Conseil National de la Comptabilité
3, Boulevard Diderot
75572 PARIS CEDEX 12

Téléphone 01.53.44.52.01

Télécopie 01 53 18 99 43 / 01 53 44 52 33

Internet http://www.cnc.bercy.gouv.fr
Mel jean-francois.lepetit@cnc.finances.gouv.fr

Le Président

JFL/DC

N°53

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IASB
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Dear Madam, dear Sir,

I am writing on behalf of the CNC to comment on the IASB DP "Credit Risk in Liability Measurement".

Having on different occasions called for a debate on this issue, we welcome the IASB's invitation to comment on such an important matter. However, we doubt that such a cross-cutting issue can be thoroughly debated within such short a comment period.

As underlined in the Staff paper accompanying Discussion Paper DP/2009/2, the French delegation on the JWG as well as the CNC have on numerous occasions consistently argued :

- in favour of including own credit risk upon initial recognition in the case of liabilities generated in an exchange transaction, and
- against including an entity's credit risk in the measurement of its liabilities following initial recognition, and therefore against recognising the effects of the change in own credit risk in profit or loss for the following reasons :
  - taking into account an entity's own credit risk, which reflects the possibility of an insolvency, contradicts the going concern presumption in § 23 of the Framework for the Preparation and Presentation of Financial Statements ;
  - the fact that a drop in an entity's credit rating would give rise to immediate profits is counter-intuitive as an entity would usually not have any discretion regarding the settlement of its own debt. It also has a misleading effect in that an entity which is becoming insolvent will appear solvent and profitable.
  - such a situation does not result in decision-useful information for users in their objective of assessing the amounts, timing and uncertainty of the cash outflows

from its obligations ; in practice, we note that users generally eliminate effects of own credit risk's changes;

- the effects of changes in own credit risk reflect changes in an entity's internal operational activities and affairs and may also, at least in part, reflect changes in its internally generated goodwill, which is not recorded under existing accounting standards. This creates an accounting mismatch, as noted in the DP.

Our position remains unchanged.

Our detailed answers to the Discussion Paper's questions are set out in the Appendix 1 to this letter.

We hope you will find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,

Jean-François Lepetit

APPENDIX 1

Answer to the Discussion Paper's specific 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) ?

In its answer to the Discussion Paper "Preliminary Views on Insurance Contracts", the CNC stated that it believes that " users of financial statements find information to be more relevant and more reliable if the measurement of the liability reflects the contractual obligation and the basis for which such liabilities will ultimately be settled (or expected to be settled) ".

Therefore, to answer the above question, the CNC believes that, when a liability is first recognised; its measurement should sometimes incorporate the price of credit risk inherent in the liability.

The distinction is to be based on the origination of the liability :

- when the liability has arisen from an exchange transaction in which the obligations are customarily priced on terms that incorporate the credit risk of the liability (such as in the case of a borrowing or of a issued bond), and as mentioned in DP § 21, we agree that the initial measurement of the liability includes the effects of the borrower's credit risk, adjusted for collateral, guarantees and other features of the contract as the amount exchanged is deemed to represent fair value in that transaction.
- When the liability has not arisen from an exchange transaction, i.e. a transaction for which there is no price per se and therefore no inherent price of credit risk in the transaction, for instance in the case of decommissioning liabilities, we do not believe that the discount rate used in measuring the liability at present value should include the entity's credit risk.

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?

The CNC believes that current and fair value measurements following initial recognition should never incorporate the price of credit risk inherent in the liability, regardless of the distinction expressed in our answer to Question 1, that is that changes in own credit risk should never be recognised in profit or loss or said differently, for those liabilities for which own credit risk was incorporated upon initial recognition, such credit risk remains fixed throughout the life of the liability.

The CNC believes that including credit risk in subsequent measurement of liabilities would fundamentally contradict the going concern assumption under which an entity is expected to settle its liabilities in full. We consider it is inappropriate for a company to take into account the risk that it might not be able to pay its liabilities in full or that it can avoid paying them.

Also, the CNC considers that incorporating the price of credit risk in subsequent measurement would lead to recording gains when credit standing deteriorates which is :

- counter-intuitive as the recording of gains usually demonstrates an improvement in an entity's financial position ;
- misleading as the financial statement of an entity which is becoming insolvent would represented that entity as being solvent and more profitable ;
- and would not provide decision-useful information, as confirmed by users who generally eliminate them, in their analysis of future cash flows from the entity's obligations, their timing and their uncertainty.

Indeed, incorporating credit risk changes could result in an entity unduly offsetting part of losses on its assets by recognising gains on its liabilities. It results de facto in deferring losses creating cut-off issues from one year to the next, as there is no link between losses on assets, based on cash flow appreciation, and gains on liabilities based on the risk adverse attitude of the market towards the instruments issued by the entity.

We note that the same arguments are applicable in the case of the improvement of an entity's credit standing, resulting in the recognition of a loss.

Moreover, the CNC concurs with the statement in DP § 8 according to which "effects of changes in own credit risk of the entity reflect changes in its internal operational activities and affairs and may also, at least in part, reflect changes in its internally generated goodwill, which is not recorded under existing accounting standards".

On the argument regarding matching the accounting treatment of liabilities at fair value or at present value with that of assets, the CNC opposes that most often an entity has a lot of discretion in what it can do with its assets – it can sell them more or less at any time - (and it is therefore appropriate to recognise them at the value for which they could be sold, i.e. at fair value), whereas that is not the case for its liabilities because :

- the entity would usually have to seek for permission in order to be able to transfer its liabilities ;
- the entity would have to finance the settlement or transfer of its liabilities. The conditions required by lenders on that financing will directly or indirectly be linked to the credit standing of the entity : if the credit standing of the entity deteriorates, it would have to pay more to enter into new borrowings. Therefore, fair values changes on own debt due to changes in own credit risk will generally be automatically offset by opposite changes in new borrowing conditions.

Moreover, if an entity purchases its own debt, it will be able to spread the additional costs coming from the funding necessary to the purchase : indeed, it could in effect manipulate its financial statements by replacing its liabilities accounted for at fair value under the fair value option, for instance, and contract a new borrowing which is more costly and accounted for over a longer term on an accrued basis.

We also note that the Financial Crisis Advisory Group, in its report dated 27th July 2009, stated the following with regard to own credit risk in liabilities :

"In addition, as part of the financial instruments project, we have suggested that the Boards reexamine the reporting of gains from declines in the fair value of a reporting entity's own indebtedness within profit or loss, as entities are now permitted to do when they have elected the fair value option under either IFRS or US GAAP.

While there may be some conceptual justifications, reporting gains in profit or loss seems counterintuitive and may not provide relevant, decision-useful information when the gain results from a change in the credit risk of the borrower rather than from the general price of credit, especially when the borrower lacks the ability to buy its own debt and actually realize the gain."

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 the CNC considers that subsequent measurement of liabilities at fair value and using current value measurement should not reflect changes in the entity's own credit risk, reference to risk free interest rates available for the type of debt concerned, to which the own credit risk premium at origination should be added, should be used for subsequent measurement, therefore eliminating changes in the rating of inherent 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?

The CNC agrees with the following approach to liability measurement (approach c in the DP):

- Initially measure :
    - Borrowings and other liabilities that result from an exchange transaction at the amount of the exchange;
    - Liabilities that do not result from a exchange transaction at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk as per our answer to question 3 ;
- Subsequently measure all above-mentioned liabilities incorporating changes in market interest rates, such changes excluding the entity's credit quality or the price of its credit, thus fixing the credit spread at the original amount and incorporating all changes in the risk-free rate as per our answer to question 3.