Background

As the decade, century and millennium draw to a close, there has been a groundswell of activity in a variety of accounting circles in which the basic balance sheet model for financial reporting has come under review. While the discussion is most obviously taking place under the auspices of the International Accounting Standards Committee (IASC), reviews are also under way in the Financial Accounting Standards Board (FASB) in the United States, the G4+1 (made up of the accounting standard setting bodies of Great Britain, the U. S., Canada, Australia, New Zealand, and the IASC), and in the Joint Working Party of Independent Accounting Standard Setters (made up of representatives from about twenty accounting organizations). A common theme in these deliberations is the issue of how to report the value of financial instruments (e.g., bonds and stocks) and related assets. At this stage, the consensus seems to be moving in the direction of reporting these on the basis of fair values. In the interest of consistency in financial statements, many are advocating that, where assets are valued on a fair value basis, their value as liabilities (on the part of the issuers or obligees) should be as well.

While most actuaries and accountants involved in the discussion have a general understanding of, and comfort with, what the fair value of assets might be, there is still a great deal of controversy surrounding the determination of the fair value of liabilities. Currently, one of the most contentious issues in the development of an agreed upon methodology to determine the fair value of certain liabilities has been whether, or how, to reflect the expected risk associated with the credit standing of the enterprise that bears the responsibility for fulfilling the obligation. One reason for this controversy is that, while many financial instruments held as assets (the right to receive future cash flows upon fulfillment of specified conditions) are traded (traded) in active markets, many financial instruments held as liabilities (future obligations) are not.

The objective of this paper is not to determine the final answer to the question of whether the enterprise’s own credit risk should be reflected in its liabilities, but is to present a discussion of the issues involved. Thereby, we intend to alert actuaries and others to these developments and we hope this will assist in reaching an appropriate resolution of the matter. Consequently, further discussion of the topic is encouraged.

Definitions

A few definitions are needed to provide framework for this discussion:

- **Liability.** A liability is “a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits” (IASC Framework, paragraph 49). Typically, this obligation takes the form of future cash flows or their equivalent. As such, their value is affected by expectations associated with the amount and timing of the cash flows and by risk preferences.

- **Financial liability.** A financial liability is “any liability that is a contractual obligation: (1) to deliver cash or another financial asset to another enterprise; or (2) to exchange financial
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instruments with another enterprise under conditions that are potentially unfavorable” (IAS 32, paragraph 5).

- **Fair value.** Fair value is “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction” (IAS 32, paragraph 5). Fair values have sometimes been interpreted as being market values if a sufficiently active market exists and as being estimates of what market values would be if an active market did exist. In the latter case, a present value based model of future cash flows is often used as a surrogate for market values.

- **Risk.** In this context, risk is the financial effect of uncertain future events. An efficient market will incorporate in the market price of a financial instrument many types of risk, including credit risk.

- **Credit standing.** Credit standing is the assessment by an outside party, such as a rating organization, of the financial creditworthiness of an enterprise.

- **Credit standing risk.** Credit standing risk is the risk associated with the possible deterioration in an enterprise’s credit standing. In some cases, a significant deterioration in credit standing may precipitate liquidity problems, such as in a ‘run-on-the-bank’ situation of a financial institution, which may in turn lead to an inability to fulfil the obligation.

- **Default risk.** Default risk is the risk associated with the possible inability of a party to be able to fulfil a specific financial obligation or set of obligations, for example, as a result of becoming insolvent. It represents an important subset of credit risk, not reflecting the probability of a credit downgrade not involving default risk during the period in question.

- **Credit risk.** Credit risk is the general risk associated with possible future deterioration of credit standing of the enterprise(s) responsible for fulfilling the applicable future obligation and also reflects the probability associated with lack of complete fulfillment of the terms of a particular obligation. As such, it has elements of both default risk and credit standing risk. Although both credit risk and default risk can be affected by the overall financial condition of an enterprise, within the context of this discussion paper and in the context of a specific obligation, they both relate to performance relative to that specific obligation. In certain cases, the uncertainty associated with payment may only involve the timing of payment and not the amount; in such cases, the impact would be the difference in the present value of the actual payments and the present value of promised payments. Note that most publicly available credit ratings relate to the financial condition of the enterprise as a whole rather than to a specific obligation.

- **Going concern.** “The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed” (IASC Framework, paragraph 23). Other accounting regimes, such as the one
adopted by the FASB do not assume that a going concern is a fundamental concept underlying accounting standards.

**Statement of the Issue**

Although the methodology for the determination of the fair value of assets has been discussed extensively, it is only recently that the fair value of liabilities has been given a significant amount of attention. It is well documented and understood that, in a fair value accounting system, an asset that is freely traded in an efficient market is expected to have a reported value that reflects its market value fairly closely. The issue of whether such reported value should reflect the market value in a particular market at a point in time, or an average value over a period of time and/or over a number of markets is beyond the scope of this discussion. Let it suffice that some standard will have been established which relates the reported fair value of an asset to its market value in a fairly direct manner.

Further, it is widely accepted that the value that a market places upon an asset incorporates, in some measure, an expectation of the likelihood that the nominal value of the asset is, or will be, realizable. In most cases, market considerations differ for different asset categories, as follows:

- **Equity assets.** A common example is common shares (stocks). Since the issuer of shares has no contractual obligation to the holder of the asset, that expectation is formed on the basis of an assessment of the future financial prospects of the issuing enterprise and how the market will react to these prospects.

- **Debt assets.** The expectation here is based, as well, upon the specific contractual obligation undertaken by the issuer (or the party expected to be responsible for fulfilling the obligation), since it is presumed that the market price incorporates an assessment of the likelihood that the issuer will be able to fulfill its contractual obligation. In many but by no means all cases relating to a specific obligation, the assessment of default risk is based upon the credit standing of the issuer.

Where there is no active market, a variety of techniques, depending on the nature of the asset, may be employed to establish a fair value of the asset meant to reflect the asset’s market value as if an active, efficient market for it were to exist. One common approach is to apply present value techniques, appropriately adjusting for applicable risks.

There has been far less consideration of what might be reported as the fair value of liabilities. It has been suggested by some in the accounting community that, where an efficient market exists for a debt asset, the issuer of that debt should report in its financial statement a liability value equal to the value reported by the holder of the corresponding asset. This is equivalent to assigning a value to the liability that reflects directly the value that the market places upon it as an asset. Since the market is presumed to incorporate in its valuation its composite assessment of the likelihood that the obligation will be fulfilled (e.g., will reflect the default risk of the issuer of the obligation), it has been suggested that, in a fair value system, the value of a liability should also reflect the likelihood that the obligation will be fulfilled (i.e., that the value assigned to the
liability should also reflect the credit standing of the issuing enterprise). Others, however, are not convinced of the validity of this position and are concerned about anomalies that its adoption as a standard could generate. The focus of this paper is to review the arguments on both sides of this question and to stimulate further discussion based on these arguments.

**Types of Obligations and Relevant Characteristics**

There are a number of types of obligations for which a liability would be included in the balance sheet of an enterprise and for which the amount or timing of associated future cash flows might be altered by the credit standing of the responsible party. These include:

- Accounts payable
- Unsecured debts
- Collateralized obligations
- Property/casualty loss liabilities
- Life insurance policy liabilities
- Demand deposits
- Pension plan liabilities.

A number of characteristics of these liabilities should be considered in this discussion including:

1. **Who bears the responsibility for fulfillment** of the obligation. In some cases, by contract or agreement, the full obligation remains with the original party even if the obligation is exchanged. In others, some or all of the responsibility may be exchanged as well. Thus, for a particular obligation, whether the responsibility can be transferred by sale or settlement may also affect its recognition for accounting purposes. This characteristic of the obligation may influence its treatment for credit risk recognition. To the extent that the party at risk for the obligation is transferable may create significant issues associated with the determination of whose credit risk should be recognized in a fair value environment in which value reflects the realizable value on sale or exchange. While the enterprise currently responsible for an obligation is ordinarily the relevant one, in this case the enterprise(s) expected to be responsible when the commitment comes due is more important.

   For example, currently it is difficult either to exchange or to transfer insurance obligations, except through reinsurance or issuance of certain catastrophe bonds. Sales of blocks of business have occurred, but the market is neither deep nor efficient, so it is unlikely that prices can be derived directly from the prices of these transactions. In many such sales the responsibility for fulfillment is transferred, but that is not always the case.

2. **The existence of markets** for the obligation. If an efficient, active market exists, more support is likely to be given to the reflection of credit risk. To the extent that such market does not exist, recognition becomes more problematic, in respect of both whether, and to what extent, credit risk should be reflected. The tradability of liabilities, depending on type and availability of markets, can vary significantly by type of obligation and within each type. However, there has been a trend toward an increase in markets for a number of obligations, for example through securitization.
3. These liabilities could also be categorized by the degree to which a **third party** will fully or partially **guarantee** to undertake the obligation. Assuming that the guarantor will be able to fulfill the obligation if and when the issuer is unable to do so, a resultant reduction in credit risk associated with the obligation should be expected. A pertinent example is a governmental guarantee for deposit insurance. This guarantee might be provided through law, regulation or contract. In certain cases, it may exist as a result of the general environment (such as government authorized to take over a bank or insurer before insolvency occurs in order to assure payment to the policyholders and/or investors). To the extent that such explicit or implicit guarantee exists, the credit risk associated with a specific liability would be expected to reflect, if anything, the credit risk of the third party guarantor (assuming that it is better than that of the original obligee). In fact, the market price for an obligation can be expected to reflect such a guarantee. This would support the contention that, for any liability with an explicit, or a sufficiently strong implicit, guarantee, credit risk if reflected in its fair value should be so only to the extent that the obligation is likely not to be fulfilled, and not simply to the extent of the expected ability of the issuer to fulfill it (measured in terms of probabilities associated with frequency, timing and severity).

**Users of Financial Statements**

The emphasis given specific elements of general purpose financial statements may vary depending upon the user of the statements. Therefore, the values presented in public financial statements may not satisfy all the needs of every reader of a financial statement. It may be useful, though, to consider who are the potential users of such values and what are their perspectives. A significant consideration in evaluating whether to reflect credit risk in the value of a liability may be whether the potential user is more interested in the unadjusted liability value or the market’s (or an estimate of the market’s) assessment of it.

Users include the following:

- **Owners and potential owners** of the enterprise that bears the responsibility for fulfilling the obligation. This group of users is interested in the degree to which fixed obligations exist that may affect their interest as well as the impact the obligation will have on the financial condition of the enterprise. They are often the ones for whose needs general purpose accounting is primarily aimed. Although moral hazard (in this case, the possibility that incentives will arise not to fulfill an obligation) may exist, their primary interest is to assess the value (cost) and risks associated with the obligation that they are obliged to fulfill.

- **Creditors**. Creditors need to assess the financial condition of the enterprise that is responsible for fulfillment of the obligation. They may wish to assess it themselves, independent of a market assessment (if an efficient market existed, the information is assumed to be equally available to all with a common assessment of risk). In fact, the application of the market’s assessment may simply complicate their analysis (unless the unadjusted values are disclosed separately).
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- **Managers.** If there is a market for an enterprise’s obligations, its managers should assess the implications of whether to participate in this market. It would be lax of management to remain ignorant of the financial impact of the market’s assessment of the enterprise’s own credit risk, since this risk affects its cost of new debt and capital. Nevertheless, it would seem quite unusual, and of questionable integrity, that management would want to assume that the enterprise would not honor its obligations. In fact, it may be against the public interest for an enterprise to enter into a transaction with an expectation of not honoring it, or rather, in reflecting the probability and / or cost of not honoring it. Clearly, however, in management planning and decision-making, management should recognize the costs associated with potential changes in the enterprise’s credit standing.

- **Regulators.** One of the most important functions of a regulator of an enterprise is to monitor and evaluate its solvency. In such analysis, it does not seem reasonable to reflect the enterprise’s own credit risk. The information the regulator seeks would be used to determine whether the public interest is likely to be affected adversely by the financial condition of the enterprise. That perspective should not be affected by the market’s assessment of specific balance sheet items.

If it is assumed, by the market or others, that the enterprise is a going concern (that is, it will remain sufficiently solvent to meet its obligations in a timely manner), a user would be interested in financial reporting values that do not reflect credit risk. This points to the need for possible inclusion of an enterprise’s credit standing, and the consequence thereof, in the notes to financial reports. Moreover, if one were to assume that the obligation(s) would be fulfilled whether or not the enterprise was solvent, the reported value of the liabilities should not reflect credit risk of the issuer.

Two questions arise:

(1) Is the assumption of a going concern with no nonpayment risk an appropriate one?

(2) Even if this is not an appropriate assumption, does a flaw exist in the recognition of the probability of non-performance of the obligation?

**The Case for Recognizing Credit Standing**

Several arguments have been raised in favor of the recognition of credit standing in the valuation of an enterprise’s own liabilities. A number of them follow:

1. **The value of an obligation as a liability should equal the value of that obligation as an asset.** An efficient market for the obligation (if one exists) will recognize the probability that the obligation will be fulfilled. If within the context of a fair value accounting environment this is recognized in the value of an asset, then the principle of consistency of market recognition demands that it be recognized in the value of the same obligation as a liability. By definition, it is argued, the fair value of a liability should be based on its market value if an active market exists or on an estimate of its market value if no active market exists. Not
to do so would be inconsistent with the definition of fair value. Though the concept of estimating a fair value in an inefficient market is less clear, the application of efficient market concepts seems to be the most appropriate available.

2. **The value of an obligation should mirror what would happen if exchanged for its fair value.** In response to the argument that it is illogical for an enterprise in decline to register an increase in capital as a result of deterioration in its credit rating, proponents argue that this “increase in profitability” would be precisely the effect that would be recorded in financial statements if the enterprise were to exchange (settle) its obligation in the market for its then fair value (consistent with the intent of fair value reporting). Moreover, it is argued, if the enterprise had to finance the retirement of its debt obligation by taking on another obligation, then the latter obligation would be available only on a basis reflecting the enterprise’s current credit standing. Therefore, although the result considered in isolation is apparently illogical, it may be consistent with the change in market realities.

3. **A liability should reflect market realities.** Not to reflect credit standing for a class of obligations that is traded in an active market might lead to a difference between market value (assuming that such values are based on discounted expected future cash flows reflecting risk) and reported value, reflecting the amount of likely future cash flows. The value of these future cash flows associated with the obligation is referred to by Black and Scholes as a “default put option.” If such a difference does emerge, the enterprise might exchange its obligations to achieve an immediate reported profit that may not be in its best economic interest. Business decisions that rely on such accounting arbitrage, rather than on sound economic reasons, might lead to inferior decisions.

4. **Apparent illogical result only due to looking at one item, rather the entire balance sheet.** The apparently illogical result of a change in credit rating resulting in the opposite change in reported financial condition may not be a reality, but may only be due to the fact that the liability is examined in isolation or on a marginal basis, rather than as part of the overall financial statement of the enterprise. If the condition that contributed to the change in credit standing is reflected elsewhere in the financial statements at the same time (assuming that the market is efficient with respect to this information), it would be inappropriate to look only at the marginal impact of the change in the enterprise’s own liabilities. Only to the extent that the cause of the change in credit standing is not reflected in the enterprise’s reported assets and liabilities would an inconsistency in the reported results of the enterprise occur. The fact that two types of change may occur (those recognized in the enterprise’s accounts and those that are not) may, however, lead to practical problems in estimating this impact in a timely manner.

5. **Even though there is a problem with (4) to the extent of changes in intangible assets or liabilities, one should not try to offset one problem with another one.** Even though financial reporting currently does not, in an effective manner, explicitly address the consequence of changes in intangibles which can influence assessment of credit risk, not to do a good job in one area of financial reporting, simply because another area is not perfect, is inappropriate. That is, two wrongs do not make a right.
The Case Against Recognizing Credit Standing

Several arguments have been presented in opposition to the reflection of credit risk in determining the value of liabilities. A number of observers contend that in a fair value accounting system, the assertion that the reported value of one enterprise’s liability must be equal to the value at which another holds it as an asset is not necessary, not proven, and simply not acceptable. The arguments presented include the following:

1. **Reflection of own credit risk will lead to an illogical result.** Opponents of recognition of an enterprise’s own credit risk in valuing its liabilities have noted that such an approach can lead to an internally illogical, if not misleading, result. This is evident during a period during which the enterprise’s credit standing deteriorates, wherein the value of its obligations decreases, leading to an increase in reported profitability and a potential improvement in the level of the enterprise’s capital/surplus. Conversely, if an enterprise takes action to enhance its credit-worthiness, its reported profitability could suffer as it writes up the value of its liabilities to reflect the improvement in its credit risk. Many users of financial statements will neither understand, nor accept, such anomalies or explanations of changes in financial condition and performance measurement.

   If an enterprise decreases the reported value of its liability to reflect its own depressed credit rating but ultimately pays all of the amounts owed, over time it will experience losses as the obligation is met simply because it was a good corporate citizen. It seems illogical that the fulfillment of its obligation, a good thing, would result in a loss, a bad thing. In fact, an incentive for management to default on the obligation (moral hazard) is thus created. In certain cases the improvement in a credit rating could lead to deteriorating financial results, as the liability increases in value.

2. **The importance of the expectation that the enterprise will fulfill its obligation matter.** The case for fair value of an asset being fairly directly related to market values and, therefore, reflective of credit rating of the issuer is a reasonable one on the basis of an arm’s length view. However, for a liability, the arm’s length view is not appropriate. Ultimately, the question is, “Does the enterprise intend to meet its obligation?” If it does, then it should tell that to the public by valuing its obligation with 100% probability of meeting it. To do otherwise suggests that management is questioning its own integrity. For management of an enterprise to incorporate, in its public financial statements, a valuation of its liabilities which is reduced to reflect the market’s assessment of the likelihood that the associated obligations will not be met, is tantamount to denial by management of its responsibility to fulfill those obligations.

3. **The perspective to be used.** The market for many liabilities is either inefficient or does not exist. In such cases, relevant discounted cash flows can be used to value the liability, but this in turn raises the question of from whose perspective should the expected cash flows be assessed. From the perspective of the enterprise that is currently responsible for the legal obligation, the expectation that the obligation will be fulfilled should be adopted. Consequently, it would not be appropriate to reflect credit risk. For example, once a
property/casualty contract is sold, any loss that occurs is rarely sold or exchanged again. To reduce the value of the loss provision based on changes in the credit standing of the insurer, in an attempt to reflect a market, does not make sense because the obligation will not be marketed. Conversely, from the perspective of the owner of the obligation as an asset, it is appropriate for expected cash flows to reflect the probability of receipt of the cash flows is appropriate. Thus a distinction would be appropriate between the obligation as an asset and as a liability. In addition, a distinction between different types of liabilities may be appropriate because of the perspective required.

4. **Impact of possible exchange.** In a fair value environment, if the obligation for performance is transferred through a sale or exchange, the default or credit standing risk of the original party obliged to perform, is no longer applicable. Since the fair value concept is predicated on what a liability could be settled, and with whom it would be settled, it is impossible to determine who the subsequent obligee would be and what its credit risk will be. As a result of a lack of knowledge of whether the obligation will ultimately be paid, it follows that an assumption should be made that it will be ultimately be paid, for other possibilities would not be measurable. If the enterprise wants to transfer its liability (and the succeeding party has a higher credit rating), it would likely have to pay a higher price than the value in its balance sheet, with a resulting loss. Whether or not the enterprise actually sells the liability, application of the credit rating adjustment argument would suggest that the fair value of the obligation on its balance sheet would then seem not to require application of its own credit rating, but rather to demand the application of the credit rating of the most likely purchaser of the obligation. Thus, by ‘reductio ad absurdum’ the logic of adjustment for credit rating must be rejected.

5. **If a credit risk event occurs, the enterprise is unlikely to have the money to exchange it, making market comparisons irrelevant.** The argument that credit standing should be reflected in the value of a liability which is actively traded as an asset, on the ground that the liability could be retired by the issuing enterprise by trading in the market, is flawed. In particular, the more material the apparent reported benefit of exercising that option, the more unlikely it is that the enterprise has sufficient funds available to do so. In fact, as the enterprise becomes less able to exercise the option, the apparent reported benefit is inflated. The consequent information provided to the public users of the statements is therefore misleading.

6. **Potential logic to include credit risk is untenable when carried to the extreme.** As noted above, it is illogical to decrease the reported value of the liability (with concomitant improvement in the reported income of the enterprise) during a worsening of financial condition. One commentator has indicated that, taken to the extreme, this argument would lead to an enterprise technically never be declared insolvent/bankrupt until it has exhausted all of its assets. This is not a defensible position.

6. **Inconsistent with going concern principle.** According to the Framework document of the IASC, accounting statements should be prepared according to the International Accounting Standards only on the basis that an enterprise is a going concern since, upon liquidation, an enterprise’s accounts may be very different. If the enterprise is expected to be a going
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concern, it is a reasonable expectation that it will continue to be such and, therefore, that the obligation will be performed according to the applicable contract with 100% likelihood. Note that in some other accounting systems, such as the one currently applied in the U.S., the going concern assumption is not required.

7. **If change in credit standing is due to values of intangibles, inconsistent overall result will occur.** A change in credit standing can be generated by a change in intangibles or for some other reason that is not reflected in the accounts of the entity, such as a decrease in intellectual capital, loss of value of brand, or increase in liquidity risk. To the extent that a change in credit risk arises from such source, the illogical result of reflecting credit risk noted above will always result. If it was determined that it was partly due to a tangible effect, it might prove to be impractical to estimate this tangible effect.

8. **Could lead to unstable financial results.** Reflection of credit standing in the value of liabilities could lead to financial reporting instability (the “yo-yo” argument). Consider, for example, that without reflection of credit risk reported values are: Assets = 100; Liabilities = 105. In most such cases, a significant default risk would exist. However, if inclusion of an estimate of such credit risk would reduce the value of the liability by 15, the consequent capital and surplus account becomes +10. If this were recognized as the economic worth of the enterprise, the market (or rating agencies, or loan providers) might reassess the credit risk to 5. Although this case would be unlikely, it illustrates the possible oscillating instability of reported financial values. Which value would be recognized? Could it stabilize?

9. **Credit risk is ultimately a result of entire enterprise, not a specific liability.** While the market may reflect general credit standing, it does always do so in a direct or explicit manner. A decline in market value following a deterioration of credit standing can simply reflect a change in the demand for a higher return as a result of a perceived increase in risk. In fact, the contractual obligation of the debtor need not have changed, any more than it would have changed had the debtor realigned its assets to match better the cash flows of its obligations. The reflection of credit risk is not an issue related to a particular obligation, but rather to the financial condition of the enterprise as a whole. It would be illogical to reflect the long-term credit worthiness of an enterprise in the reported value of a short-term obligation.

10. **Such reflection is an indirect way of reflecting the overall financial condition of an enterprise in the value of a specific item.** In a fair value based accounting structure, it has often been argued that the enterprise’s assets should not influence the value of the enterprise’s liabilities. If this were a general rule, then it would be inconsistent to reflect the credit risk that is influenced by both assets and liabilities of the enterprise. This is particularly the case if the sole reason for the reduction in the enterprise’s credit rating arises from a mismatch of the cash flows of its assets with those of its liabilities.

11. **If credit risk is reflected, the value of a liability should recognize all guarantees.** A significant element of obligation risk is the extent to which it will be paid. It should not matter who pays it. If a guarantor is obligated to complete any unfulfilled obligation, then the probability of payment should be reflected, independent of the source of payment.
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Therefore, even if it is determined, in the case of an unsecured or non-guaranteed obligation, that the credit risk of the enterprise obliged to perform should be reflected, it would be inconsistent to ignore the existence of such a guarantee or collateral.

Practical Considerations

Although in an efficient market, the adjustment for credit risk is measurable, a number of practical issues are usually involved in measuring and applying credit risk if a market isn’t efficient. For example,

- If there is no active market for a class of liabilities, it may be difficult, or at least overly subjective, to estimate an appropriate credit risk adjustment, especially for small enterprises with no available credit rating.

- If it is determined that credit standing risk in excess of default risk should not be reflected, it might prove quite difficult to establish a separate value for default risk.

- It is not desirable to adopt accounting rules applying to one’s own obligations that can be manipulated through the use of related organizations, such as holding companies or subsidiaries. Thus, obligations between enterprises within a consolidated group should be reported on consistent bases in order to avoid creation of false capital.

- In some cases, it is unclear who bears the responsibility for fulfilling a contract obligation. For instance, if reinsurance is involved, is it the credit risk of the reinsurer or the direct writer that prevails? It could be argued that reinsurance transfers risk, but for most reinsurance, the ultimate risk is still born by the direct writer. In fact, both parties could bear responsibility for fulfilling the obligation, one being primary and the other secondary. Would it be appropriate to reflect the credit risk of the reinsurer on the portion ceded? If the direct writer and reinsurer were of differing credit quality, logical inconsistencies could arise for a block of business reinsured? One practical approach could be to recognize the credit standing of the better of the two enterprises’.

- To the extent that the obligation that forms the basis of a liability is transferable, significant issues may arise in the determination of whose credit risk should be reflected if based on realizable value on sale or trade.

- The period of time during which the obligation will fall due and the size of this obligation (as well as the cumulative amount of other obligations) compared to the amount of the resources available to the enterprise will affect the degree of relevant credit risk. For example, a life insurance obligation payable over fifty years (assuming no back-up guarantees) certainly would be affected by credit risk to a greater extent than would be a typical liability for an account payable. Thus, even if a general principle were adopted that credit risk should be reflected in the fair value of liabilities, uniform application (if no efficient market existed for the obligation) to a variety of situations may not be practical or indeed be appropriate.
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• If a change in credit risk involves changes in both intangible and tangible (measured through reported) assets and liabilities, it would be appropriate to reflect credit risk only to the extent that the source of the change in credit risk is reflected in tangible assets and other liabilities. Otherwise, the illogical result noted above would arise, even if the perspective of the entire enterprise were taken. This problem arises from the difficulty of assigning values to intangible assets and liabilities. Although such an approach may be judged by some as conceptually appropriate, it may prove difficult to implement such a system due to the difficulty in determining the contribution that these sources make to overall credit risk.

Conclusion

The objective of this paper is to provoke discussion of this issue. We hope that this objective has been accomplished. We conclude by providing a few pertinent observations and disclosing our own current conclusions.

The importance of reporting financial values on a going concern basis will be influenced heavily by the underlying assumptions of the accounting model used (for example, international accounting standards are based on this principle, while U.S. accounting standards are not) and by the perspectives of the users to whom the financial information is provided. If it is important to assess a company under the assumption of a going concern, an enterprise’s own credit risk should not, in our view, be reflected in the reported value of its liabilities.

To the extent that the source of the change in credit risk is not reflected in financial reporting, it would be inappropriate to recognize the effect of the change; to do otherwise would result in misleading financial results.

However, information regarding the amount of an enterprise’s own credit risk is certainly useful disclosure. It should either be reflected in an enterprise’s balance sheet or disclosed in a note to that balance sheet.

Even if credit risk is reflected in the value of the liability, this risk should reflect the risk associated with the party expected to fulfill the obligation. Thus, the credit risk associated with a guarantor (e.g., regulator or insurer) would have to be recognized.

After consideration of the arguments on both sides of the question, the authors admit to being persuaded currently that the case against reflection of credit standing of the enterprise in the reported value of liabilities is the stronger position. This assessment derives from their view that financial statements should be straightforward, clear, and logical and, above all, should serve the public interest. The bulk of the arguments against reflection of credit standing in the liability valuation stand in support of those principles.

Sam Gutterman, FSA, FCAS, MAAA, FCA, Hon.FIA
Mo Chambers, FCIA, FSA, MAAA, Hon.FIA
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