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Discussion Paper - Credit Risk in Liability Measurement

Grant Thornton International is pleased to comment on the International Accounting Standards Board's (the Board) Discussion Paper *Credit Risk in Liability Measurement* (the DP). We have considered the DP along with the accompanying Staff Paper and set out our comments below.

We welcome the Board's decision to seek views on the role of 'own credit risk' in measuring liabilities. As noted in the DP, this issue has generated considerable comment and controversy. It is also relevant to several of the Board's current projects.

We believe the DP and Staff Paper set out a clear and balanced summary of the main arguments for and against the inclusion of the effects of own credit risk in measuring liabilities. These arguments demonstrate that there is probably no perfect solution that will address all criticisms. Accordingly, to move forward the Board needs to decide which factors are most important (for example, consistency on initial recognition, income statement effects and so on). In doing so, we suggest that the decision-usefulness of the information produced (by including or excluding the effect of own credit risk) is paramount. We therefore welcome the DP's call for views from analysts and other users of financial statements about whether and how this information is used by them.

We are not necessarily convinced that the same approach to own credit risk is necessary or appropriate for all types of liability. At standards-level the usual range of factors, including practicality and cost-benefit considerations, should be considered. Conclusions may justifiably differ for different classes of liability.

Our other main comments on the DP are as follows:

- In general we believe that the objective of measuring a liability should be to portray the 'burden' of the liability rather than the obligor's ability (or perceived ability) to honour the obligation. We acknowledge that this line of argument does not resolve how to arrive at a discount rate. At a conceptual level we believe that the discount rate should reflect the nature of the obligation rather than the entity's ability to meet the obligation. At an operational level, selecting a rate often requires judgement under existing IFRSs and will probably continue to do so.
- We also share the concerns of many constituents that reporting gains (or losses) as a result of changes in an entity's own credit standing is counter-intuitive. These concerns

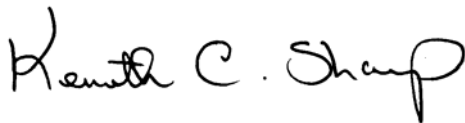
are well articulated in paragraphs 48 to 52 of the Staff Paper. Moreover, we doubt that these reported gains (losses) represent useful information in practice and indeed suggest that they are simply 'noise' in many cases. Having said that, we recognise that decision-usefulness is primarily a matter for comment by investors and other users.

- Nonetheless, we acknowledge and agree that the *fair value* of a liability reflects the effect of non-performance risk if that risk alters the amount the obligor would pay to transfer its obligation to a market participant at the measurement date. (We are not however convinced that this hypothetical transfer price should be estimated on the assumption that non-performance risk is the same both before and after the transfer - we will consider this in more detail in responding to ED/2009/5 *Fair Value Measurement*).
- Linking these two points, we believe that the key challenge is to address the circumstances in which fair value (ie a transfer value) provides useful information for liabilities. Although this question is beyond the DP's scope, we suggest that a general starting point is that a transfer value is not likely to be relevant for liabilities which are rarely transferred. We would therefore characterise fair value as a basis to be used in special cases when a transfer value provides the most relevant information.
- Where liabilities are measured other than at fair value, we believe that the discount rate used to determine a measurement date carrying value should not incorporate an explicit adjustment for 'own credit'.

Our responses to the questions in the DP's Invitation to Comment are set out in the Appendix.

If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,



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Invitation to comment questions

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)?**

Where a liability is incurred in exchange for cash (or other consideration whose value is observable) we believe that it should be recorded initially at the amount of the proceeds. This amount will normally reflect the price of credit risk inherent in the liability, although exceptions will arise in situations such as related party transactions. This is generally consistent with current practice and we see no persuasive reason to change. We are not particularly concerned that this can result in similar cash obligations being measured at different amounts depending on the issuer's credit status - the difference will be reflected in future interest charges.

For other types of liabilities that do not have a cash exchange, such as many provisions, the question becomes one of selecting an appropriate discount rate. As noted in the main body of this letter, we believe that the discount rate should reflect the nature of the obligation rather than the entity's ability to meet the obligation.

Discounting is of course a long-standing challenge in financial reporting, and existing requirements are diverse. Making operational a requirement to discount based on the nature of the liability is of course far from straightforward. We envisage a continued role for the use of appropriate judgement.

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?

With the exception of fair value measurements, our general view is that current measurements of liabilities should not reflect changes in the entity's own credit standing. This is because we believe:

- the effect of incorporating changes in credit risk is to create 'noise' (ie non-useful information) in the income statement
- the burden of the obligation has not changed unless the effect of change in credit risk is that the entity has the practical ability to extinguish the liability for a different amount.

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?

As noted in the main body of this letter, we suggest that the effects of own credit risk should be included in the measurement only in the context of fair value (and then only when credit risk affects the estimated price that would need to be paid to transfer the liability). Accordingly, this issue is not generally applicable under our suggested approach.

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?

Of the alternatives presented, our preferred starting point is approach (c) in paragraph 62 of the Staff Paper. This approach involves:

- measuring borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds
- measuring liabilities that do not have a cash exchange at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk
- subsequent current measurements incorporating changes in market interest rates, but excluding changes arising from the entity's credit quality or the price of credit.

This approach seems simplest to apply of those presented and is consistent with our preference for measuring the liability in a way that is not affected by the obligor's ability to meet the obligation.

However, we note that this proposal involves re-measuring liabilities for changes in market rates. This is not therefore consistent with amortised cost using the effective interest rate as applied to most financial liabilities. The Staff Paper (at paragraph 15) implies that amortised cost is not a current measurement, presumably on the grounds that it is normally determined using a historical discount rate. We note however that amortised cost incorporates current expectations of future cash flows and therefore believe that it could be characterised as a current measure.

On a related matter, we would not necessarily agree that measures of non-financial liabilities necessarily require the use of a current discount rate. We believe that further work is needed on a case-by-case basis to decide whether and when discount rates should be revised after initial recognition.