1 September 2009

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

Email: CommentLetters@iasb.org

Dear Sir/Madam

SAICA SUBMISSION ON DISCUSSION PAPER ON *CREDIT RISK IN LIABILITY MEASUREMENT*

In response to your request for comments on the IASB's discussion paper on *Credit Risk in Liability Measurement*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

We bring to your attention that the Long Term Insurance Project Group of SAICA has submitted a separate comment letter on this exposure draft that contains the views of the long term insurance industry of South Africa.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

Integritas, 7 Zulberg Close, Bruma Lake, 2198 POSTAL ADDRESS PO Box 59875, Kengray, 2100, Johannesburg
TEL +27 11 621 6600 FAX +27 11 621 3321 CALL CENTRE 08610 SAICA (72422) EMAIL saica@saica.co.za WEB saica.co.za | accountancysa.org.za

SAICA SUBMISSION ON DISCUSSION PAPER ON *CREDIT RISK IN LIABILITY MEASUREMENT*

GENERAL COMMENTS

Whilst we are generally of the view that the price of credit risk inherent in a liability should always be included in the initial measurement of a liability, there are some concerns regarding this principle as noted in our responses to the questions below.

Subsequent to initial recognition changes in credit risk should only be included in the measurement of a financial liability if it has been classified as either held for trading or designated as at fair value through profit or loss in terms of paragraphs (a) and b(ii) of the definition of 'a financial asset or financial liability at fair value through profit or loss' in the section on 'Definitions of four categories of financial instruments' contained in paragraph 9 of IAS 39 - *Financial Instruments: Recognition and Measurement* (IAS 39). Therefore, the current measurement of those financial liabilities that have been designated to be recognised at fair value through profit or loss in order to eliminate or reduce an accounting mismatch in terms of paragraph b (i) of this definition after initial recognition should exclude the effects of changes in credit risk[1]. We note that this recommendation would create a third measurement category but is, in some respects, no different to that which currently arises for fixed rate debt instruments that have been adjusted for fair value changes due to interest risk only in terms of a fair value hedging relationship. The only exception to this is where, in what we believe would be in rare circumstances an entity designates a financial liability to be recognised at fair value to eliminate a measurement inconsistency that arises from or incorporates the effects of changes in credit risk[2] (e.g. non derivative financial assets are measured at fair value with financial liabilities designated as at fair value through profit or loss so that the change in fair value of the liabilities due to changes in credit risk offsets, in whole or in part, the changes in fair value of the assets due to changes in credit risk). We recommend that an entity be required to disclose, as part of its accounting policies, the instances where credit risk has been included in the subsequent measurement of financial liabilities and the reasons why.

In our view, subsequent measurement of non-financial liabilities after initial recognition, should exclude the effects of changes in credit risk.

We wish to emphasise that the answers provided below may be influenced by our comments on the exposure draft dealing with amendments to IAS 37 – *Provisions, Contingent, Liabilities and Contingent Assets,* and could change depending on the Board's conclusions reached on the exposure draft *Financial Instruments: Classification and Measurement* and the Board's future hedge accounting project.

If credit risk is not included in the measurement of a liability, it cannot be stated explicitly that the liability is at fair value, thus creating a different measurement category.

---

[1] In terms of the exposure draft, *Financial Instruments: Classification and Measurement*, the same would be applicable to those financial instruments that are managed on a contractual yield basis, but that are subsequently measured at fair value.

[2] This exception would also apply to the exposure draft, *Financial Instruments: Classification and Measurement*, paragraph 9.

SAICA SUBMISSION ON DISCUSSION PAPER ON *CREDIT RISK IN LIABILITY MEASUREMENT*

SPECIFIC COMMENTS

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)?

In our view, when a liability is initially recognised it should always incorporate the price of credit risk inherent in that liability. If this is applied no day 1 profit or loss would be recognised in the statement of comprehensive income arising from the initial recognition of the liability, which we believe to be appropriate since the act of borrowing in itself should not be a driver of profit or loss.

This conclusion was reached after considering various types of liabilities. Examples of this include an invoice for an expense that is payable within a short period of time that includes an appropriate price for credit risk. The invoice should initially be recognised at the amount established as the invoice price between the two parties. The amount at which financial liabilities with deferred settlement features (e.g. an interest free long term loan) are initially recognised should be at fair value which includes the effects of the time value of money. In determining the effects of discounting it should include the price of the initial credit risk of the debtor. Non-financial liabilities, such as pension fund liabilities, warranty obligations and rehabilitation liabilities should initially be recognised at an amount that includes an adjustment for the credit risk of the entity (i.e. should not be discounted at the risk free rate).

The basis for this conclusion is that the transaction price for liabilities is established on the basis that the entity is a going concern at the time that the relationship is created and the amount incorporates the counterparty's assessment of credit risk of the entity. We are of the opinion that if credit risk is not included in the measurement of a liability at initial recognition it would result in the recognition of gains and losses that are not reflective of the performance of the entity.

It was however noted that there can be issues that might make this principle difficult to apply. Firstly, paragraph 49 of IAS 39 states that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. If that first date is at a future date then the credit risk can be taken into account in determining the appropriate discount rate. If, however, that first date is the date that the liability is incurred then arguably no credit risk should be taken into account in the initial measurement of that liability (i.e. including credit risk would reduce the liability which would be contrary to the requirements of paragraph 49 of IAS 39). This suggests that this might have to be accepted as an exception to the proposed principle.

Secondly, the discussion paper assumes that the credit risk inherent in a liability can always be determined. While this might be the case when credit risk is specifically considered in determining the terms of the liability, this might not always occur. If any entity sells goods to many customers it might agree to credit terms that apply to all customers that meet specified credit criteria. Subsequent to that it might continue to sell on the same terms to those customers without determining whether those credit criteria are still met, except if they are informed that the customer is not paying according to the agreed terms. This could occur, for example, if the entity sells relatively small amounts to a large homogeneous customer base. In this case, some customers might have an increased credit risk, without this being necessarily known to the entity or their supply terms being altered. It would be difficult for the customer to determine the extent of credit risk it should include in its initial recognition of the liability. This can be illustrated as follows: an entity is suffering from cash flow difficulties, but can be regarded as a going concern if it delays paying amounts due by three months. It purchases goods from its supplier which is required to be paid for seven days after receipt of the goods. Does it record the full liability as it is the equivalent of being payable on demand (IAS 39.49)? Alternatively, how should the entity determine what discount rate is appropriate to a highly risky liability payable in three months when there is no such market of which it is aware?

Even these two questions ignore another issue, namely whether credit risk affects just a discount rate or whether it could also affect future cash flows. For example, in the previous paragraph the customer might not be able to operate without obtaining goods from its supplier, but the supplier might not be prepared to extend further credit and thereby possibly incur future losses. In this case, should the customer record the liability on the basis that it might not be able to pay the amount payable on demand (and would not be able to pay the full amount in three months if the supplier does not continue to supply goods)? While IAS 39.49 would suggest not, it is less clear in the discussion paper.

Therefore it is suggested that the interrelation between credit risk and going concern be further explained as well as the interaction between the discussion paper and IAS 39.49. If credit risk is *‘the risk that one party will cause a financial loss for the other party by failing to discharge an obligation’* (IFRS 7 – *Financial Instruments: Disclosures* Appendix A) then going concern has some role in considering the issue of credit risk. While IAS 39.49 requires the contractual cash flows to be used to determine the liability to be recorded even if it might not be able to pay amounts owing, it is less clear what the discussion paper is suggesting as it only seems to deal with credit risk in the context of setting an appropriate discount rate, but not when the full liability might not be payable.

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?

We believe that the current measurement of liabilities, subsequent to initial recognition, should <u>sometimes</u> incorporate the price of credit risk inherent in the liability. In our opinion a liability should be measured subsequently in the manner that reflects management’s intention to settle the liability, based on the initial classification of that liability. We have provided an analysis below for financial and non financial liabilities.

In those situations where the credit risk inherent in a liability is not included in the subsequent measurement of a liability that would otherwise have been subsequently measured at fair value, we recommend that disclosures of what the effect would have been had credit risk been included in the measurement of the liability be provided. This amount would be determined as the difference between the fair value of the liability (incorporating credit risk) and the fair value of the liability (excluding credit risk).

Financial liabilities

In terms of IAS 39, financial liabilities that are classified either as 'held for trading' or designated at fair value through profit or loss (where it is part of a group of financial liabilities that is managed and its performance evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and information about the group is provided internally to the entity's key management personnel) should always include the price of credit risk in the subsequent measurement of those liabilities. This is because the entity has either classified the financial liability as 'held for trading' or the entity manages the liability's cash flows on a fair value basis. Only those financial liabilities that have been designated to be carried at fair value through profit or loss to eliminate or reduce a measurement or recognition inconsistency in terms of IAS 39 should exclude the effects of changes in credit risk[3]. The only exception to this is where, in what we believe would be limited instances, an entity designates a financial liability to be carried at fair value to eliminate a measurement inconsistency that arises from changes in credit risk[4] (e.g. financial assets are measured at fair value and the designation of the financial liability to include changes in credit risk would reduce the measurement inconsistency due to changes in credit risk). We recommend that an entity be required to disclose, as part of its accounting policies, the instances where credit risk has been included in the subsequent measurement of financial liabilities and the reasons why.

This conclusion has been based on the fact that illogical results will arise when credit risk is included in the subsequent measurement of those liabilities excluded from the previous paragraph, i.e. the widening of an entity's credit spread will result in a gain being recognised in the statement of comprehensive income. The converse of this is also true, i.e. an improvement in an entity's credit spread will result in the recognition of a loss. We therefore concur with the argument against incorporating credit risk as noted in paragraphs 48-52 of the discussion paper. As these liabilities are neither trading liabilities nor managed on a fair value basis, the gain or loss described above will never be realised and therefore we are of the opinion that the recognition of this gain or loss will not provide decision-useful information to the users of the financial statements.

[3] In terms of the exposure draft *Financial Instruments: Classification and Measurement*, the same would be applicable to those financial instruments that are managed on a contractual yield basis but that are subsequently measured at fair value.

[4] This exception would also apply to the exposure draft, *Financial Instruments: Classification and Measurement*.

<u>Non-financial liabilities</u>

In our opinion, the current measurement of non-financial liabilities (with the exception of insurance contracts) after initial recognition should never incorporate changes in the price of credit risk. The majority of non-financial liabilities are not readily transferable to a third party and would not be settled at a different value as a result of changes in the issuer's own credit risk. Furthermore, the incorporation of a change in credit risk in the measurement of a non-financial liability would not, in our opinion result in decision-useful information (such as gains and losses arising due to changes in credit risk) being provided to the users of the financial statements. Accordingly, this is considered to be the equivalent of obtaining a loan (financial liability) with fixed interest rates, which in terms of current requirements could be treated as a liability that is subsequently measured at amortised cost.

It is acknowledged that, depending on the unit of measurement for a liability, this may result in practical implementation issues when subsequently measuring those particular liabilities. An example of this is that in our opinion credit risk should be included in the initial measurement of a pension fund liability but changes in the credit risk should not be included in its subsequent measurement. In the subsequent measurement of a pension fund liability, new liabilities are recognised each month that the employee renders a service. This would require the maintenance of discrete credit spreads in order to subsequently measure the liabilities. Maintaining monthly spreads will pose practical difficulties. It is therefore suggested that entities be permitted to 'freeze' those credit spreads for subsequent measurement purposes using similar practices as embodied in IAS 21 – *The Effects of Changes in Foreign Exchange Rates*, i.e. the use of average rates for a period to approximate the actual spread at the date of the transaction(s). This is discussed further in our answer to question 4 below.

<u>Liabilities with a demand feature</u>

We are of the opinion that both financial and non-financial liabilities with a demand feature should be measured on a similar basis to that described in IAS 39, paragraph 49 which states that '*The fair value of a financial liability with a demand feature (e.g. a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.'* This principle is consistent with our conclusion that certain liabilities should not include the effects of re-measurement for changes in credit risk.

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?

In our view, and where applicable, the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability should be determined in accordance with paragraph 9(c) (i) and (ii) of IFRS 7 i.e. either

a. *'as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or*

b. *using an alternative method the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the liability.'*

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?

In our view, the option included in paragraph 62(c) of the staff paper represents the best option for the measurement of those liabilities that we have noted above.

OTHER COMMENTS

We note that part of the US Financial Accounting Standard Board's (FASB) recent proposals for the classification and measurement of financial instruments indicates that certain liabilities are required to be measured at fair value (including the effects of credit risk). Whilst we believe that the approach that we have proposed above is the most appropriate accounting measurement basis to provide decision useful information, we recommend that, in the event that the Board adopts a similar approach to the FASB that requires liabilities to be measured at fair value including the effects of credit risk, that all changes in fair value of the liability[5] due to changes in own credit risk should be recognised in other comprehensive income. No transfers of such gains and losses from other comprehensive income to profit or loss should be permitted in line with the Board's proposals for investments in equity instruments that are measured at fair value through other comprehensive income in terms of the exposure draft, *Financial Instruments: Classification and Measurement*.

We do not believe that the change in an entity's credit risk for those liabilities represents the financial performance of the entity and should therefore be included, if required, in other comprehensive income.

#279441

[5] Only those financial liabilities that have been designated to be carried at fair value through profit or loss to eliminate or reduce a measurement or recognition inconsistency in terms of IAS 39.