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Dear Kevin

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on ITC 21 which is a re-badged copy of the International Accounting Standards Board's Discussion Paper DP/2009/2 (the DP). We have considered the DP along with the accompanying Staff Paper 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's global submission will be finalised by the IASB's due date of 1 September 2009.

We welcome the Board's decision to seek views on the role of 'own credit risk' in measuring liabilities. As noted in the DP, this issue has generated considerable comment and controversy. It is also relevant to several of the Board's current projects.

We believe the DP and Staff Paper set out a clear and balanced summary of the main arguments for and against the inclusion of the effects of own credit risk in measuring liabilities. These arguments demonstrate that there is probably no perfect solution that will address all criticisms. Accordingly, to move forward the Board will need to decide which factors are most important (for example, consistency on initial recognition, income statement effects and so on). In doing so, we suggest that the decision-usefulness of the information produced (by including or excluding the effect of own credit risk) is paramount.

We therefore welcome the DP's call for views from analysts and other users of financial statements about whether and how this information is used by them.

We are not necessarily convinced that the same approach to own credit risk is necessary or appropriate for all types of liability. At standards-level the usual range of factors, including practicality and cost-benefit considerations, should be assessed. Conclusions may justifiably differ for different classes of liability.

Our other main comments on the DP are as follows:

- In general we believe that the objective of measuring a liability should be to portray the 'burden' of the liability rather than the obligor's ability (or perceived ability) to meet honour the obligation. We acknowledge that this line of argument does not resolve how to arrive at a discount rate. At a conceptual level we believe that the discount rate should reflect the nature of the obligation rather than the entity's ability to meet the obligation. At an operational level, selecting a rate currently requires judgement and will probably continue to do so.

- We also share 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. These concerns are well articulated in paragraphs 48 to 52 of the Staff Paper. We have our doubts as to whether these reported gains (losses) represent useful information in practice - and indeed suggest that they are simply 'noise' in many cases. Having said that, we recognise that this is primarily a matter for investors and other users.

- Nonetheless, we acknowledge and agree that the *fair value* of a liability reflects the effect of non-performance risk if that risk alters the amount the obligor would have to pay to transfer its obligation to a market participant at the measurement date. (We are not however convinced that this hypothetical transfer price should be estimated on then assumption that non-performance risk is the same both before and after the transfer - we will consider this in more detail in responding to ED/2009/5 *Fair Value Measurement).*

- Linking these two points, we believe that the key concern is to address the circumstances in which a fair value measure produces useful information for liabilities. Although addressing this question is beyond the DP's scope, we suggest that a general starting point is that a transfer value is not likely to be relevant for liabilities which are rarely transferred. We would therefore characterise fair value as a basis to be used in special cases when a transfer value provide the most relevant information.

Where liabilities are measured other than at fair value, we believe that discount rate used to determine a measurement date carrying value should not incorporate an explicit adjustment for 'own credit'

Appendix 1 contains our more detailed preliminary responses to both the IASB's and the AASB's 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

Grant Thornton

# Appendix 1: Responses to ITC 21 Questions

**Invitation to comment questions**

**Question 1**

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

a If the answer is 'sometimes', in what cases should the initial measurement exclude the price of the credit risk inherent in the liability?

b If the answer is 'never':

i what interest rate should be used in the measurement?

ii what should be done with the difference between the computed amount and cash proceeds (if any)?

**Response**

Where a liability is incurred in exchange for cash (or other consideration whose value is observable) we believe that it should be recorded initially at the amount of the proceeds. This amount will normally reflect the price of credit risk inherent in the liability, although exceptions will arise in situations such as related party transactions. This is generally consistent with current practice and we see no persuasive reason to change. We are not particularly concerned that this can result in similar cash obligations being measured at different amounts depending on the issuer's credit status - the difference will be reflected in future interest charges.

For other types of liabilities that do not have a cash exchange, such as many provisions, the question becomes one of selecting an appropriate discount rate. As noted in the main body of this letter, we believe that the discount rate should reflect the nature of the obligation rather than the entity's ability to meet the obligation.

Discounting is of course a long-standing challenge in financial reporting, and existing requirements are diverse. Making operational a requirement to discount based on the nature of the liability is of course far from straightforward. We envisage a continued role for the use of appropriate judgement.

**Question 2**
Should current measurements following initial recognition (a) always, (b) sometimes or (c) never incorporate the price of credit risk inherent in the liability? Why? If the answer is 'sometimes', in what cases should subsequent current measurements exclude the price of the credit risk inherent in the liability?

**Response**
With the exception of fair value measurements, our general view is that current measurements of liabilities should not reflect changes in the entity's own credit standing. This is because we believe:

- the effect of incorporating changes in credit risk is to create 'noise' (ie non-useful information) in the income statement
- the burden of the obligation has not changed unless the effect of change in credit risk is that the entity has the practical ability to extinguish the liability for a different amount.

**Question 3**
How should the amount of a change in market interest rates attributable to the price of the credit risk inherent in the liability be determined?

**Response**
As noted in the main body of this letter, we suggest that the effects of own credit risk should be included in the measurement only in the context of fair value (and then only when credit risk affects the estimated price that would need to be paid to transfer the liability). Accordingly, this issue is not generally applicable under our suggested approach.

**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?

**Response**
Of the alternatives presented, our preferred starting point is approach (c) in paragraph 62 of the Staff Paper. This approach involves:

- measuring borrowings and other liabilities that result from an exchange for cash at the amount of the cash proceeds
- measuring 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
- subsequent current measurements incorporating changes in market interest rates, but excluding changes arising from the entity's credit quality or the price of credit.

This approach seems simplest to apply of those presented and is consistent with our preference for measuring the liability in a way that is not affected by the obligor's ability to meet the obligation.

However, we note that this proposal involves re-measuring liabilities for changes in market rates. This is not therefore consistent with amortised cost using the effective interest rate as applied to most financial liabilities (which we would also describe as a current measurement).

For other types of (non-financial) liability, we believe that further work is needed on whether and when discount rates should be revised after initial recognition.

**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.

**Response**
Apart from our earlier comments, we are not aware of any regulatory issues that may effect the implementation of the proposals.

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

**Response**
Apart from our earlier comments, we are not aware of any regulatory issues that may effect the implementation of the proposals.

3 Whether the proposals are in the best interests of the Australian economy.

**Response**
Apart from our earlier comments, we are not aware of any regulatory issues that may effect the implementation of the proposals.