Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

1 September 2009

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

Dear Sirs,

IASB Discussion Paper on *Credit Risk in Liability Measurement*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Discussion Paper. Our responses to the questions raised in your Discussion Paper are set out in the Appendix for your consideration.

Credit risk in liability measurement is often referred to as "own credit risk" and it has been one of the most controversial accounting issues. We are pleased to note that IASB issued the Discussion Paper on this aspect setting out in detail the arguments for and against and the alternatives to the inclusion of own credit risk in all current measurement of liabilities.

In our view, non-performance risk, including credit risk, should be considered in measuring the fair value of any liability. However, we do not believe that fair value is the appropriate measurement basis for many liabilities. Accordingly, we believe that an entity's own credit risk should "sometimes" be incorporated in the measurement of liabilities. In respect of initial measurement, we would only support including "own credit risk" when there is an actual transaction occurring and there is an associated transaction price.

In respect of subsequent measurement, we would only support including credit risk for those liabilities which are held for trading (including derivatives) and for liabilities that are quoted in an active market such that the entity has the practical ability to realise recognised gains. Incorporating changes in the price of default risk in other liabilities is inconsistent with the assumption that the liability will be extinguished through performance in accordance with its terms, and hence does not provide decision-useful information to users.

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If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong

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APPENDIX

Hong Kong Institute of CPAs

Comments on the IASB Discussion Paper on *Credit Risk in Liability Measurement*

<u>Question 1</u>

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)?

We believe that when a liability is first recognised, its measurement should "sometimes" incorporate the price of credit risk inherent in the liability.

In our view, the initial measurement should include the price of credit risk only where there are exchange transactions occurring between identified counterparties and there are transaction prices associated with the transactions. The rationale for this view is that the terms of the deal as reflected in the transaction prices would normally have taken into consideration the enterprise's own creditworthiness.

<u>Question 2</u>

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?

Most liabilities are settled through performance rather than through transfer. Accordingly, except for certain financial instruments as discussed below, we believe that current measurements following initial recognition should not incorporate changes in the price of credit risk, as changes in the price of credit risk do not affect the timing or amount of cash flows required to settle the liability. The inclusion of the effects of changes in own credit risk in liability measurement often results in counter-intuitive results that do not provide decision-useful information to the users of the financial statements.

However, there are important circumstances in which we believe that users are interested in the fair value of liabilities, and hence a current measurement that incorporates changes in own credit risk. These circumstances include financial liabilities that are held for trading (including derivatives) and those liabilities that are quoted in an active market, and hence movements in fair value attributable to own credit risk is realisable.

In conclusion, we consider that current measurements following initial recognition should "sometimes" incorporate the price of credit risk inherent in the liability. Subsequent measurement of liabilities, with the exception for those financial liabilities referred to above should exclude the price of the credit risk inherent in the liability.

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?

We believe the credit risk premium can be inferred as the difference between the risk-free rate and the market interest rate. Please refer to our view in Question 4.

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?

We do not support the approach (a) and approach (b) mentioned in the Discussion Paper that a risk-free rate of interest should be used in all liabilities in both initial and subsequent measurement. As stated in our response to Question 1, credit risk is relevant to the initial measurement of liabilities arising from an exchange transaction, and we are concerned that the difference between the initial amount measured using the risk-free rate and the cash proceeds received, i.e. transaction price, would need to be accounted for.

We prefer approach (c) as we believe the cash proceeds received on the date of the transaction would have incorporated the price of the inherent credit risk in the transaction. This is in line with our view in Question 1. We also believe that this would be the simplest approach. The risk-free rate is generally directly observable, except in certain countries with slow marketisation of interest rate such as Mainland China where the risk-free rate may not be observable. If a risk-free rate is used, the credit premium can be inferred without undue cost and effort.