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Agenda paper 9.4 (M131)

ED237 sub 1

Hayes Knight

Hayes Knight (NSW) Pty Ltd
Level 2, 115 Pitt St, Sydney NSW 2000
GPO Box 4565 Sydney NSW 2001
Tel +61 (0)2 9221 6666 **Fax** +61 (0)2 9221 6305
Email info@hayesknight.com.au
ABN 25 125 243 692

www.hayesknight.com.au

REF: PR/AS

8 May 2013

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West
MELBOURNE VIC 8007

Email: standard@aasb.gov.au

Dear Sir,

EXPOSURE DRAFT 237
FINANCIAL INSTRUMENTS: EXPECTED CREDIT LOSSES

We appreciate the opportunity to provide comments on the Exposure Draft 237.

We are a member firm of Morison International, the winners of the 2012 International Accounting Bulletin Awards for "Association of the year" and "Rising Star Association".

Hayes Knight supports this Exposure Draft.

The global financial crisis highlighted the need for more timely recognition of reporting credit losses on loans and other financial instruments held by financial institutions and other public and private entities. This Exposure Draft moves away from the "incurred Loss" model which delayed recognition of credit losses until a loss trigger event occurred.

Our response to the specific questions is included in Appendix 1.

We would be pleased to discuss any comments further.

Please contact me on (02) 9221 6666 if you require any further information.

Yours faithfully,
Hayes Knight (NSW) Pty Ltd

Pran Rathod - Director Audit Services

Responses to Specific questions

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Responses to Specific questions

Question 1

(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credit losses only after significant deterioration in credit quality, will reflect:

(i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and

(ii) the effects of changes in the credit quality subsequent to initial recognition?

If not, why not and how do you believe the proposed model should be revised?

(b) Do you agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

Comments:

Question 1 (a)

We comment as follows:

(i) We believe that expected credit losses are inherent in any portfolio of financial assets, even though an entity may be unable to specifically identify the asset on which a loss is likely to occur.

There is merit in the argument that the pricing of certain financial assets with low credit worthiness (e.g. loans on a high risk debtor on which interest rate may be higher than normal) compensates the expected credit loss at initial recognition.

Accordingly, an expected credit loss should be recognised as the expectations of credit losses have been priced into the financial instrument.

(ii) We agree with the recognition of a loss allowance which reflects the effects of changes in credit quality subsequent to initial recognition. This method provides a more reliable information on the expected contractual cash flows from the underlying assets.

Question 1 (b)

We do not agree with the statement, based on other responses in question 1 (a) (i).

Question 2

(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?

(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?

Comments:

Question 2 (a)

We agree with the above. This will result in a more timely recognition of expected credit losses than the weakness in the incurred loss model.

Question 2 (b)

We agree with the above for the following reasons:

(i) **The 2009 ED considered a loss allowance of nil at initial recognition, and as a result the loss allowance over the life of the financial asset increased as credit worthiness deteriorated.**

This did not result in a pattern of credit losses that are inherent in the portfolio.

(ii) **The 2009 ED presented many operational challenges, which we believe, have now been addressed in the current ED237.**

Question 3

(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?

(b) Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?

Comments:

Question 3 (a)

We agree with the proposed scope of the Exposure Draft.

Question 3 (b)

The credit loss in the Exposure Draft relates to a financial asset, which is in the balance sheet. Whether fair values changes in financial assets are recognised in profit & loss or other comprehensive income, it does not necessitate a different measurement criteria for such assets.

We therefore agree that accounting for financial assets that are measured at FVOC1 should be as proposed in this Exposure Draft.

Question 4

Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

Comments:

The 12 month expected loss calculation will need to use the total (lifetime) expected credit losses that would result from a default. The determination of such life time expected credit losses will require estimates that can only be based on internally and externally available information, such as information about past events, current conditions and reasonable and supportable forecasts.

This may have a significant impact on the systems and processes relating to credit management. As the Exposure Draft does not prescribe a specific method for calculating expected losses there would be varied basis by entities depending on the type of financial assets, and the existing credit systems.

This may also increase the subjectivity element in the calculations unless there are adequate methods developed, which can be applied consistently and supported by appropriate evidence.

We believe that it can be operational but time and effort will need to be invested by an entity.

It is difficult to quantify such costs as these could vary significantly from one organisation to another.

Question 5

(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?

(b) Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?

(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?

(d) Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?

(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

Comments:

Question 5 (a)

We agree with the above.

Question 5 (b)

We consider that sufficient guidance and or information has been provided to assist entities in determining when a provision for lifetime credit losses is required.

Question 5 (c)

We agree with the above as it will avoid the need for a full estimation of expected credit losses.

Question 5 (d)

We agree with the operational simplifications (the rebuttable presumption of a 30 days past due account and the investment grade of the financial instrument) as this can be easily adopted and used by all entities.

However, the 30 day rule may be too stringent and this period may be variable within entities depending on the customer relationship. Historical experience may indicate that amounts that are more than 30 days past due do not result in a significant increase in the probability of a default occurring.

In our view, a 60 day past due may be more appropriate.

Question 5 (e)

We agree with the proposal as this will reflect the credit quality of the financial asset.

Question 6

(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?

(b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (i.e. that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

Comments:

Question 6 (a) & (b)

We agree that where there is objective evidence of an asset's impairment, the interest revenue should be calculated on the net carrying amount.

Question 6 (c)

We agree with the proposal that the interest revenue approach be symmetrical as the interest income reflects the rate of return implicit in a non-impaired debt instrument.

Question 7

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

(b) Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.

(c) What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

Comments:

Question 7 (a)

We agree with the proposed disclosure requirements, though we believe that not all should be required for smaller entities.

Question 7 (b)

There could be operational challenges for all entities. Even though some entities will be able to use the risk management system, they may still need to have systems to track data to capture changes in credit quality.

Question 7 (c)

We consider following additional disclosures as good practice:

- **(i) Value of assets on which interest has been recognised on a net of impairment basis.**
- **(ii) Value of such interest recognised on above.**

Question 8

Do you agree with the proposed treatment of financial assets on which contractual cash flows are modified, and do you believe that it provides useful information? If not, why not and what alternative would you prefer?

Comments:

We agree with the proposed treatment of financial assets whose contractual cash flows are modified.

Question 9

(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?

(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

Comments:

Question 9 (a)

We agree that same impairment approach should apply to both as they both have similar credit risks.

Question 9 (b)

We do not foresee any significant operational challenges arising from the proposal.

Question 10

(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

Comments:

Question 10 (a)

We support the proposed simplified approach for trade receivables and lease receivables.

Question 10 (b)

For trade recoverable, maturities are usually 12 months or less and therefore the credit loss for 12 months would be same as lifetime credit losses. Therefore we agree to the proposal to use a provision matrix as relevant.

Question 11

Do you agree with the proposals for financial assets that are credit-impaired on initial recognition? Why or why not? If not, what approach would you prefer?

Comments:

We agree with the proposals.

Question 12

(a) What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.

(b) Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

(c) Do you agree with the proposed relief from restating comparative information on transition? If not, why?

Comments:

Question 12 (a)

We note there are a number of changes that may effect other accounting standards, including the completion of all phases of IFRS9. We therefore believe that the implementation date should not be earlier than 1 January 2017.

Question 12 (b)

We agree with the proposed transition requirements.

Question 12 (c)

We agree with the proposed relief in relation to restarting of comparable information on transition.

Question 13

Do you agree with the IASB's assessment of the effects of the proposals? Why or why not?

Comments:

We believe that such a proposal may initially imply a larger allowance for impairment for certain entities in the first year of application.

However, a balance sheet under this approach will clearly communicate to investors the present value of cash flows expected to be collected from debt instrument.