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September 4, 2009

International Accounting Standards Board
30 Cannon Street,
London EC4M 6XH
United Kingdom

Dear Sirs,

Credit Risk in Liability Measurement, Discussion Paper, June 2009

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB staff) to the IASB's Discussion Paper on Credit Risk in Liability Measurement, dated June 2009.

The AcSB staff discussed this Discussion Paper with the AcSB's User Advisory Council, as well as soliciting comments from individual members of the AcSB's Academic Advisory Council.

The views expressed in this letter take into account comments and perspectives of these constituents. However, they do not necessarily represent a common view of the AcSB, its Committees or staff. Views of the AcSB are developed only through due process.

As noted in the Discussion Paper, there are many strongly held, and varied, views regarding the issues in question. We were unable to achieve a common view among those we consulted on the issues. Neither were we able to achieve a common view among each of the subsets of financial statement users, academics or AcSB staff.

Overall, we agree that the *fair value measurement* of liabilities should include the market's best estimate of credit risk at a particular point in time. However, the matter in question is whether there are circumstances in which liabilities should be measured at current measures that exclude the effects of the entity's credit standing. Such measures, by definition, would not be fair value measures.

Many people think that most liabilities should not be measured at current amounts subsequent to initial recognition. For them, the question regarding inclusion of the effects of the entity's credit standing arises only for measurement on initial recognition. Other people think that a current measure is almost always better than a stale one, even if it excludes the effects of the entity's credit standing. For them, the question arises for measurement both on initial and subsequent recognition.

Some people advocate that current measures of a liability should *always* include the market's best estimate of credit risk inherent in the liability, both on initial recognition and subsequently. These people think that the merits of doing so outweigh any disadvantages and that the arguments against doing so can be rebutted. They do accept that there might be some circumstances in which there is such significant uncertainty regarding the measurement of the entity's credit standing that a faithful representation is not achievable and, hence, an alternative might be required.

At the other end of the spectrum, other people advocate that current measures of a liability should exclude the effects of an entity's own credit risk, both on initial recognition and subsequently. In particular, they base their arguments on their views that the entity's credit standing is not part of the obligation to be measured. In addition, they think that, absent the entity ceasing to be a going concern, the obligation of the entity to incur future cash outflows is unaffected by its own credit risk. Some of these people would accept inclusion of credit risk, rather than seek to remove it, for liabilities that are traded in public markets and for which the entity's credit risk can readily be realized, but would not accept its inclusion for other liabilities.

In the Appendix to this letter, we answer the questions asked in the Discussion Paper. However, we have not been able to reflect all permutations of views held. We have tried to summarise only the most common views and arguments put forward, as well as information that might add to that in the IASB Staff Paper.

We would be pleased to elaborate on any of our comments in more detail if you require. If so, please contact Peter Martin, Director Accounting Standards at +1 416 204-3276 (e-mail peter.martin@cica.ca), or Ian Hague, Principal Accounting Standards at +1 416 204-3270 (e-mail ian.hague@cica.ca).

Yours truly,



Peter Martin
Director,
Accounting Standards

Appendix

Comments on the Discussion Paper, *Credit Risk in Liability Measurement*, June 2009

Question 1: Measurement on initial Recognition

Some people think that when a liability is first recognised, its measurement should *always* incorporate the price of credit risk inherent in the liability. Other people think that when a liability is first recognised its measurement should *sometimes* incorporate the price of credit risk inherent in the liability.

Those people who think that when a liability is first recognised its measurement should *always* incorporate the price of credit risk inherent in the liability also think that most practical difficulties with such measurement can be overcome and that this leads to consistent accounting for all liabilities issued by the same entity, whether financial or non-financial. These people accept that there might be some circumstances in which there is such significant uncertainty regarding the measurement of the entity's own credit risk that it is incapable of faithful representation and that an alternative might be required. However, this seems less likely on initial recognition than subsequently, since a transaction price is often available on initial recognition.

Other people are concerned that an entity may have no practical ability to avoid an outflow of economic benefits, other than by ceasing to be a going concern (see further discussion under question 2, below). They think that portraying the financial statements as if the entity does have the ability to avoid the outflow of economic benefits is confusing to financial statement users. Therefore, these people advocate that, when the entity has no practical ability to avoid an outflow of economic benefits, the measurement on initial recognition should exclude the price of credit risk entirely. This would be the case for liabilities that are to be measured subsequently at current measures excluding the price of credit risk, as well as for those to be measured subsequently on other than current bases.

Question 2: Current measures subsequent to initial recognition

Some people think that current measurements subsequent to initial recognition should *always* incorporate the price of credit risk inherent in the liability. Other people think that current measurements subsequent to initial recognition should *sometimes* incorporate the price of credit risk inherent in the liability.

Those people who think that current measurements subsequent to initial recognition should *always* incorporate the price of credit risk inherent in the liability note that there is evidence that equity markets recognize the wealth transfer associated with changes in credit risk.¹ Also, these people think that consistency with initial recognition supports incorporating the price of credit risk in measurement subsequent to initial recognition when it has been included on initial recognition. These people note that an entity that issued debt when it had a good credit risk is better off after its credit risk has declined than a corresponding entity that waited to issue debt until after its credit risk declined. The reverse applies to an entity issuing debt when its credit risk was high — it is worse off than an entity issuing the same debt when it has a lower credit risk.

Other people think that there are difficulties with such an approach. These people think that the entity's credit risk is not part of the obligation to be measured and that, absent the entity ceasing to be a going concern, the obligation of the entity to incur future cash outflows is unaffected by its own credit risk. They think, for example, that two obligations for identical cash outflows from two entities with different credit risks should be measured at the same amount, because in each case the entity is obligated to meet those cash outflows, other than if it fails to be a going concern (at which point different accounting conventions apply). These people are concerned also about the difficulties arising as a result of accounting mismatches between assets not recognized or not measured at fair values compared with liability measures that take into account an entity's credit standing, as well as the ability to faithfully represent changes in an entity's own credit risk in particular circumstances.

¹ See, for example, Mary E. Barth, Leslie D. Hodder and Stephen R. Stubben, "Fair Value Accounting for Liabilities and Own Credit Risk," *The Accounting Review*, Vol. 8, No. 3, 2008, pp. 629-664. However, we note that this paper tests the wealth transfer at the level of the common equity holders and does not necessarily provide evidence regarding the information content to creditors or preferred equity holders, who are also identified in the IASB Framework as primary users of financial statements.

We think that we are in a “no-win” situation regarding accounting mismatches and, recognising that we will retain a mixed-measurement/incomplete recognition accounting model for the foreseeable future, do not see a solution that will entirely eliminate this issue.

The concerns about counter-intuitive results of including the price of credit risk in measurement of liabilities also stem, in large part, from the accounting mismatch issues. We think that the financial statement effects of including the price of credit risk can be explained conceptually, but acknowledge that it is very difficult to explain those effects clearly to the vast majority of users of financial statements. Some financial statement users propose to mitigate the counter-intuitive effects by including gains and losses resulting from changes in own credit risk in other comprehensive income. However, this does not seem to resolve the issue, since to avoid an accounting mismatch, that would require that corresponding declines in asset values also be recognised in other comprehensive income – thus, effectively moving the issue to a different part of the statement of financial performance, rather than resolving it. Those who advocate including credit risk in measurement of liabilities think that this issue can be overcome by education. Those who advocate excluding credit risk think this argument supports their conclusions.

Most people think that realisation is not a critical event when the entity has the ability to avoid the outflow of economic benefits arising from a liability by, for example, repurchasing its debt in a public market. However, a few would recognise a gain from a decline in credit standing only when realised in cash, even on public debt. Those who think that realisation is not a critical event recognise that some liabilities cannot be transferred or the underlying outflow of economic benefits cannot be avoided in any practical way. In these circumstances, those advocating exclusion of credit risk think that the price of credit risk should not be included in subsequent measurement. These people also point out that users of financial statements desire the ability to predict future cash flows. An entity may have no practical ability to avoid an outflow of economic benefits other than by ceasing to be a going concern, at which point many different considerations apply. In such circumstances, these people think that portraying the entity’s financial position as if it does have the ability to avoid the outflow of economic benefits is confusing to financial statement users. Those advocating inclusion of credit risk agree that realisation is not a critical event, but would make no distinction between a liability that can be

transferred and one that can be ‘realised’ only by settlement with the counter-party. In both cases they would include the effects of credit risk.

In addition to the arguments set out in the IASB Staff Paper, we think that there may be additional practical issues. In some cases it is very difficult to faithfully represent the effects of changes in credit standing on financial liabilities. There is a range of views as to when an entity is able to faithfully represent the effects of changes in credit standing in a liability. Some people think that the circumstances in which incorporating the effects of credit standing is possible are very limited – perhaps limited to liabilities quoted in public debt markets for which the necessary information is publicly available. Others think that the information is available in all but the rarest of circumstances. Some people are concerned that, outside public debt markets, adjustments for an entity’s own credit risk result in the entity providing proprietary information about itself.

Question 3: Determining the amount of a change in market interest rates that is attributable to the price of credit risk

We think that it is very difficult to isolate the part of a change in fair value attributable to the price of a liability’s credit risk. Therefore, we would seek to avoid such an approach whenever possible.

Question 4: Alternative approaches to liability measurement and credit standing

For those people who would *always* include the effects of an entity’s credit standing in determining current measures of liabilities, this question is not applicable.

The majority of those people who would *sometimes* exclude the effects of credit standing favour either alternative (b) or (c) in paragraph 62 of the IASB Staff Paper. There is probably a stronger leaning to alternative (c), with some people proposing modified versions of alternative (c), including use of a current settlement rate or a risk-free-rate, rather than market rates that exclude the effects of credit risk.

Other matters

We note that many financial statement users wish to know the entity's view of the effects of changes in its own credit risk, but prefer it to be omitted from the measurement of financial liabilities so that they can make their own assessment. Therefore, they advocate measuring liabilities, when current measures are used, at the amount excluding the effects of credit risk and providing disclosures about those effects. If the effects of credit risk are included in the measurement they also desire the disclosures, so that they can remove those effects and replace them with their own assumptions. Regardless of the resolution of this issue, many users desire separate presentation of realised and unrealised changes in value.

From a practical perspective, we note that when the Financial Instruments Joint Working Group of standard setters considered this issue in its Draft Standard² it proposed that, for non-traded liabilities, at subsequent measurement dates, an entity could assume that its own credit rating had not changed in the absence of available information indicating otherwise.

² See Financial Instruments and Similar Items, An Invitation to Comment on the JWG's Draft Standards, December 2000, paragraphs 370-372