Mr Kevin Stevenson
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Dear Kevin

EXPOSURE DRAFT ED 196 & ED/2010/4 FAIR VALUE OPTION FOR FINANCIAL LIABILITIES

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on ED 196 which is a re-badged copy of the International Accounting Standards Board's (the Board) ED/2010/4 (the ED). We have considered the ED as well as the accompanying draft Basis for Conclusions, 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 public and private 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 16 July 2010.

We set out our main comments below. Our responses to the specific questions raised in the ED's Invitation to Comment section, and the AASB's request for comments are set out in the Appendix.

General Comments

We support the Board's proposal to retain most of IAS 39's existing requirements for the classification and measurement of financial liabilities for the time being. We agree that the accounting issues arising during the financial crisis related primarily to financial assets. We therefore agree that there is no pressing need for fundamental changes to IAS 39's classification and measurement model for financial liabilities. In addition, given the extent of change planned in other areas of IFRS in the near future, limiting the changes to this aspect of IAS 39 may be welcomed by many constituents at this time.

Having said this, we think the Board should revisit the classification and measurement of financial liabilities at a later date. In particular, we believe that a review of IAS 39's requirements on embedded derivatives is merited. We believe that retaining the current rules is inconsistent with the Board's long-term objective of improving and simplifying the reporting for financial instruments.

In relation to the treatment of own credit risk, we broadly agree with the proposals in the ED. In our comment letter of 24 August 2009 on credit risk in liability measurement, we noted that we shared the concerns of many constituents that reporting gains (or losses) as a result of changes in an entity's own credit standing is counter-intuitive. We also noted that we were not convinced that the same approach to own credit risk is necessary or appropriate for all types of liability. We therefore support the ED's proposal that changes in a liability's credit risk do not affect profit or loss unless the liability is held for trading. We believe however that gains or losses resulting from changes in a liability's credit risk that have been included in other comprehensive income should be reclassified to profit or loss if the instrument is derecognised prior to maturity.

Non-Publicly Accountable Entities

We note that the IASB has not indicated whether it will amend the existing requirements for non-publicly accountable entities. The IFRS for SMEs accounting standard contains much simplified accounting requirements which we believe are far more relevant to non-publicly accountable entities.

Grant Thornton therefore does not believe that the AASB 139 standard should be mandatorily applied to non-publicly accountable entities given the complexity and costs contained in AASB 139. To require non-publicly accountable entities to adopt AASB 139 would add significant complexity and costs that would not be borne by similar structured overseas entities.

We expand on these comments in our responses to the questions in the ED's Invitation to Comment below.

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 1: Responses to Invitation to Comment Questions

Invitation to Comment questions

Question 1 - Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

We agree. We note that, in some limited cases, excluding the effect of credit risk from profit or loss can result in the fair value designation being less effective in reducing an accounting mismatch. On balance, however, we consider that treating all liabilities designated under the fair value option in the same way is preferable on the grounds of simplicity and comparability.

There is also a wider question (not raised in the Invitation to Comment questions) of whether changes in credit risk should be excluded from profit or loss for all liabilities that are measured at fair value through profit or loss. While it seems appropriate for changes in the credit risk of liabilities that are held for trading to be recognised in profit or loss, the same does not necessarily apply for derivative liabilities. A derivative liability may be held for the long term as an economic hedge but accounted for at fair value through profit or loss (for example because it does not meet the criteria for hedge accounting or because management chooses not to use hedge accounting because of its complexity). There does not seem to be a strong reason why changes in the credit risk of such liabilities should not also be excluded from profit or loss. We believe however that it is desirable to have symmetry with the treatment of derivative assets given that the value of a derivative may switch from positive to negative from one day to the next. The level of own credit risk associated with such derivative liabilities is also likely to be difficult to ascertain and may be relatively low. On balance therefore, we feel that the benefits to be gained from excluding changes in the credit risk of such derivative liabilities from profit or loss are outweighed by the simplicity of the ED's proposed approach.

Question 2 - Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?
As set out above, we believe that changes in credit risk should be excluded from profit or loss for all liabilities designated under the fair value option.

While we recognise that the proposals will result in the fair value option being less effective as a means of reducing an 'accounting mismatch' in profit or loss in certain situations, we support them for the reasons set out in our response to question 1 above.

Question 3 - Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?
We agree. We share the concerns of many constituents that reporting profit or loss as a result of changes in an entity's own credit standing is counter-intuitive, especially given that most of these changes are nor realisable in practice. We therefore support the proposal to exclude from profit or loss the portion of any gain or loss that attributable to own credit risk.

Question 4 - Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?
We are not convinced that a mandatory two-step approach will provide more useful information in practice, although we suggest that this is primarily a question for users.

We note that financial liabilities are commonly designated as at fair value through profit or loss to reduce an accounting mismatch. We suggest that a mandatory two-step approach in presenting the gain or loss on the liability will not necessarily provide the best reflection of the economic offset underlying the designation. The two-step approach will result in extra lines being added to the Statement of Comprehensive Income (or separate Income Statement). We note that some other current projects might also introduce requirements for additional line items and suggest that the Board should bear this in finalising those projects.

Having said this we acknowledge that the proposed two-step approach has the advantage that the entire change in fair value of the liability is included in profit or loss with the amount attributable to changes in the credit risk of the liability then being backed out in a clear and transparent manner.

Question 5 - Do you believe that the one-step approach is preferable to the two-step approach? If so, why?
See our response to Question 4.

Question 6 - Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?
We do not believe that the effects of changes in the credit risk of the liability should be presented in equity.

We note that there is a conceptual argument that a change in a liability's credit risk represents a wealth transfer between liability holders and equity holders. Under the current Framework for the Preparation and Presentation of Financial Statements, however, income and expenses are defined in terms of increases and decreases of assets and liabilities other than those relating to contributions from or distributions to equity participants. A re-measurement of a liability is not a contribution from or distribution to equity participants and should not therefore be presented directly in equity.

Question 7 - Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?
We disagree. We believe that gains or losses resulting from changes in a liability's credit risk that have been included in other comprehensive income should be reclassified to profit or loss if the liability is repaid prior to maturity.

If an entity repays a liability measured at amortised cost prior to its maturity, it recognises the difference between the carrying amount of the liability and the consideration paid (which will in many situations be representative of fair value) in profit or loss. We do not see why a liability which has been designated using the fair value option should be treated differently.

Question 8 - For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?
We agree. While the default method proposed might be criticised on the grounds that it may not provide a reliable approximation of changes in the liability's credit risk in all situations, we believe it is justifiable on cost-benefit grounds given that many users have noted the

difficulty in determining that amount more precisely. Where an entity can demonstrate a method that more accurately calculates the change in fair value attributable to the entity's credit risk, we believe it should be able to use that method.

Question 9 - Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

We agree. The proposal is part of the overall project to replace IAS 39, and it is therefore appropriate that an entity should be required to apply the other parts of IFRS 9 if it elects to apply the proposals in the ED early. To allow entities to do otherwise would result in a lack of comparability between entities.

Question 10 - Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

We agree. Given that IFRS 7 requires entities to disclose the amount of the change in the fair value of a liability that is attributable to changes in the liability's credit risk; it should be possible for them to use that information to apply the proposed changes retrospectively.

AASB Request for comments

The AASB would particularly value comments on the following:

1 *Whether there are there 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 that there are regulatory or other issues arising in the Australian environment, apart from our earlier comments on the proposals.

We believe that there are regulatory and other issues arising in the Australian environment for non-publicly accountable entities as the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.

2 *whether, overall, the proposals would result in financial statements that would be useful to users.*

We are not aware of any reasons that would impact on the usefulness of these proposals to users for publicly accountable entities, apart form our earlier comment son the proposals.

However we do not believe that these requirements should apply to non-publicly accountable entities as the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.

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

For publicly accountable entities, apart from our earlier comments on the proposals, we are not aware of any reasons that would impact on the interests of the Australian economy and our New Zealand firm will comment direct to the AASB if there are any New Zealand implications.

We do not believe that these requirements should apply to non-publicly accountable entities as the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.

4 *whether there are any implications for GAAP/GFS harmonisation.*

For publicly accountable entities, apart from our earlier comments on the proposals, we are not aware of any specific implications.