rate**, e.g. a high quality bond rate like the one used for pension liabilities substitutes some other entity's credit risk for the employer's credit risk.



DP/2009/2 – Arguments in favour (4)

Wealth transfer

- Liabilities and equity represent the two classes of claims against the entity. A change in the credit risk of the entity's liabilities represents a transfer of wealth between the creditors and investors (i.e. holders of equity).



DP/2009/2 – Arguments in favour (5)

Accounting mismatch

- between asset and liability measurements
 - If an entity's assets are measured at fair value, then changes in credit spreads on those assets will affect their fair value and either profit or loss or other comprehensive income.
 - If the measurement of liabilities does not incorporate changes in credit spreads, then there is an accounting mismatch and the amounts of profit or loss or other comprehensive income will be distorted by the mismatch.



DP/2009/2 – Arguments against (1)

Counter-intuitive results

- Example: The entity's credit standing has been downgraded.
- When liability measurement includes credit risk, an entity reports a gain from a decline in the credit quality of its liabilities. This gain is counter-intuitive.
- Gains should result from improvements in an entity's financial position, not from declines.



DP/2009/2 – Arguments against (2)

Accounting mismatch

- Including changes in credit risk is likely to increase the mismatch between assets and liabilities.
- A decline in an entity's credit quality usually signals a decline in the value of assets that may not be measured on a current basis (like fixed assets and goodwill) or unrecognised intangible assets. Because changes in those items are not recognised in financial statements, changes in credit quality should be similarly excluded.



DP/2009/2 – Arguments against (3)

Realisation

- In accordance with fair value measurement, realisation is not a critical event in accounting for some assets. In general, an entity can sell an asset every day.
- Otherwise liabilities are seldom transferred.
- The relevant measurement of some liabilities clearly requires inclusion of **current** information. Those who hold this view accept the argument that **current** measurements are often more relevant than historical measurements, but only if the entity has the ability to benefit from a change in value.



DP/2009/2 – Arguments against (4)

Realisation

- Example: asset removal obligation
A **current** interest rate is needed to determine the present value.
- Some hold the view that the rate should not include the effects of credit risk because the shareholders will neither gain nor lose from those effects. It cannot, in this view, be realised in most situations.



DP/2009/2 – Arguments against (5)

Realisation

- An entity might be able to realise the benefits of decreased credit quality by repurchasing bonds or repaying borrowings at discounted amounts.
- Realisation, in this view, is more hypothetical than actual.



DP/2009/2 – Complications on determination

- Isolating the effect of credit risk in a market transaction is not straightforward. Even at initial recognition, the credit premium in an interest rate can only be inferred. It cannot be observed directly.
- The marketplace does not deliver an itemised invoice that details the portions of the interest rate attributable to the risk-free rate, the instrument's credit enhancements such as collateral, the entity's general credit quality, the instrument's liquidity, and other factors.
- Changing market conditions, especially of the sort experienced in the past two years, make the problem even more complicated.



DP/2009/2 – Questions (1)

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?

If the answer is ‘sometimes’, in what cases should the initial measurement exclude the price of the credit risk inherent in the liability?

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)?



DP/2009/2 – Questions (2)

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?



DP/2009/2 – Questions (3)

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?



DP/2009/2 – Questions (4)

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?

Three categories:

- (a) Measure all liabilities using the risk-free rate of interest and expected future cash flows, excluding any expectations about default. Any difference between the resulting amount and cash proceeds (if any) should be charged to income immediately.



DP/2009/2 – Questions (5)

Three categories:

- (b) Measure all liabilities using the risk-free rate of interest and expected future cash flows, excluding any expectations about default. Any difference between the resulting amount and cash proceeds (if any) should be charged to equity and amortised over the life of the liability.
- (c) Measure borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds. Measure 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 should incorporate changes in market interest rates. Changes arising from the entity's credit quality or the price of its credit should be excluded from the market interest rates. This would have the effect of fixing the credit spread at the original amount and incorporating all changes in the risk-free rate.



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