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Dear Kevin

Exposure Draft ED 189 & ED/2009/12 - Financial Instruments: Amortised Cost and Impairment

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on ED 189 which is a re-badged copy of the International Accounting Standards Board's (the Board) Exposure Draft ED/2009/12 (the ED). We have considered the ED and set out our comments below.

Grant Thornton's response reflects our position as auditors and business advisers both to listed companies and privately held companies and businesses, and this submission has benefited with some initial input from our clients, Grant Thornton International which is working on a global submission to the IASB, and discussions with key constituents.

The views expressed here are preliminary in nature, and a more detailed Grant Thornton global submission will be finalised by the IASB's due date of 30 June 2010.

Our responses to the questions in the ED's Invitation to Comment, along with a number of drafting suggestions, are set out in the Appendix.

Summary of our views

Our principal comments are as follows:

- We do not support the mandatory application of this proposed accounting standard to non-publicly accountable entities as the requirements are far too complex and costly for such entities and note that the IASB is not requiring any such mandatory application. We therefore believe it is extremely important that the AASB allows non-publicly accountable entities to have the option of using the IASB's IFRS for SMEs accounting standard (which the IASB has specifically designed for such entities) as an alternative to adopting this proposed accounting standard.

- We commend the Board for acknowledging problems with the incurred loss impairment approach, which became more evident during the financial crisis. We support the Board in its attempts to address those weaknesses.
- We also note however that the approach to classification and measurement of financial assets adopted in phase I of IFRS 9 Financial Instruments addresses some of the problematic aspects of the impairment requirements in IAS 39 Financial Instruments: Recognition and Measurement (IAS 39).
- We believe that the expected loss approach proposed has theoretical advantages. In particular we believe that a model that incorporates expectations of default into measurement and income recognition throughout the life of a financial asset better reflects the economics of a lending business. We also agree that a measurement that uses current estimates of expected future cash flows will provide relevant information.
- We are however concerned that the operational challenges of implementing the proposed approach may result in cost and complexity that exceeds its benefits. Moreover, we believe that these challenges could be disproportionately burdensome for many non-financial institutions. We suggest that additional (and more effective) practical expedients are needed if the benefits of an expected loss approach are not to be outweighed by its costs.
- We support the Board's tentative decision to reject impairment approaches based either on fair value and or on loss estimates that do not reflect the existing loan portfolio and current conditions.

We expand on these comments in the following paragraphs.

Issues with the IAS 39 incurred loss approach

The existing requirements of IAS 39 were tested by the financial crisis and in the eyes of many were found to be wanting. A number of the criticisms expressed are mentioned in BC11 to the ED. In addition we also note that the existing requirements of IAS 39 result in:

- different bases for measuring impairment losses depending on how an instrument is classified (as available for sale or within loans and receivables or held to maturity)
- the inability to reverse impairment losses recognised in profit or loss on available-for-sale equity instruments
- some assets carried at amortised cost being assessed for impairment both individually and as part of a collective assessment.

We support the Board's acknowledgment of shortcomings in the current approach, and its efforts to develop an improved model. We note also that the introduction of IFRS 9's classification and measurement model addresses the first two of these points. The case for further changes to impairment requirements is now perhaps less compelling (although we nonetheless support the Board's efforts to make further improvements).

Expected loss approach - benefits and challenges

We agree that the use of an expected cash flow approach to recognising impairments on assets held at amortised cost will result in more forward looking information being presented in financial statements.

For lending businesses, we believe that the proposed approach is also more consistent with the business model. For a lending business, assessing the possibility of credit losses is an integral factor in making lending decisions and in pricing the risks assumed. It therefore seems appropriate to incorporate the possibility of credit losses, and changes to that possibility, in the measurement of loans and allocation of income over the life of the instrument. Compared to IAS 39's incurred loss approach, such an approach will more closely reflect current economic conditions and management expectations at the reporting date.

We are however concerned that the costs of the proposed approach could outweigh the benefits - in particular for many non-financial entities whose primary financial assets in concern are normal trade receivables. This is because:

- We acknowledge that any entity that provides credit is exposed to a risk of credit losses that needs to be managed. However, we also note that the financial crisis-related criticisms of the incurred loss approach arose mainly in the context of financial institutions. Despite the conceptual advantages of incorporating expected credit losses into amortised cost measurement generally, it is not obvious that the existing model has been proved deficient in practice outside the financial sector.
- Many non-financial entities follow a business model which differs markedly from that used by a financial institution. Providing credit to customers in the form of normal trade receivables is usually a necessary but incidental activity. The assessment of customers' credit-worthiness is usually unsophisticated and credit risk is not explicitly priced into the terms of trade. It is therefore questionable whether the ED's proposed approach is consistent with the business models of most non-financial entities.
- We believe that the proposals will present most entities with operational challenges. Furthermore, we expect that non-financial institutions will in general be less familiar with some of the techniques involved and also have less data on which to base their expected loss estimates.
- We also note that some of the terminology used in the ED is somewhat technical and appears to be oriented towards more sophisticated financial institutions.

We note that the Board has established an Expert Advisory Panel to provide advice on dealing with the operational problems that are likely to be encountered. We welcome this initiative and note that it will be important for the Board to consider carefully the advice of that Panel when deciding how to progress the project. We hope that the Panel will devote adequate time to implementation issues for non-financial institutions as well as to banks and other financial services entities.

Despite these comments, we do not advocate differential industry-based requirements on impairment of financial assets. Rather, we suggest that the Board should consider the need for additional, and more effective, practical expedients with a particular focus on instruments most commonly held by non-financial institutions.

Practical expedients

To alleviate the operational problems noted above, we believe that practical expedients will be needed in any final Standard.

We note and welcome the inclusion of proposed practical expedients and guidance on their use in the ED. We are concerned however that the ED constrains their use to situations where their overall effect (in comparison to the general approach) is immaterial. We believe this will reduce or negate the benefits of practical expedients.

In addition, we believe that further practical expedients should be considered for variable rate financial assets. We suggest that such an expedient could be scoped in terms of the type of activity for which an asset is held, possibly by relating use of the expedient to the reporting entity's business model.

Alternative impairment approaches

We agree with the Board's decision to reject a fair value-based approach to impairment. The Board notes that such an approach would in effect require fair value accounting on a contingent basis. In addition we believe that a fair value-based model would undermine the Board's decision to retain a mixed measurement model for classification and measurement of financial assets in IFRS 9.

We also support the Board in deciding to reject approaches to impairment based on through the cycle or dynamic provisioning. We agree that such impairment approaches could result in the recognition of losses on contracts that have not yet been entered into at the balance sheet date and are unrepresentative of the underlying economic characteristics of the financial asset as held at the reporting date.

We note also that a number of other bodies are currently looking at alternative methods of amortised cost and impairment accounting that would permit earlier recognition of credit losses than under the current incurred loss model. We understand that the European Banking Federation is considering a model that would keep the calculation of the effective interest rate separate from the recognition of expected losses, while the US Financial Accounting Standards Board is considering developing an approach to impairment that would be based on an enhanced version of the incurred loss model currently used. The Board may wish to consider the merits of these alternative approaches when more detail is known about them.

Pro- and counter-cyclical effects

We note that the existing incurred loss impairment approach has been criticised for producing financial statement information that has exacerbated the swings of the economic cycle. It has been argued by some that earlier recognition of credit losses (as is envisaged by the proposed approach) may serve to reduce those cyclical swings. We question whether this will be the case however, as the proposed approach may still have pro-cyclical effects during a long period of benign credit losses. For example if actual losses turn out to be lower than expected over an extended period, then credits will be recognised in profit or loss and unexpected loss events (by their very nature) will not be anticipated.

We therefore recommend that the effects of the proposed approach in terms of pro-cyclicality or counter-cyclicality are not considered by the Board in deciding whether to implement the proposed approach.

We expand on these comments in our answers to the invitation to comment questions.

If you require any further information or comment, please contact me.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED

Keith Reilly
National Head of Professional Standards

Appendix

IASB Invitation to comment questions

Objective of amortised cost measurement (paragraphs 3-5)

1 Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

We believe that the description of the objective of amortised cost measurement in the ED is clear as far as it goes. We note however that, as currently worded, the objective emphasises solely the allocation of interest revenue or interest expense. For reasons we expand on in our response to Question 2, we would like the objective to also refer to repayments of principal. We have included a drafting suggestion to accomplish this at the end of this Appendix.

2 Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

For financial institutions engaged in lending business, we believe the objective of amortised cost set out in the ED is appropriate as currently worded. We say this because their primary interest is earning a lender's return and the draft objective captures this.

We have some doubt over the appropriateness of the objective for assets at amortised cost which are held for reasons other than earning a lender's return. For many entities, the time value of money in relation to trade receivables is incidental to the collection or repayment of the principal amount, and is effectively viewed as part of the sales process. As discussed in our response to Question 1, we therefore suggest that the emphasis on interest revenue and interest expense needs to be reduced by incorporating reference to the repayment of the principal amount in the description of the objective.

More generally, it is questionable whether the proposed approach will provide more useful information for entities whose financial assets are short-term trade receivables. We therefore encourage the IASB to consider scope exclusion for short-term trade receivables where they are held by a reporting entity whose business model is not that of a lender.

Measurement principles (paragraphs 6-10)

3 Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

We support the use of principles-based approaches wherever possible, and therefore welcome the way in which the ED has been drafted. We believe the ED to be an improvement on IAS 39, which included numerous different approaches to impairment.

We include some drafting suggestions on the measurement principles at the end of this Appendix

4 (a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

For the reasons set out in our covering letter, we agree with the Board's decision to reject impairment approaches based on fair value or on loss estimates that do not reflect the existing loan portfolio and current conditions.

We also agree that having information based on expected cash flows at each measurement date will address the problem of the delayed recognition of impairment losses, which is the main conceptual problem with the current incurred loss model. The expected cash flow approach proposed also eliminates the need for an incurred loss trigger, thereby avoiding the problems in determining when that trigger is activated.

We feel however that the application of measurement principles for variable rate instruments will not be readily understood by many preparers, in particular the process for re-evaluating the effective interest rate on such instruments. As noted earlier, we suggest that a practical expedient may be needed for such instruments.

4 (b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

We believe that greater emphasis should be given to the repayment of principal in the ED's discussion of expected cash flows. While paragraph B1 in the Application guidance to the ED refers to principal repayment, it is not currently discussed in the main body of the ED. We suggest that it may be worth preceding paragraphs 6 to 10 with a description of amortised cost similar to that contained in the first paragraph B1.

Objective of presentation and disclosure (paragraphs 11 and 12)

5 (a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

Yes, we believe that the objective set out in the ED is clear.

5 (b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

We question whether an objective of presenting and disclosing information that enables users of the financial statements to evaluate the financial effect of interest revenue and expense is appropriate for entities that hold mainly short-term trade receivables and payables.

We also question whether the objective-based approach is undermined by paragraph 12(a) and the requirement to present what is essentially a list of disclosures as set out in paragraph 13-22 of the ED.

Presentation (paragraph 13)

6 Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

We agree that the proposed presentation requirements are, at a general level, appropriate in terms of the measurement approach proposed in the ED.

We believe that requiring disclosure of the items listed in paragraph 13 on the face of the Statement of Comprehensive Income risks clutter however. We suggest that disclosure of these items should only be required on the face of the Statement of Comprehensive Income where it is relevant to an understanding of the entity's financial performance; where this is not the case, disclosure in the notes to the financial statements should suffice.

Disclosure (paragraph 14-22)

7 (a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

As noted above, we believe that the ED takes an overly prescriptive approach to disclosure. This approach does not fit well with the high level objective set out in paragraph 11 of the ED. We would prefer entities to have more discretion to disclose only those matters which are relevant to an understanding of the entity's financial performance and position. As currently drafted, the list of information to be presented is very long, and may be excessive for entities holding financial instruments that consist mainly of short-term trade receivables and trade payables. We recommend then that the Board re-evaluates the usefulness of the information proposed in relation to its benefits. It may indeed be sensible to provide a practical expedient which would have the effect of exempting some financial assets and liabilities from the disclosure requirements of the proposed Standard on cost-benefit grounds, particularly where they are not held for the provision of finance.

In addition to these general remarks, we have the following specific comments on the proposed disclosures:

Classes of financial instruments and level of disclosure

In relation to the proposed disclosure, we note that 'class of financial asset or financial liability' is not defined. Guidance on aggregation may therefore be needed if the benefits from providing this information are not to be outweighed by the costs of collecting it.

Allowance account and Estimates and changes in estimates

We note that 'credit loss' is not a defined term in the Standard and may be problematic to interpret given that expected credit losses form an integral part of the amortised cost of the asset in concern under the proposals.

That aside, we agree that an analysis of the allowance account is useful. We believe however that a comparison of actual credit losses to expected credit losses will be more useful information given the necessity for management judgement in applying the proposed approach and we therefore support disclosure of the 'loss triangle' proposed in paragraph 19. Such a comparison has been shown to be useful information in other areas with a high degree of estimation uncertainty (such as retirement benefits).

In relation to the specific disclosures proposed, however, we note that as currently worded, there appears to be no time limit to the comparison between the development of the credit loss allowance over time and cumulative write-offs required by paragraph 19(a). This point could usefully be clarified.

Also in relation to paragraph 19, we note again that a class of assets needs to be defined and guidance provided on aggregation.

Stress testing

The proposed stress testing disclosures could be viewed as penalising entities that prepare such information for internal use. We note, however, that IFRS 7 contains precedents for adopting such an approach. Some entities which do not perform stress testing at present may decide to implement it in order to demonstrate best practice. We also note that the IASB has sought to minimise the costs of compliance with this requirement by specifying that the disclosure should be through the eyes of management. On balance we support the proposal.

Credit quality of financial assets

We agree that the existing disclosure requirements in this area are weak. It is right that the Board is seeking to address these weaknesses, and we support the proposed disclosure.

Origination and maturity information

We believe that entities with large numbers of financial assets are likely to find the proposed disclosure onerous to comply with. We believe then that guidance should be provided on how to aggregate the information to be disclosed, for example through the use of time bands.

7 (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

We do not propose any additional disclosures.

Effective date and transition (paragraphs 23-29)

8 Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

We foresee considerable operational difficulties in moving to the proposed approach. Changes will need to be made to systems, and there will be costs in collecting and analysing the information needed to apply the proposed approach. Entities that have never collected such data will experience particular problems.

We agree then that a lengthy lead time will be needed for implementing the proposed approach. We believe that a proposed effective date of about three years after the date of issue of the IFRS is appropriate.

9 (a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?

Although we generally support retrospective application wherever possible, we recognise that significant operational problems are likely to be encountered in implementing the new approach. We also note that the IASB has already departed from the policy of general retrospective application in other projects on cost-benefit grounds. We therefore support the proposed transition requirements for providing a pragmatic solution to the issue of comparability by approximating the effective interest rate that would have been determined if the approach in the ED had always been in use.

9 (b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

We do not support the alternative transition approach of providing an exception to prospective application under which entities would be permitted to choose retrospective application if the information required to do so is available without using hindsight, and the previous IAS 39 effective interest rate would be used for other instruments that were initially recognised before adoption of the proposed approach.

We believe that such an approach is inappropriate as it would create a lack of comparability between individual instruments that were recognised before adoption of the proposed approach as well as between instruments initially recognised either side of the transition date.

We also agree with the Board in rejecting the 'collar-based' approach for the reasons outlined in BC 74 to the ED.

9 (c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

We agree that full prospective application is not appropriate as it is likely to lead to 'grandfathering' the incurred loss model for a significant volume of financial instruments for many years. We therefore believe that comparative information should be restated in accordance with the adjusted effective interest rate alternative proposed in the ED.

10 Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

We agree with the proposed disclosure requirements.

Practical expedients (paragraphs B15-B17)

11 Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

We welcome the Board's recognition of cost-benefit considerations in proposing the use of practical expedients, and we support the inclusion of such expedients in any final Standard. We are concerned, however, over the wording in B15 of the ED, which states that an entity may use practical expedients in calculating amortised cost if their overall effect is immaterial. In our view, it will be problematic to ensure that effect of using a practical expedient is immaterial without actually also applying the general expected loss measurement requirements in full. We believe that the wording of this paragraph needs to change for it to be effective, and we have included a drafting suggestion to accomplish this at the end of this Appendix.

12 Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

We believe that the introduction of a practical expedient for variable rate financial assets should be considered.

Some of the terminology used in the ED is somewhat technical and appears to be oriented towards more sophisticated financial institutions. Phrases such as 'derive the forward yield curve from the spot yield curve' and 'determine the expected spread by iteration' are unlikely to be familiar to such entities, and therefore less likely to be readily understood. Preparers may also be confused by monies collected on receivables being allocated partially to revenue and partially to gains if they are not used to thinking about the advancement of credit on trade receivables in terms of a lending decision. We therefore believe that the need for a practical expedient should be considered if the benefits of the approach proposed in the ED are not to be outweighed by the costs of implementing it.

Drafting suggestions

We have the following suggestions on possible improvements to the drafting of the ED:

Paragraph 2

We suggest the description of the objective of amortised cost measurement should refer to the repayment of the principal of the financial instrument. Our suggested wording is:

"The objective of amortised cost measurement is to provide information about the effective return on, and the ultimate repayment of the principal amount of, a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument."

Paragraphs 6 - 10

Expected credit losses are incorporated only into the measurement of amortised cost financial assets, not financial liabilities. This is an important point that is not made explicitly in the main body of the Exposure Draft. The point is made by implication in paragraph 5 of the ED but is only made explicitly in paragraph B3(c). We suggest replacing paragraph 5 with the following:

"The effective return reflects an allocation over the expected life of the instrument of fees, points paid or received, transaction costs and other premiums or discounts. The effective return includes the initial estimate of expected credit losses for financial assets but not for financial liabilities."

Paragraph 7

We also found the wording of paragraph 7 of the ED to be unduly complicated, and believe that it could be better expressed. We suggest paragraph 7 is replaced with the following:

"Amortised cost reflects at each measurement date current inputs regarding the cash flow estimates. As a cost-based measurement, amortised cost also reflects an input relating to initial measurement, which is the effective interest rate to the extent that it is not contractually reset to current conditions. For a fixed rate financial instrument where no component of the contractual interest is reset, this is the effective interest rate at initial recognition. For a floating rate financial instrument, the effective interest rate at initial recognition is updated to reflect the resetting of the benchmark interest while the effective spread determined at initial recognition remains constant."

Paragraph B15

We suggest the first sentence of paragraph B15 is replaced with the following:

"An entity may use practical expedients in calculating amortised cost if their overall effect is immaterial."

Specific AASB Questions

1 Whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

a not-for-profit entities; and;

b public sector entities;

We are not aware of any regulatory issues that may affect the implementation of the proposals except as detailed in our earlier comments and particularly as they relate to non-publicly accountable entities. We do not support the mandatory application of this proposed accounting standard to non-publicly accountable entities as the requirements are far too complex and costly for such entities and note that the IASB is not requiring any such mandatory application. We therefore believe it is extremely important that the AASB allows non-publicly accountable entities to have the option of using the IASB's IFRS for SMEs accounting standard (which the IASB has specifically designed for such entities) as an alternative to adopting this proposed accounting standard.

More specifically on the questions raised, we would suggest that most, if not all not-for-profit organisations would be non-publicly accountable, but note that this is a Differential Reporting issue that is currently before the AASB. Whether some not-for-profit entities should be considered publically accountable (based on a size test perhaps) should warrant further consideration by the AASB.

Similarly we believe that there should be some public sector entities (again based on a size test) that should not be considered "publicly accountable". This is a matter we believe should be further considered by the AASB, in conjunction with the Commonwealth, State and Local governments to individually clarify, as detailed in our ED 192 Differential Reporting submission.

2 Overall, the proposals would result in financial statements that would be useful to users;

Our detailed comments need to be taken into account before we are able to state that we believe that the proposals will result in financial statements that would be useful to users. In particular we do not support the mandatory application to non-publicly accountable entities as detailed elsewhere in our submission.

3 Whether the proposals are in the best interests of the Australian and New Zealand economies.

Our detailed comments need to be taken into account before we are able to state that the proposals are in the best interests of the Australian and New Zealand economies. In particular we do not support the mandatory application to non-publicly accountable entities as detailed elsewhere in our submission.