



1 September 2009

International Accounting Standards Board
1st Floor 30 Cannon Street
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(By email: CommentLetters@iasb.org)

Dear Sirs

RESPONSE TO DISCUSSION PAPER: CREDIT RISK IN LIABILITY MANAGEMENT (DP/2009/2)

The Accounting Standards Council (ASC) appreciates the opportunity to comment on the Discussion Paper on Credit Risk in Liability Management (DP) issued by the International Accounting Standards Board (IASB) in June 2009.

General Comments

2. We agree that the questions about the role of credit risk in liability measurement have generated more attention and have been one of the most controversial accounting issues in recent years. Therefore, we support the IASB's initiative to discuss and analyze both the arguments for and against the inclusion of the effects of credit risk in liability management, which is covered in-depth in its IASB Staff Paper. We presume this DP covers both financial liabilities and non-financial liabilities. However, we noted that the DP does not explain further on the measurement objective for liabilities. We believe that it is important and relevant for us to understand different measurement methods that are applied to different categories of liabilities so that a more holistic view could be achieved.
3. This DP is one of the IASB's Financial Crisis related projects and it should be analyzed in conjunction with the fair value measurement projects. We believe that the credit risk issue can be addressed, analyzed and interpreted in a more appropriate and comprehensive manner once the fair value measurement has been defined. The current ED on Financial Instruments: Classification and Measurement suggested two measurement models for financial liabilities, i.e. amortized costs and fair value.

4. In paragraph 49 of the Staff Paper, a point is made that when there is a fall in the liability's fair value due to the entity's deteriorating credit standing, measuring the liability at fair value leads to an increase in the equity holder's wealth and this is clearly a counter-intuitive result. If a fall in a financial liability's fair value is due solely to the market's assessment of the entity's own credit risk, there should be similar negative assessment about the fair value of the entity's equity (likely to be already manifested in the share price). Adjusting the liability to a lower fair value with a surplus to the equity (either directly or through profit or loss) while not capturing the impact of the declining equity value will produce a result that is contrary to the economic position of the entity, no matter how much one would like to advocate fair value accounting as a "technically correct" model for liability measurement. One should ask an over-arching question of whether the change in an entity's own credit risk should manifest itself as a gain or loss (unless the entity intends and is able to realize such gain or loss without replacing the existing liability with one at equally or more onerous terms) through liability measurement. This question has already been answered for changes in the fair value of an entity's equity as its impact is neither reflected in the entity's profit or loss, the statement of financial position or disclosed elsewhere in the financial statements. It is highly questionable whether the market's changing view of an entity's credit standing should be captured periodically by the entity as its gain or loss, in the absence of impending realization. Subject to the overall deliberation outcome of the EDs on the Financial Instruments (IAS 39 replacement) projects undertaken by IASB, our comments on the specific questions to the discussion paper are as follows:

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)?

5. Our answer is "sometimes" based on the following considerations:

5.1. When a liability is assumed in a market transaction, the market price of the company's own credit is factored into the transaction price. The

measurement of the liability at cost would therefore have the effect of the company's credit risk being taken up on initial recognition.

- 5.2. For other liabilities that are outside the scope of IAS 39 (such as defined benefit pension schemes decommission obligations, warranties, or insurance claim liabilities), the measurement should not incorporate the price of own credit risk. Instead, these liabilities should be measured using a risk-free rate to reflect the time value of money. In arriving at this position, we had taken into account the fact that the entity does fund these liabilities, and that such funding is obviously at the entity's cost of capital.
- 5.3. We also considered the argument that consistency enhances comparability, and that the initial measurement attribute of all liabilities should under such argument either include or exclude the entity's own credit risk. On balance, we were of the view that liabilities stated at the entity's cost of capital does not appropriately reflect the burden of the obligation to the obligor (although it might reflect the value of the asset in the hands of an investor). We also did not believe that consistency in measurement of all liabilities provides useful information to users of financial statements. We set out our reasons below:

5.3.1 Excluding own credit risk in the initial measurement of all liabilities

Liabilities incurred in exchange for cash (usually in straightforward borrowing transactions) in an arm's length transaction always include the market price of the company's own credit in the transaction price.

If we choose to adopt an approach to exclude the company's own credit risk from the initial measurement of all liabilities, such liabilities would be recorded at an amount higher than the cash proceeds, resulting in a day one loss. As discussed in the DP, some consider this day one loss as a borrowing penalty and therefore should be recognised as an expense in profit or loss immediately, while others believe that this represents a put option granted to shareholders and therefore should be recognised in equity.

The framework lists "understandability" as one of the qualitative characteristics of financial statements. We are aware that users understand, in a straightforward borrowing transaction, that the amount of cash received represents the amount borrowed. Therefore, we do not believe that recording such liabilities at an

amount other than the cash proceeds represents an improvement to current financial reporting.

Furthermore, we could not accept that a transaction carried out on an arm's length basis results in an "expense" and we have difficulty understanding why an option granted to the shareholders, if any, should be reflected in the financial statements of the reporting entity.

On this basis, we do not support the approach to exclude the entity's own credit risk from liabilities where the market price of own credit is factored into the transaction price of that liability.

5.3.2 Including own credit risk in the initial measurement of all liabilities

As explained in the DP, many liabilities do not arise in straightforward borrowing transactions. They may not even have an individual counterparty that places a price on the chance of not being repaid (i.e. there may not be an inherent price for the credit risk). Liabilities not arising from straightforward borrowing transactions include:

- (a) asset removal or decommissioning liabilities
- (b) product warranty liabilities
- (c) performance obligations arising from sales to customers
- (d) employee benefit obligations
- (e) insurance claim liabilities.

We presume that the IASB's intent is to include those liabilities that are outside the scope of IAS 39 (except for deferred tax) in the DP.

We have considered the benefits of having a consistency in measurement for all liabilities. We are not convinced that "consistency" in this aspect results in relevant information. Liabilities as described above are rarely exchanged in arms' length transactions and entities are obligated to perform regardless of their own credit risk. We also have difficulty in rationalizing why all-liability would be acquired by a third party at its full amount, in exchange for consideration of a lower amount (in other words, this is different from an asset where a third party would acquire an asset at a discounted amount). Therefore, we believe that the most appropriate measurement attribute for these liabilities should be the amount an entity expects to settle in future, i.e. measured using a risk-free rate (without adjusting for own credit risk).

On this basis, we do not support the approach to include the entity's own credit risk in measuring liabilities which do not result from an exchange of cash (i.e. liabilities outside the scope of IAS 39).

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?

6. Our answer is "sometimes" based on the following scenarios:

- 6.1. Credit risk should be reflected in the measurement of liabilities whose value changes in response to a specified variable (such as an interest rate, commodity price, or equity price index) that is not specific to one of the parties to the contract e.g. where an entity enters into a derivative liability. While the terms may not include an explicit adjustment for credit risk (e.g., where two swap counterparties have similar credit risk), credit risk would typically be reflected in the terms (e.g., through collateral arrangements or, if credit risk is significant, compensation in the pricing terms).
- 6.2. In addition, we have considered whether there are any circumstance where the inclusion of gains / losses arising from changes in its own credit risk would provide useful information. We believe that the inclusion of gains/losses could provide useful information if those gains/losses are probable of realization in the ordinary course of business (i.e. not a firesale or a forced transaction such as bankruptcy or liquidation) within a short period of time, with the company having committed plans and financial ability to realize the gains/losses. Therefore, we believe that financial liabilities that are held for trading or designated at fair value through profit or loss (FVTPL) under IAS 39 should continue to be measured at fair value. The fair value should incorporate the entity's own credit risk.
- 6.3. On the other hand, changes in credit risk should not be reflected in the subsequent measurement of non-derivative liabilities whose contractual cash flows are fixed or fluctuate solely based on a market interest rate (including non-leveraged inflation) and are not managed on a fair value basis.
- 6.4. Similarly, changes in its own credit risk should not be reflected in the subsequent measurement of non-derivative liabilities where the entity does

not have the practical ability to realize gains or losses associated with changes in own credit in the ordinary course of business (i.e., other than in bankruptcy or liquidation) [emphasis added]. If such a liability has variable cash flows (e.g., payment terms based on earnings), we recommend the approach suggested in paragraph 62(c) of the Staff Paper.

- 6.5. Likewise, we also feel that credit risk should not be reflected in the initial or subsequent measurement of liabilities that are incurred on terms or conditions that do not consider the credit risk associated with the liability. Instead such a liability should be measured using a high quality credit approach.

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?

7. Assuming that the credit risk is priced into an entity's liability, we hereby set out below the possible ways (examples) where credit risk could be determined:

7.1. Recent loan/bond issue spread

The interest/coupon spread above the risk-free rate derived from the recent loan/bond issued by the entity to the external market will be a good estimation of the perceived credit risk that the external market is willing to accept. If the liability is of similar status (Seniority, time to maturity, etc) as compared to the loan/bond, the derived spread will be a good proxy to determine the fair value of the credit risk as of the point in time.

7.2. Credit default swap (CDS) spread

The spread of the CDS represents the market's perceived risk of default of the entity. If the entity has quoted CDS of similar status traded in the external market, it will be a good proxy to determine the fair value of the credit risk as of the point in time.

8. It is worthwhile to note that the separation of credit risk from other changes in value will often be arbitrary and rely on practical conventions. A certain level of judgment and estimation will need to be exercised in the above mentioned techniques and hence an entity has to ensure that the technique used is in accordance with IAS 39 or the possible outcome from the IAS 39 replacement.

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?

9. We do not support paragraphs 62(a) and 62(b) of the Staff Paper accompanying Discussion Paper as alternatives to including credit risk. We are in favor of paragraph 62(c) in certain circumstances. The reasonings for our position are discussed below.
10. Paragraph 62(a) – The resulting difference represents the profit margin to the supplier of funds for the credit risk undertaken and an embedded service charge. This basis of accounting is akin to an entity recording goods and services at the supplier's cost and charging the supplier's profit margin to profit or loss upon initial recognition. It is a novel idea that is difficult to implement, with results which are difficult to interpret.
11. Paragraph 62(b) - A liability with a credit risk premium priced in can be decomposed into a risk-free component at inception offset by a simultaneous cash outflow for the risk premium at inception. As the credit risk premium is a prepayment, it should be amortized over the life of the liability. However, it is doubtful whether charging the credit risk premium to equity upon initial recognition, which immediately depresses the equity, makes any economic sense. If the lender were to follow the same principle, all future credit risk margin and embedded service charge will immediately raise the lending institution's equity upon initial recognition. This clearly cannot be the intended outcome.
12. Paragraph 62(c) - This has the effect of fixing the credit spread at inception for the liability arising from the cash transaction with subsequent measurement incorporating the change in interest rate excluding credit risk premium.
13. As discussed earlier, the same market forces that drive the risk-free interest rate affect the fair values of both assets and liabilities that generate cash flows. It is believed that currently financial statement users do not expect the financial statements to reflect a gain or loss from the net exposure of an entity's financial position to changes in the risk-free interest rate as the precise impact, which may not be significant, may be difficult to isolate. The only exception is where there is significant interest rate risk exposure from trading portfolios.
14. For liabilities arising from business obligations (without an initial exchange of cash) of the entity, we are of the view that the risk-free rate interest rate is more appropriate and it is conceptually more robust than the bank deposit interest rate.

This is because the deposit interest rate contains an element of risk premium to be earned by the entity for taking on a credit risk on the bank deposit. Therefore we should allow the interest spread over the interest expense (arising from unwinding the discount embedded in the liability) to be captured as income over the life of the liability.

15. In reality, there is no single observable risk-adjusted interest rate for an entity and this is evident from the way in which banks quote interest rates in the interbank market. Banks makes two-way quotes all the time (in fact more ways if we include the interest rates they offer to retail customers). If a counterparty voluntarily makes a placement with a bank, the bank enjoys a lower interest rate in the form of bid rate. On the other hand, if the bank seeks to borrow from a counter-party, it pays the higher offer rate.
16. One can argue that an entity does not really seek to establish a "borrowing" rate for its operational liability (such as a provision for litigation or for warranty) and therefore it is appropriate to use the risk-free interest rate without regard to its own credit risk.
17. To illustrate, if a litigation liability of \$100 is expected to be payable in a year's time. Discounting it at a risk-free interest rate of say, 2%, will result in an initial recognition of the liability at \$98 and interest expense of \$2 for the subsequent 12 months. Discounting it at a risk-adjusted interest rate of, say, 5%, will result in an initial recognition of the liability at \$95 and interest expense of \$5 for the subsequent 12 months.
18. For any liability payable at a future date, it is conceptually possible for the entity to enter into a financial arrangement to early settle the liability now. It is more likely for the entity to settle the liability today at \$98 and not as likely at \$95 (no financial intermediary will take \$95 from an entity to assume a liability that is accruing at the entity's risk-adjusted rate in the next 12 months). Allowing a high discount rate (especially when the entity is in a poor credit condition) for measuring an entity's operational (non-borrowing) liability runs the risk of depressing the entity's obligation today.
19. Other Issues - In developing a new consistent set of principles for valuing liabilities, we encourage the Board to coordinate its efforts and any standard setting projects the Board may undertake as a result of this Discussion Paper, with the FASB to help achieve the common goal of convergence between IFRSs and U.S. GAAP so as to minimize any inconsistency.

20. We hope that our comments will contribute to the IASB's future deliberations on this project. Should you require any further clarification, do contact me. Thank you.

Yours faithfully,

Dexter Tan
Secretary, Accounting Standards Council