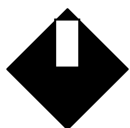

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Comments on the Disccusion Paper of *Credit Risk in Liability Measurement*

To the Board Members:

The Japanese Institute of Certified Public Accountants appreciates the continued efforts of the International Accounting Standard Board (IASB) on the financial crisis and welcomes the opportunity to comment on the discussion paper of *Credit Risk in Liability Measurement.*

As the issues of credit risk in liability measurement have a significant impact on the broad accounting standards, we agree with the IASB's efforts to address them based on public comments. At the same time, we believe that careful examination is required in the handling of these issues.

The following is our response to the items in 'invitation to comment' with which we disagree or have questions or concerns.

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)?

Comment:

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

Under normal circumstances, assets and liabilities are initially recognized based on fair value measurement. However, financial liabilities and non-financial liabilities have different characteristics. For example, with respect to a financial liability to be individually settled in relation to corporate bond issuance which is a third party transaction, the fair value is observable including the spread existing in a transaction between independent third parties. In the case of normal borrowing transactions, the lender normally determines the lending rate or other terms of the loan by considering the non-performance risk of the borrower. Therefore, it is expected that the initial recognition of these transactions is based on fair value measurement. On the other hand, with respect to non-financial liabilities, there is no observable price reflecting their non-performance risk. Furthermore, depending on the nature of the asset related to such liabilities, there may be little necessity to consider the non-performance risk. Therefore, in such cases, credit risk should not be incorporated in the initial measurement of these liabilities.

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?

Commnet:

We believe that current measurements following initial recognition should **sometimes** incorporate the price of credit risk inherent in the liability.

We agree with the view that the impact of changes in the non-performance risk associated with a liability lacks understandability and relevance in that entities are required to recognize benefits that cannot be enjoyed in reality. Furthermore, the price of non-performance risk associated with individual liabilities is not observable. Even if the existence of a market in which the liability can be transferred is assumed, the price estimate should often lack reliability as the debtor is not relieved from its contractual obligation to pay. Therefore, we believe that changes in the non-performance risk should not, in principle, be incorporated into current measurements following initial recognition.

However, certain types of liability, such as derivative liabilities, are required to be measured at fair value or permitted to be measured at fair value at the option of the reporting entity by accounting standards. Since fair value measurement is relevant for these liabilities, if changes in the non-performance risk are to be incorporated into current measurements following initial recognition, it should be done in accordance with the definition of fair value.

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?

Comment:

It is not easy to separate the effect of credit risk in market transactions. Also at the initial recognition, it is impossible to observe directly the credit risk premium included in the interest rate. Such premium can only be estimated (Staff Paper, paragraph 18).

Therefore, we believe it appropriate to permit a method to calculate such amount by subtracting the effect of changes in market interest rates from the change in the market price, as prescribed in "change in fair value not attributable to change in market environment in which market risk is generated" (IFRS 7, paragraph B4).

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?

Comment:

As indicated in the comments to Questions 1 and 2, we believe that it is appropriate to incorporate the price of credit risk inherent in the liability only to a limited extent with respect to both initial measurement and current measurements following initial recognition. Therefore, we prefer the alternative (c) with partial amendment to affect the change of credit risk, not to fix the credit spread, with respect to certain liabilities.

Yours faithfully,

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