COMMENTS ON IASB DISCUSSION PAPER ON "CREDIT RISK IN LIABILITY MEASUREMENT" (DP/2009/2)

The discussion paper needs to be specific about the scope of the proposal. It seems to cover all current measurements of liabilities, ie financial and non-financials.

I am of the opinion that the recognition of own credit risk could lead to counter-intuitive and potentially confusing financial reporting. All the arguments against recognising own credit risk described in the discussion paper are convincing. Moreover, it may go against the going-concern concept as well. My comments on the specific questions are set out as below:

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)?**

Answer 1
Whether the price of credit risk should be incorporated into the liability measurement at inception is dependent on two factors, namely:

1. if there is a transaction involved cash exchange; and
2. if credit risk is priced into the transaction.

Reference is made to the illustration in the discussion paper where an entity issues bonds at market rate. In that example, the cash inflow is an identifiable transaction and the market rate apparently has already reflected the entity's credit risk. In such case, measurement of the liability with the priced credit risk can be reliably made.

In the example of asset removal obligation, as there is no market transaction on which the credit risk is priced, the measurement of the liability is therefore based on the expected cash flows. The inclusion of an estimate credit risk, which is not actually priced, will be controversial.

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?

Answer 2
Current measurements of the liability following initial recognition should not incorporate the price of credit risk inherent in the liability.

One of the objective of financial statements is to provide useful financial information for readers' purposes. Such objective may be compromised if the financial statements included the effects of changes in own credit risk subsequently, as it goes against the intuitive concept as depicted in paragraph 48 of the DP. For instance, it goes against common sense for an entity, in financial difficulties to book the gain / profit arising from its own credit risk that is deteriorating. The inclusion will only impede the quality of financial statement, distorting users' view on the financial standing of the entity.

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?

Answer 3
The change in market interest rates would affect the entity's own credit risk as in point 2; subsequent liability measurement should not incorporate the change of credit risk.

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?

Answer 4
The approach described in paragraph 62(c) is preferable.

Approaches (a) and (b) measuring all liabilities using the risk-free rate are not appropriate. It is because the measurement of financial liabilities in relation to the price of credit risk is different from that of non-financial liabilities.

Prepared by : Paul Mok
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Note : The above views represent those of Paul Mok only, not of any organisations to which he is related.