



25 August 2009

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

Dear Board Members:

Consejo Mexicano para la Investigación y Desarrollo de Normas de Información Financiera (CINIF), the accounting standard setting body in Mexico, welcomes the opportunity to submit its comments on the Discussion Paper on Credit Risk in Liability Measurement. Set forth below you will find our comments to the topics included in the Discussion Paper.

### **Our viewpoint**

We have read the Discussion Paper on Credit Risk in Liability Measurement, and we believe that several of the proposals are constructed on a very unstable basis, if there is any basis at all. There are several economic concepts that are opposed to basic financial reporting principles.

The main question is why some liabilities are measured (or intrinsically measured) considering the credit risk of the entity and other are not. We believe it is because this is the best way to determine the cash outflows that will be required to extinguish the liabilities.

A business on a going concern basis will be paying all of its liabilities, and therefore what is needed is to value such liabilities such that at the date they are paid the amount reflected in the statement of financial position is the amount being paid. This is easy for accounts payable to suppliers since the full amount of the invoice will be paid, with perhaps a prompt payment discount being allowed. However, the entity cannot tell the supplier that a reduction in the payment will be made because its credit risk has increased. If that would happen, the entity would run out of suppliers and run out of business.

Likewise, if an entity proposes to its financial creditors that they will receive a lower payment because its credit risk is higher, the entity would cut its access to future financing. Also, an entity cannot tell its employees that the payments they will receive in the future will be adjusted taking into consideration its credit risk. Doing so will not allow them to retain or hire the best people, and the entity will have problems.

Therefore, an entity should not measure its liabilities at an amount different than the amount it will pay. In the normal course of business, suppliers are to be paid in accordance with the negotiated terms, creditors will receive the principal they loaned with the agreed-upon interest, and employees will receive the amounts that were agreed with them.

We understand that this may change if an entity is financially unstable and its going concern capability is questioned, but that is a question of restructuring troubled debt and not of measuring liabilities on a going-concern basis.

### **Arguments in favor incorporating credit risk**

The Discussion Paper includes some arguments in favor incorporating credit risk. Below you will find our comments on these arguments.

#### **Consistency at initial recognition**

The first argument deals with consistency at initial recognition. It is a fact that certain liabilities incorporate a credit risk factor when initially recognized. For instance a supplier may charge more to a start-up business due to lack of volume, but also due to a perception of higher risk. In the case of a loan, a bank may charge a higher interest rate to a start-up than to an "AA" entity, which makes the present value of future payments for the start up higher if these were discounted at the same rate of the "AA" entity. However, that is how businesses operate, and the effect of a higher interest rate will be shown in the statement of income with no need to also show it in the balance sheet.

Also, other liabilities such as employee benefits and future restoration costs are measured discounting the estimated future cash flows using a risk-free interest rate. This rate is indeed different than the rate the entity is paying due to its credit risk when financing is being obtained, but it allows the same kind of liability to be measured with the same metrics in all entities. As a result, the liability will differ due only to higher or lower benefits and the size of the labor force of the entity.

Therefore, what we believe would be conceptually consistent would be to initially recognize each liability at the amount that will be paid, which is either an agreed-upon amount or an estimated amount for certain liabilities. The implicit interest rate in each of them might be different, but the goal is to determine how much will be paid and not measure all of them with the same rate.

#### **Wealth transfer**

The argument of wealth transfer does not have a sound basis. If an entity does not have sufficient resources to pay its debt, it does not mean that the liability is lower and equity has increased. In all cases of entities in financial trouble, equity is diluted by the losses the entity is incurring. If at the end of a restructuring process the entity will pay less to its creditors, it is due to negotiations that led the creditors to accept a reduction of the future cash flows they will receive from a going-concern entity rather than receiving what may be left in the case of liquidation liquidation.

Therefore, there is no wealth transfer just because of a change in the credit risk of an entity, but only when an agreement to restructure debt is reached. The equity owners will not be better off until the debt is restructured.

Conversely, the improvement of credit risk also does not create a wealth transfer, since the creditors will not receive more at the expense of the equity owners. They could receive less if the cash generation of the entity is such that it has the possibility to prepay the liabilities.

### **Accounting mismatch**

The accounting mismatch due to the fact that the credit risk is incorporated in the value of assets and not in the value of liabilities is not a valid argument. An entity usually has several customers and some of them might experience an increase in their credit risk that may originate an impairment of the amounts receivable from some of them. However, that should not be reflected in the amount of the liabilities just by considering that the credit risk of the entity is also lower because certain receivables have a credit risk problem. Our experience is that entities on a going-concern basis recognize the losses from receivables but still have to pay their suppliers and creditors the agreed-upon amounts.

Therefore, it is a false argument to suggest that to avoid an accounting mismatch liabilities must be adjusted since a loss has created a credit risk. If the entity continues in business it will pay the full amount of the liabilities and recover the losses from its customers (or any other financial asset) with cash generated from its current operations.

### **Arguments against incorporating the credit risk**

The Discussion Paper also incorporates certain arguments against incorporating the credit risk in the measurement of liabilities. We believe that these arguments make sense. Below are our comments on these arguments.

### **Counter-intuitive results**

We fully agree with the statement included in the Discussion Paper that “*Gains should result from improvements in an entity’s financial position, not declines. Reporting a gain from a decline in credit risk is potentially misleading and can mask a deteriorating situation.*” We believe that the reader of financial statements will be misled when a profit is reported and liabilities are stated at an amount less than the one that is to be paid. For reporting purposes it would be illogical to recognize a profit just because there is a possibility that because of a lower credit risk the creditor may agree to receive a lower amount. Creditors are not soft people.

The Discussion Paper also indicates that “*A decrease in the liability’s estimated cash flows for reasons other than credit obviously benefits the owners. A change in credit risk does not.*” We fully agree with this statement.

### **Accounting mismatch**

Paragraph 47 of the Discussion Paper indicates that liabilities do not change in vacuum to support including credit standing in liability measurement. We believe that only a transaction or an external event may make them change, but not an internal estimate of a change in credit risk standing. The external events that may originate a change in a liability may be a change in the general market interest rates at which employee benefits are measured or a new technology that will make site restoration less expensive.

There are internal events that change assets, such as transforming raw materials into finished goods, that have to be accounted for. Also, transactions such as hiring or discharging employees may change the employee benefit liability.

As previously indicated, it is common for an entity to have declines in the value of its assets, such as losses due to unrecoverable receivables, which result in losses that may affect the credit risk standing of the entity. But as this will not change the amounts due to suppliers or creditors, we do not see how this change in credit risk standing has to be recognized.

### **Realization**

We believe that realization of the benefit of having liabilities traded below face value because of a deterioration of credit risk standing is very difficult, if not impossible. It may be very difficult to raise cash from a new loan or issue of bonds when the credit risk standing has deteriorated. If possible, creditors or investors will require a much higher interest rate and guarantees on the entity's assets. Usually the spread between the new interest rate and the old one will wipe out any profit in paying the old debt with a new loan, which would not make business sense and would raise questions whether in fact a profit has been realized.

We consider that fair value is a good measure for assets, as these are continuously sold, used in cash generating activities or recovered through collection. Changes in their fair values can lead to lower sales, cash generation or collections. However, in the normal course of business, trade and financing liabilities are usually paid at their face value. Those that are paid based on their fair value are derivative financial instruments that are to be paid at their fair value on their liquidation date.

### **Alternatives to including credit risk**

Regarding the alternatives proposed in paragraph 62, we believe that the one that should be used is alternative c), which states that "*Measuring borrowing and other liabilities that result from an exchange for cash at the amount of cash proceeds. Measure liabilities that do not have a cash exchange at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk.*" This alternative should also address trade accounts payable, which should be valued at the agreed-upon value of goods or services.

### **Questions for respondents**

Set forth below are our answers to the questions included in the Discussion Paper:

#### **Question 1**

*When a liability is first recognized, its measurement (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why?*

We believe that a liability should never include in the initial measurement the price of credit risk and should always be valued at the amount that is agreed to be paid in the case of trade accounts payable or financing. In the case of financing the credit risk is implicitly recognized in the interest rate of the loan or financial instruments issued. However, the amount that has to be shown in the statement of financial position should be the amount the entity has agreed to pay.

In the case of other liabilities whose amount has to be estimated, such as employee benefits and site restoration costs, and for which the payment date is uncertain but is

long term and has to be estimated, the liability should be initially recognized at present value using a risk free market rate. This is because the only way to make a comparison of such liabilities among entities is using the same rate, and being an estimate of a future disbursement using a market risk free rate will allow the use the less optimistic approach.

Question 1 also requests that:

*(b) If the answer is “never”:*

- (i) What interest rates should be used in the measurement?*
- (ii) What should be done with the difference between the computed amount and cash proceeds (if any)?*

We believe that these questions are irrelevant and even biased to the objective of recognizing the credit risk standing of the entity, with which we do not concur. As indicated above the liability should be shown at the amount to be paid and the agreed interest rate of the financing should be used, either stated in the loan or issuance agreement or implicit. Therefore there is no question of measuring the liability at any different rate and no difference is to be recognized separately.

## **Question 2**

*Should current measurements following initial recognition (a) always, (B) sometimes or (c) never incorporate the price risk inherent in the liability? Why?*

Our answer follows the same rationale as above. There should be no remeasurement of the liability because of changes in the credit risk standing of an entity. That could lead to presenting a liability different to the amount to be paid and the objective of financial statements regarding liabilities is to show the amount to be paid, based on the agreed upon financing terms or the amount agree to purchase goods or services.

As indicated above, estimated liabilities should be measured using a risk free market interest rate.

## **Question 3**

*How should the amount of a change in market interest rate attributable to the price of credit risk inherent in the liability be determined?*

As far as we do not believe in measuring liabilities considering the interest rates attributable to the credit risk standing of the entity, answering this question is irrelevant.

## **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?*

Regarding the alternatives proposed in paragraph 62, we believe that the one that should be used is alternative c), which states that “*Measuring borrowing and other liabilities that result from an exchange for cash at the amount of cash proceeds. Measure liabilities that do not have a cash exchange at the present value of expected future cash flows, discounted at market rates that exclude the effect of credit risk.*” This alternative should also address trade accounts payable, which should be valued at the agreed-upon value of goods or services.

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Should you require additional information on our comments listed above, please contact Juan M. Gras at (52) 55 5596 5633 ext 105 or me at (52) 55-5596 5633 ext 103 or by e-mail at [jgras@cinif.org.mx](mailto:jgras@cinif.org.mx) or [fperezcervantes@cinif.org.mx](mailto:fperezcervantes@cinif.org.mx), respectively

Sincerely,

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President of Consejo Mexicano para la Investigacion y Desarrollo  
de Normas de Informacion Financiera (CINIF) (The Mexican  
Financial Reporting Standard Board – MFRSB)