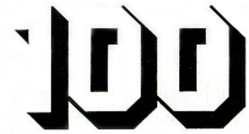


The Hundred Group
of Finance Directors

Financial Reporting Committee

Gavin Francis
Director of Capital Markets
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

22 September 2009

Dear Mr Francis,

Discussion Paper: Credit Risk in Liability Measurement

We are pleased to submit our comments on the above proposals.

Who we are

The Hundred Group represents the views of the finance directors of the UK's largest companies drawn largely, but not entirely, from the constituents of the FTSE100 Index. Our members are the finance directors of companies whose market capitalisation collectively represents over 80% of that of companies listed on the London Stock Exchange. Whilst this letter expresses the views of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

Our comments

On this occasion, we have chosen not to answer the Board's specific questions because we believe that consideration of credit risk in liability measurement is a pervasive issue affecting many IFRSs (for example, those on financial instruments, provisions, post-employment benefits and leases). We therefore wish to focus our comments on the principles underlying the proposals.

Due process

We had expected that consideration of own credit risk in liability measurement would be addressed in the discussion paper on Phase C of the Conceptual Framework project which is expected to be published soon. We are therefore surprised that the Board has chosen to address this issue on a piecemeal basis. Moreover, we are concerned that the Board issued the discussion paper with a restricted comment period of only six weeks during what was the summer holiday season for many of its constituents.

We believe that such a fundamental issue which, by the Board's own admission, has been addressed on a piecemeal basis in the past should be the subject of full and proper due process.

Potentially misleading

We share the concerns expressed in the discussion paper that the inclusion of an entity's own credit risk in the measurement of its liabilities may be misleading for two reasons:

a) it may give counter-intuitive accounting results (as the entity's creditworthiness decreases, it would recognise gains on the re-measurement of its liabilities); and

b) it may not be compatible with the presumption that the entity's financial statements are prepared on a going concern basis.

Relevance

We believe that there are two important debates to be had: first, what are the appropriate bases for measuring liabilities; and second, whether an entity's own credit risk should be taken into account in applying those measurement bases.

Consistent with our comments on the Board's discussion paper on fair value measurement, we believe that the principal qualitative characteristic of a basis of measurement is 'relevance', i.e. is the basis of measurement relevant to an asset or liability in the circumstances of the reporting entity's operations? We believe that the characteristic of relevance is equally important in deciding whether the entity's own credit risk should be taken into account in measuring its liabilities.

We believe that in financial statements 'relevance' should be viewed from the perspective of the entity's shareholders. Accordingly, the measurement of an asset or a liability should reflect the future cash flows that are most likely to be derived from the asset or liability by the entity. For example, if an asset is held for trading, it is appropriate that the measurement of the asset or liability should be based upon its fair value.

Initial measurement

We consider that on initial recognition all liabilities are effectively measured at the present value of the future cash flows required to settle the obligation (though in practice the cash flows associated with most short-term liabilities are not actually discounted because the effect of discounting is not material).

The question at issue here is: what discount rate should be used? Should it, or should it not, reflect the entity's own credit risk?

We believe that the discount rate should reflect the entity's own credit risk only if that risk affects the future cash out flows that are required to settle the obligation (in other words, the entity's own credit risk is *relevant* to those cash flows from the perspective of the entity's shareholders).

Accordingly, where a liability is negotiated on terms that reflect the entity's own credit risk, the discount rate applied to the future cash flows should reflect that risk. For example, the carrying amount of a loan or a finance lease should be based on the interest rate implicit in the loan or lease agreement because that interest rate (and therefore the future interest or rental payments) will reflect, inter alia, the entity's own credit risk.

Where the cash outflows associated with a liability are not affected by the entity's own credit risk, the discount rate applied to the future cash outflows should not reflect that risk. For example, the carrying amount of a provision for environmental remediation costs should be based on a risk-free discount rate because from the perspective of the entity's shareholders

the cash flows are risk free (and the purpose of applying a discount rate is solely to reflect the time value of money).

Subsequent measurement

We believe that the principles that we would apply in the initial measurement of a liability can also be applied to the subsequent measurement of the liability.

The key question at issue here is: what basis of measurement should be applied to the liability? We expect that this will be addressed in the forthcoming discussion paper of Phase C of the Conceptual Framework. Without pre-empting our comments on those proposals, we would remind the Board of our view that the measurement of assets and liabilities should reflect the way in which those assets and liabilities are expected to be realised or settled by the entity.

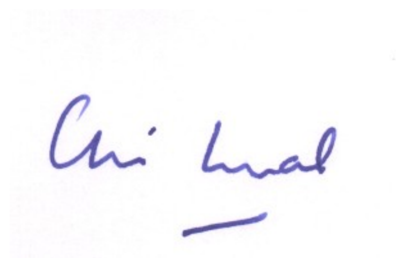
We believe that this implies the continuance of a mixed measurement model in which liabilities will be subsequently measured at cost (or amortised cost) or fair value.

While we recognise that some entities choose to measure certain financial liabilities at fair value in order to eliminate an accounting mismatch, we believe that fair value is usually relevant to the measurement of a liability only if management is committed to the early settlement or transfer of the liability. Fair value in this context will reflect the entity's credit risk but only in the sense that it represents the opportunity cost of the counterparty investing the funds in an entity of equivalent credit risk (because in the case of early settlement or transfer the creditworthiness of the entity itself would no longer be relevant).

We believe that other liabilities should be subsequently measured at cost or amortised cost. Where the liability was negotiated on terms that reflected the entity's own credit risk, the applicable discount rate should be changed only if the terms are changed. Otherwise, the discount rate will change in response to changes in the market-related risk free interest rate so as to reflect changes in the time value of money.

Please feel free to contact me if you wish to discuss our comments on the proposals.

Yours sincerely,



Chris Lucas
Chairman
The Hundred Group - Financial Reporting Committee