MAZARS

IASB
30 Cannon Street
London EC4M 6XH
UK
Paris, August 31st, 2009

Re: DP – Credit risk in liability measurement

Dear Sir or Madam,

MAZARS welcomes the opportunity to comment on the IASB Discussion Paper – Credit Risk in Liability Measurement. Our answer to the discussion paper questions are shown in the appendix to this letter which summarises our concerns and opinion.

We welcome the decision of the Board to issue a discussion paper on own credit risk since its inclusion in liability measurement is one of the most controversial issue.

As a general comment, we strongly disagree with taking into account changes in own credit risk in the measurement of a liability. Thus we recommend the Board:

- to include the own credit risk component in initial measurement only when the own credit risk is priced into the transaction giving rise to the initial recognition of the liability (e.g. financial liability).

- to exclude changes in own credit risk component from any subsequent re-measurement, except when the business model of the entity is to settle a liability at fair value.

Own credit risk mechanically participates in the determination of the initial value of a liability each time the own credit risk is priced into the transaction giving rise to the initial recognition of the liability (e.g. financial liability). If it were not the case, a day-one loss would be recognised each time a liability is issued, as its pricing takes into account the credit risk of the issuer. This credit risk should therefore always be taken into account in the initial recognition of a financial liability.

However, for subsequent measurement of liabilities, the impact of own credit risk variations on profit or loss is entirely counter-intuitive: if the entity were to experience a deterioration of its financial situation resulting in a downgrade of its credit risk, it would see the value of its liabilities decrease, thus leading to a mechanical profit.

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We agree that consistency should exist within an accounting framework. But we are convinced that users of financial statements always favour the relevance of information over this consistency requirement. As mentioned above, we consider that increasing the net asset and income of an entity when it experiences credit deterioration result in misleading information. We also note that users of financial statements generally adjust the reported figures to neutralise this impact. Users are doing so because potential gains or losses related to own credit spread variations are in practice rarely realised, rather reversed in subsequent periods. For all these reasons, we consider that this information which is both misleading and irrelevant should neither appear in the statement of financial position nor in the statement of comprehensive income.

Moreover, we believe that taking into account own credit risk in non financial liabilities measurement would dramatically impair the comparability between entities. We believe that two entities facing the same obligation with the same expected economic outflow should recognise a liability of similar amount without taking into account their own credit quality.

Furthermore, taking into account the credit risk quality of an entity in measuring its non financial liability is in opposition to the going concern principle of the framework. Taking into account in a liability the fact that the entity may default and thus avoid facing its obligation would result in flawed information for financial statements' users.

Our detailed answers are set out in the Appendix.

Do not hesitate to contact us should you wish to discuss our comments.

Best regards,

Michel Barbet-Massin
Head of Financial Reporting Technical Support

APPENDIX

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)?

Yes, sometimes.

We believe that own credit risk should be taken into account on initial measurement of liability each time its initial measurement is determined by reference to the counterparty received (for example financial liability). In most case, this process will avoid creating any difference at inception between the initial carrying value of the loan and cash proceeds.

In all other cases, we believe that the own credit risk should not be taken into account for the following 2 main reasons.

The first reason is comparability. Let's take the example of two manufacturers producing the same device with the same 2-year guarantee. We consider that if both manufacturers have the same expectation of economic outflow related to these guarantee, they should recognise the same liability for the same amount without taking into account their credit risk quality.

The second reason is the going concern principle mentioned in the framework. We strongly disagree with any approach which would lead an entity to minimise its liability because of its non-performance risk (as mentioned in BC31 of IAS 19). We believe that any approach including non-performance risk in the measurement of liabilities would provide flawed information to financial statements' users and could bias the management strategy in a dangerous way.

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?

We believe that current measurement of a liability following initial recognition should never incorporate change in the price of credit risk, except when the business model of the entity is to settle a liability at fair value.

In addition to the reasons mentioned in our answer to question 1, we details below our main concerns.

Taking changes in own credit risk in current measurement of liability would result in counter-intuitive outcome. Each time the financial situation of an entity weakens, its credit risk increases, triggering mechanically a decrease in value of its liability which would generate a gain. This representation of the entity performance is flawed and misleading f or the financial statements' users.

Moreover, this information is irrelevant and useless to users of financial statements. Indeed, we observed that users of financial statements adjust figures in order to neutralise the effect of changes in own credit risk in liability re-measurement.

Eventually, the resulting recognised impact in profit or loss is rarely realised. Even for financial liabilities which are quoted in an active market, an entity rarely chooses to buy back its debt at market price (except in specific business models such as trading liability). And even in this case, recognising a profit or loss impact is misleading as the entity will generally have to finance this buy back with a new debt issue at market condition. In this case, the gain recognised up front would be offset by higher credit spread paid over the life of the new debt and recognised on an accrual basis.

If the Board nevertheless chose to take into account own credit risk variations in the current measurement of a liability, we consider that the related changes in the liability's value should be recognised in other comprehensive income.

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 we already mentioned in our answer to question 2, we consider that the change in credit risk should not be taken into account in the subsequent valuation of a liability.

If own credit risk variations were to be included in the subsequent valuation of a liability, its change in value could be determined by comparing the change in risk free rate and change in recent borrowing cost of the entity (or change in value of its listed Bonds).

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 would favour the approach detailed in paragraph 62 c) of the staff paper.

We disagree with approach a) as it leads to the recognition of a day one profit or loss. We consider that such an outcome is not acceptable as it lead to a wrong representation of the transaction at initial recognition. Indeed, the financial statements' users could consider that the transaction was mis-priced by the entity or concluded at off-market condition.

We disagree with approach b) for the same reasons. Moreover, the proposed recycling mechanism would be complex to implement and to understand for the users of financial statements.

We consider that approach c) is the most operational. Moreover it would lead to relevant and reliable information for the financial statements' users as it will not impair the initial valuation of the liability especially when the liability results from an exchange for cash.