

IFRS Briefing Sheet

Discussion Paper *Credit Risk in Liability Measurement* and accompanying IASB Staff Paper

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This IFRS Briefing Sheet summarises the International Accounting Standard Board's (IASB) Discussion Paper (DP) *Credit Risk in Liability Measurement* and accompanying IASB Staff Paper, which was published on 18 June 2009. Comments are due by 1 September 2009.

The DP and accompanying IASB Staff Paper include arguments for and against including the effects of credit risk in liability measurement.

Arguments for incorporating credit risk include consistency with measurement at initial recognition, wealth transfer and accounting mismatches with assets measured at fair value.

Arguments against incorporating credit risk include the counter-intuitive results, the difficulties associated with accounting mismatches with assets that are not measured at fair value and realisation.

The IASB Staff Paper identifies three categories of alternatives to including credit risk in liability measurement.

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Background and Executive Summary

The DP addresses the role of credit risk in the measurement of an entity's liabilities, referred to as "own credit risk".

The discussion of credit risk in liability measurement has been included in a number of the IASB's consultative documents, including Exposure Draft (ED) *Fair Value Measurement*, DP *Fair Value Measurements*, DP *Preliminary Views on Insurance Contracts*, DP *Preliminary Views on Amendments to IAS 19 Employee Benefits* and DP *Reducing Complexity in Reporting Financial Instruments*.

Many of the respondents to the ED and DPs have disagreed with proposals that liability measurements should include the effect of credit risk. However, the respondents did not comment with much detail since credit risk in liability measurement was not the focus of the documents published. Due to recent developments in financial markets, gains that have resulted from changes in the value of an entity's liabilities have led the IASB to focus on this matter.

The objective of the DP is to have a focused discussion on the role of credit risk in liability measurement. Comments received by the IASB will

be useful in several of its current projects. The scope of the DP includes all current measurements of liabilities.

Examples of liabilities considered in the DP include:

- borrowing transactions
- asset removal or decommissioning liabilities
- product warranty liabilities
- performance obligations arising from sales to customers
- employee benefit obligations
- insurance claim liabilities.

Current accounting standards differ in their treatment of credit risk for these liabilities.

Specifically, the DP examines the following questions:

- Should current measurements of liabilities (including fair value), at initial recognition and subsequent measurement, incorporate the chance that an entity will fail to perform as required?
- If not, what are the alternatives?

The accompanying IASB Staff Paper describes three arguments in favour and three against inclusion of credit risk in liability measurement.

In addition, the DP requests comments on how the amount of a change in market interest rates attributable to the price of the credit risk inherent in a liability should be determined and for views on the three categories of alternative approaches to liability measurement and credit standing described in the DP.

Arguments for Incorporating Credit Risk

Consistency at Initial Recognition

Currently, the initial measurement of a liability incurred in an exchange for cash includes the effects of a

borrower's credit risk. The cash exchange represents fair value in that market. Hence, changes in factors that were included in the initial measurement should be included in subsequent measurement. The inclusion of the effects of credit risk in the initial measurement should be applied consistently for all liabilities.

Wealth Transfer

Two classes of claims against an entity are liabilities and equity. A change in the credit risk of a liability is indicative of a transfer of wealth between these two classes.

The interests of equity holders usually are subordinate to those of lenders since the lenders' potential gains and losses are limited by the terms of a contract. On the other hand, equity holders are not required to make additional investments to cover losses incurred by an entity unless there is an existing contractual agreement. When the credit risk of a liability increases, the gain to the borrower reflects an allocation of claims between the borrower's equity holders and its lenders.

According to the IASB Staff Paper, "the current measurement of a liability may change as a result of:

- (a) a change in the estimated cash flows;
- (b) a change in interest rates, unrelated to the entity's credit risk;
- (c) a change in the credit spread for liabilities in the same class as the entity's;
- (d) a change in the entity's credit standing; or
- (e) some combination of (a)-(d)."

All of the above changes affect the relative claims of owners and lenders. Hence, there is no reason why credit risk should be excluded from liability measurement when other changes are included.

Accounting Mismatch

Liability measurement without incorporating credit risk can result in an accounting mismatch between assets and liabilities. Currently some assets are measured at fair values incorporating changes in credit spreads. If liability measurement does not incorporate credit spreads, then an accounting mismatch between assets and liabilities will occur which results in distorting amounts in profit or loss or other comprehensive income.

Arguments Against Incorporating Credit Risk Counter-intuitive Results

If an entity incorporates credit risk in liability measurement, then the entity reports a loss when its credit quality improves and a gain when its credit quality deteriorates. This result is counter-intuitive because gains should result from improvements in an entity's financial position, not declines. The recognition of gains from a decline in credit quality is misleading.

Bank and insurance regulators are concerned that this result would mask underlying weakness or insolvency and may hinder their ability to take regulatory action.

Accounting Mismatch

Liability measurement that incorporates changes in credit risk can result in an accounting mismatch between asset and liability measurements. When an entity's credit quality deteriorates, it indicates that the values of assets that are not measured at fair value may have declined. Since these declines are not reflected in an entity's financial statements, including the changes in credit risk in liability measurement would create a mismatch between assets and liabilities.

Realisation

An entity can sell an asset at management's discretion unless the asset is pledged or restricted;

this supports the use of fair value measurements that use current credit spreads for some assets. The frequency of a sale of assets is much higher than a transfer of liabilities, as a transfer usually requires permission of the counterparty, and some liabilities cannot be transferred in a practical manner. Although the relevant measurement of some liabilities requires the inclusion of current information, the measurement of assets and liabilities do not necessarily need to match.

Alternatives to Including Credit Risk

In the IASB Staff Paper, the IASB has identified three categories of alternatives to including credit risk in liability measurement. The alternatives are:

- Measuring liabilities using the risk-free rate of interest and expected future cash flows, excluding default expectations. The difference between this amount and cash proceeds would be charged to income immediately.
- Measuring liabilities using the risk-free rate of interest and expected future cash flows, excluding default expectations. The difference between this amount and cash proceeds would be charged to equity and amortised over the life of the liability.
- If a liability does not arise from a cash exchange, then it would be measured at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk. Borrowings and other liabilities that result from an exchange for cash would be measured at the amount of the cash proceeds. Changes in market interest rates, excluding changes in the entity's credit spread, would be incorporated in subsequent measurements. This alternative would have the effect of fixing the credit spread at the original amount and incorporating all changes in the risk-free rate.

Response to the IASB

The IASB has invited comments by 1 September 2009.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

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