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Comment Letter on IASB Discussion Paper: *Credit Risk in Liability Measurement* DP/2009/2

The arguments in this Discussion Paper and its accompanying staff paper (IASB, 2009b: hereafter referred to *collectively* as the ‘DP’) illustrate why it is not clear that accounting for liabilities at FV (cf. IASB, 2009a) is always useful. Nevertheless the issue of credit risk arises whatever the underlying measurement basis (although FV, which conceptually clearly requires *remeasurement* when credit risk *changes*, may make the question more acute).

As noted in the DP, at inception existing accounting practice normally measures a liability at ‘the market price’, i.e. the amount at which it was contractually incurred, and this will necessarily reflect own credit standing. If borrower A is riskier than borrower B, then *ceteris paribus* in a ‘perfect market’ (e.g. Bromwich, 2007; Hitz 2007; Dean, 2008; Whittington, 2009), borrower A will face higher interest payments (whose *risk-adjusted* present value is the same as those on B’s borrowing); or equivalently, for the promise of the same interest payments, the amount A can borrow will be less than is available to B (representing the lower certainty-equivalent of A’s *risk adjusted* future interest payments).

However accounting has not found a way to capture the consequent well-known ‘Modigliani-Miller’ effect on the risk to the equity holders—unless outweighed by the profitability of the expected investment of the borrowed money, together with any expected tax benefits etc. (which both increase equity holders’ value), taking on the loan

(with the accompanying penalties that will follow even partial default) increases the probability of the worst case scenario, where the equity holders will receive zero.¹ (Note however, that if the liability represents an obligation under a contract for goods or services, it has long been normal accounting practice to recognise a loss on ‘Day 1’ on inception of any ‘onerous contract’—as proposed by FASB/IASB (2008), cf. Walton 2006.² See further point #2. below.)

Because the anticipated future benefits of deploying the loan do not meet normal accounting recognition criteria, it would be one-sided only to measure the downward effect on equity of the increased risk from borrowing (e.g. by suggestions that the initial measurement should be at a risk-free rate resulting in an initial loss—para 31.). As correcting one side of the error would only exaggerate the other side, accounting thus appears compelled generally to adopt a ‘second best’ solution (Lipsey & Lancaster, 1956) and inevitably fails to paint the full picture at inception of the liability³ (other than through the accompanying disclosures about loan-terms, cash flow commitments etc. that other current and prospective creditors themselves need to assess the impact on their own risk), unless the effect is deemed so serious as to bring doubt that the entity is still a ‘going concern’. But this initial failure cannot justify then further exacerbating it if the debtor’s own credit risk subsequently deteriorates further. So while this DP’s arguments in favour of showing the impact of changes in credit risk on the liability values themselves, if they are to be measured at FV, may generally be accepted to be conceptually consistent, the major controversy arises, as the DP acknowledges, from the

¹ The value to the equity holders of the limited liability ‘put’ (para. 34) is that it protects their value from becoming *negative*.

² Walton (2006) p. 339 argues that IAS37’s notion in 1998 of an ‘onerous contract’ (requiring provision for any anticipated loss as soon as signed) ‘represents a first step towards bringing executory contracts within the boundaries of financial reporting’. But such provision has been part of UK GAAP from long before the beginning of UK accounting standards in 1971 (see e.g. Recommendation N22 of the ICAEW, in 1960, paras. 22(b); 30 (Zeff, 2009)).

³ The staff paper accompanying the DP also raises the issue of other ‘provisions’ e.g. for ‘asset removal’ i.e. decommissioning. It does not discuss whether for such provisions funded ‘internally’ the relevant discount rate should be determined by reference to the rate expected to be earned on the related assets (e.g. paras 13; 25). Note that a decrease in the entity’s credit standing, resulting normally from increasing doubts about its earnings ability, would in this case have the right ‘intuitive’ effect: the discounting rate would likewise fall and the liability would increase, reflecting the increased burden of meeting it out of lower future earnings. This would also be consistent with the conventional approach to accounting for ‘onerous contracts’ discussed above.

related issue of the appropriate reporting of the change in value with regard to the measurement of the entity's income or 'profit'.

Three observations on this crucial aspect of the arguments are relevant:

1. As acknowledged in the DP, changes in credit risk have counter-intuitive consequences for earnings if these are measured as 'change in FV', unless the complementary falls in asset values could also be recognised. Recent empirical research by Barth *et al.* (2008) finds that in practice for a majority of 'ordinary' US firms downward asset revaluations⁴ do outweigh the debt revaluation effect to give an overall value-relevant negative net effect on equity—but by definition any *reported* asset devaluations cannot include what (in addition to falls in previously unrecognised upward asset revaluations) may be the biggest impact for previously successful firms, i.e. the fall in the value of their unrecorded internal goodwill as their credit risk rises (e.g. Macve, 1984; Horton & Macve, 2000).⁵
2. In the case of liabilities representing contractual business obligations, such as 'deferred revenue' for long term contracts (e.g. Macve & Serafeim, 2009), there is widespread unease that using FV could often give a 'Day 1' profit. The latest FASB/IASB DP on 'Revenue Recognition' (December 2008) is therefore against using FV as the Boards' members are 'uncomfortable' about this outcome.⁶ Obviously, their discomfort should be even greater at the idea that a 'Day 2' (or later) profit can arise simply through the contractor's credit rating having subsequently worsened (and therefore the FV of its liability fallen).
3. The issues get even more complex with pension and other post-retirement benefits and with life insurance liabilities: should we be accounting on the basis of immediate

⁴ Insofar as these can be satisfactorily proxied by the reported fall in net income before extraordinary items (p.657). However, this fall could represent only the effect of *current* adverse trading results, without any recognition of consequences of the deterioration in expected future results that largely drives long-term asset impairments.

⁵ The paradox is mirrored when credit rating *improves*. Now the FV of the liability rises so, with 'clean surplus' accounting, comprehensive income *falls* even though the entity's financial position has now improved overall.

⁶ Although this 'discomfort' intuitively seems very wise, it is surely a new Conceptual Framework 'concept' that has not been exposed before?

transfer (FV / ‘CEV’?⁷) or ‘settlement over term’ (i.e. a PV of future cash flows measure) (e.g. Horton *et al.*, 2007). Either way, the issue of ‘credit risk’ requires special consideration. From the point of view of the pensioners and policyholders (and the regulators who act to protect them), should the institutions promising these future protections be allowed to show that their liabilities have got less—giving an improvement in their ‘statement of financial position’—just when it has become less likely (in the eyes of the market) that they will be able to pay them in full? This is more likely to conceal the reality of what is happening to pensioners’ or policyholders’ security than to reveal it.⁸

4. The above three issues are symptomatic of a general failure by standard-setters *directly* to consider the income effects of their proposals for asset and liability valuation. In the case of liabilities that are financial instruments, if they are traded then FV works reasonably well (subject to issues about transaction costs); but where they are not traded, the paradoxes of ‘Hicks’s Income No. I’ [has value changed?] vs. ‘Hicks’s Income No. II’ [has maintainable income changed?] make deciding how most usefully to report earnings *conceptually* intractable⁹—what is needed is more focus on what are the most socially useful *conventions* to adopt to meet the objectives of financial reporting (e.g. Bromwich *et al.*, 2009).

It is a major matter of concern that standard setters’ ingrained, almost exclusive focus on ‘assets and liabilities’ has now almost driven out any direct conceptual debate on ‘income measurement’ / ‘earnings’ (other than tinkering with presentation). But earnings / profit is what users seem primarily interested in for ‘ordinary’ companies (e.g. Penman, 2007). As noted above, the FASB and IASB Board members have now wisely stated that they need to be ‘comfortable’ with the profit patterns resulting from measurement choices (FASB/IASB, 2008). Hence what is best for the balance sheet may be different for the

⁷ CEV = ‘Current Exit Value’ was proposed in the IASB 2007 Discussion Paper *Preliminary Views on Insurance Contracts*. At that time, the Board could not identify any difference between this and FV (Horton *et al.* 2007). Now this DP indicates a move towards preferring ‘fulfilment value’ (para. 3a)).

⁸ IASB (2009c) now illustrates the related difficulties and counterintuitive corporate performance results that have arisen in the current financial crisis when it is not so much the pension sponsors’ own credit risk but the yields on the ‘high quality corporate bonds’, that provide the benchmark for determining their pension liabilities, that have been seriously affected.

⁹ A Hicks No. II approach would exclude the effect of interest rate changes from income (whether or not ‘realised’) (e.g. Macve, 1984; Horton & Macve, 2000): cf. DP paras. 41; 60.

income statement and the two different approaches may then need to be ‘reconciled’, perhaps along the lines of the IAS39 treatment for the ‘Available for Sale’ category of financial instruments. This line of enquiry should be explored further (e.g. Horton & Macve, 1996; see also now a recent paper by Kothari *et al.* 2009).

Alternatively, perhaps it should be decided that consequences for reported income should dominate the standard-setting decision (e.g. Ohlson, 2006). For example, in the case of Executive Stock Option expensing (IASB, 2004), it seems clear that it was the mounting pressure to improve ‘earnings’ for the allegedly hidden ‘cost’ of employment services that outweighed the evidence that the stock market also recognises the ‘benefit’ of the incentives ESOs can provide (Landsman *et al.* 2006). Given that ESOs have no effect on reported assets and liabilities (as the only balance sheet effect is in equity), it was surely the income reporting issues that drove this accounting change (Bromwich *et al.*, 2009). Similarly with credit risk changes, it should surely be the fact that the consequences for ‘income’ of the proposed balance sheet valuation changes make people ‘uncomfortable’ that should also make the IASB Board members ‘uncomfortable’ and lead them to find another solution to how to report liabilities at a relevant current value (with sufficient supplementary disclosure for equity and credit analysts’ needs) while also reporting useful earnings figures.

I am happy to discuss these issues further. Needless to say, these views are my own and cannot be taken as representing the views of colleagues at the LSE, individually or collectively.

Yours faithfully,

[signed electronically]

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