BAYCORP

28 August 2009

Australian Accounting Standards Board
Level 7, 600 Bourke Street
Melbourne
VIC 3000
Australia

By E-mail: standard@aasb.gov.au

Director – Accounting Standards
New Zealand Institute of Chartered Accountants
PO Box 11 342
Wellington 6142
New Zealand

By E-mail: ASD@nzica.com

International Accounting Standards Board
First Floor, 30 Cannon Street
London, EC4M 6XH
United Kingdom

By E-mail: iasb@iasb.org

Dear Sirs

This letter is in response to the following Exposure Drafts issued:

- Exposure Draft ED/2009/5 – Fair Value Measurement (IASB, May 2009)
- Exposure Draft ED 181 – Fair Value Measurement (AASB, June 2009)
- Exposure Draft ED/2009/7 – Financial Instruments: Classification and Measurement (IASB, July 2009)
- Exposure Draft ED/2009/X – Financial Instruments: Classification and Measurement (NZICA, July 2009)

Introduction and Background

Baycorp welcomes the opportunity to respond to your request for comments with respect to each of the above Exposure Drafts.

Baycorp is in the business of receivables management, both as a contingent debt collector, attempting to collect overdue debts on behalf of our clients, and as a purchaser of overdue debt ledgers and collecting those overdue debts in our own

Baycorp (Aust) Pty Limited ABN 16 086 072 004
Level 6, 6 Parkes Street Parramatta NSW 2150 Australia. Locked Bag 5031 Parramatta NSW 2124 Australia
T 61 2 9806 2400 **F** 61 2 9806 2547
www.baycorp.com.au

right. It is this latter business that is the subject of this letter. In each case, overdue debt relates to consumer based retail debt.

The company operates in both Australia and New Zealand, and acquires debt portfolios in both countries.

The Baycorp Business Model

In conducting the Purchased Debt business, the business model is broadly as follows:

- Baycorp acquires portfolios of distressed debt (Purchased Debt Ledgers, or PDL's), consisting of consumer debt. PDL's typically consist of unsecured bank debt (overdue credit card, personal loan) and utility debt (telco);
- A PDL ledger may consist of between a few hundred and a few thousand individual consumer debts. Average face values per account can range between $500 and $10,000 per debt;
- PDL ledgers are purchased at a deep discount to face value (range is 5c in the dollar and 20c in the dollar, depending on a number of parameters relating to the portfolio of debt being acquired (e.g. size, age, type,));
- Baycorp attempts to recover overdue balances from the debtor, through various means, initiating contact via mail, telephone, & legal avenues. Recoveries in excess of the purchase price and the cost incurred in attempting collection result in cash profit;
- Repayment of accounts may occur via lump sum repayment, negotiated discounted settlement, and/or instalment arrangement over time;
- Some accounts, predominantly bank debt, have the ability to charge interest, typically at an underlying contracted interest rate or default rate. Other debts may be charged interest at the court stipulated rate, or not at all;
- Some accounts may not achieve any recovery, and become uncollectable, while others may be partially collected. On a portfolio basis, Baycorps experience has been that recoverability on a purchased PDL averages in the range of 150% to 500% of the purchase price. The variability of the returns may be attributed to the nature of the underlying debt, age, type etc., as well as external economic conditions and effort applied.

Whilst many of the underlying assets in a PDL portfolio are financial assets (such as credit card balance and personal loans) the actual profit drivers of PDLs are very different from normal financial assets. A typical financial institution has very limited ability to impact the profitability of a particular instrument through operational decisions once the instrument has been acquired. This is not the case for PDL ledgers. The profit generated from a PDL ledger is a direct function of how much can be recovered above the initial purchase price, which is a direct function of the expenditure invested in operational resourcing, technology and collection strategies applied to secure payment streams.

The Market

The Australian debt purchase market consists of vendors (banks, finance companies and utilities) that generate volumes of consumer credit, and debt purchasers (a small number of privately held and ASX-listed entities).

- PDL ledgers are acquired on the basis of direct relationships between the vendor and one or more PDL purchasers;

Baycorp (Aust) Pty Limited ABN 16 086 072 004
Level 6, 6 Parkes Street Parramatta NSW 2150 Australia. Locked Bag 5031 Parramatta NSW 2124 Australia
T 61 2 9806 2400 **F** 61 2 9806 2547
www.baycorp.com.au

- There is no active market for the trading of PDL assets;
- There is no secondary market for the subsequent trading of PDL assets. Once acquired, a PDL purchaser will typically hold the asset to maturity;
- Purchase prices and other terms are negotiated directly between the vendor and the purchaser;
- "Forward Flow" contracts may be negotiated, which provide for the purchase of six or twelve monthly portfolios of debt in advance, at pre-agreed prices;
- Baycorp determines a Purchase price by estimating future expected cashflows over the expected life of each portfolio (Baycorp forecasts expected cashflows over a 5 year period) and after applying an expected cost to collect, discounts that to a present value;

For accounting purposes:

- PDL ledgers may be classified under more than one current classification (Available for sale, Loans and receivables, Fair value through profit & loss). Consistent with international counterparts and guidance provided in the current AASB139 (paras 59, AG5, and BC32), Baycorp has adopted the Loans & Receivables classification for all PDL ledgers;
- PDL assets are initially recognised at cost, being the purchase price paid to the vendor, plus any costs of acquisition (e.g. stamp duty);
- Baycorp recognises income using the Effective Interest Income method. The Effective Interest Rate (EIR%) is determined using an Internal Rate of Return based on the expected future cash recoveries on each portfolio, determined over 5 years. Given the expected cashflows and the purchase prices, EIR% can be in excess of 30%-40% per annum on some assets;
- Baycorp reforecasts the expected future cashflows on each PDL asset every 6 months, taking into account historic recovery performance, volume of accounts under payment arrangement, current market and economic conditions;
- Regular reforecasts are discounted at the original EIR% to determine the current carrying value at each six-monthly interval;
- Movements in reforecast value are reflected in the Profit & Loss, either upwards or downwards.

The Problem

1. Classification

ED/2009/7 (para 4) states that a financial asset shall be measured at amortised cost if both of the following conditions are met:

a) The instrument has only basic loan features, and
b) The instrument is managed on a contractual yield basis.

Para 5 states that a financial asset not meeting the conditions in para 4 shall be measured at fair value.

Further, para B13 defines that if a financial asset is acquired at a discount that reflects incurred credit losses, it does not meet the definition of being managed on a contractual yield basis. Consequently, it is apparent that the PDL assets acquired by Baycorp would be measured at fair value under ED/2009/7.

Baycorp (Aust) Pty Limited ABN 16 086 072 004
Level 6, 6 Parkes Street Parramatta NSW 2150 Australia. Locked Bag 5031 Parramatta NSW 2124 Australia
T 61 2 9806 2400 **F** 61 2 9806 2547
www.baycorp.com.au

Whilst a PDL ledger is a financial asset acquired at a discount that reflects incurred credit losses, it is atypical of readily traded financial market products that are intended to be caught in the distressed debt space. The business model that is applied in managing the business of PDL ledgers has very little in common with typical financial market products that are fair valued through profit and loss or traditional mark to market products. The argument on the appropriate accounting treatment needs to consider the underlying financial products, business model and business characteristics.

For the contingent recovery space, the business is a service provider using modern day call centre technology and legal avenues to optimise the debt recovery for clients. The essential point of difference is that in the case of Baycorp acquiring PDL ledgers, we are purchasing at opportunistic pricing levels, rather than assuming pricing risk. As noted above, our experience delivers profitability in the efficient management of the recoverability of those PDL ledgers, as opposed to taking arbitrage profits on trading of such financial assets.

Setting this aside, the efficiency of the business is driven by the efficiency of our operations and processes as opposed to taking direct advantage from market and economic risk typical of many financial products.

2. Determining a Fair Value

The proposed ED suggests that for this type of asset, fair value should be used as the measurement base. AASB139 defines fair value as:

> *"The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arms length transaction"*

There is no active secondary market for PDLs. The attributes of a PDL ledger change each day based on the amounts collected against it and a better understanding of the underlying accounts and debtors that make it up. Ownership of a PDL ledger, and our experience in working it, improve our ability to forecast future estimates of cash recoverability. Arguably, the intrinsic value of a PDL ledger increases over time as our experience and understanding of the behaviour of the underlying debtors becomes better understood and more predictable.

Arriving at a Fair value requires the application of a valuation methodology. The most appropriate method is to use discounted cashflows, which requires the determination of two elements at each reporting period, the forecast of expected future cashflows, and an assessment of a discount rate at the then prevailing conditions. Each of these is discussed below:

a) Forecast of Future Expected Cashflows

With over 400 PDL ledgers, comprising tens of thousands of individual debts, forecasting future cashflows is problematic and open to subjectivity. The business, and the industry, align forecast expectations with recent historical performance and with known quantities of projected payment arrangements.

Baycorp reforecasts expected future cashflows every six months to reassess and support balance sheet carrying values.

Baycorp (Aust) Pty Limited ABN 16 086 072 004
Level 6, 6 Parkes Street Parramatta NSW 2150 Australia. Locked Bag 5031 Parramatta NSW 2124 Australia
T 61 2 9806 2400 **F** 61 2 9806 2547
www.baycorp.com.au

b) Assessment of Discount Rate
Determining a fair value requires the determination of the discount rate, both at time of initial recognition (i.e. purchase of the asset) and at each reforecast interval. The discount rate used reflects the Effective Interest Rate (EIR%). As the original EIR% is driven off the purchase price, we would therefore be obliged to determine, at each reporting period, what a third party in an arms length transaction would pay for each PDL, and from there derive a new EIR% for each PDL. For a number of reasons, this is almost impossible:

- Each PDL asset is unique, in terms of underlying debts and the payment streams generated;
- The EIR% reflects the inherent unpredictability of the cashflows. The risk profile of each PDL is different and changes over time as collection activity continues and knowledge of each PDL improves. Such changes are not reflective of market conditions but of the effort, of experience and of use of technologies applied by the collector. This information would not be available to third parties, nor would new PDL purchase prices (even from the same vendor) represent an appropriate benchmark as they would not reflect this effort and knowledge;
- There is no secondary market or other valuation technique that can be applied to PDL assets to determine current market prices;

In the absence of a secondary market and any observable market data, the only option available is to continue to apply the original EIR%, determined at the initial acquisition of each asset. This appears to go against the fair value measurement criteria. The costs and effort required to arrive at a current EIR%, and therefore current fair value, are disproportionate to the business and to the asset class held.

3. Relevance of Fair Value
Given that PDL assets held are not traded, we question whether there is relevance in fair valuing such assets. Fair value only bears some relevance if the assets are not intended to be held to maturity.

4. Guidance and Consistency Across Market Participants
What makes this issue further confusing is that, between Baycorp and a small number of other similar businesses in Australia, different methods of determining "fair value" are used. Guidance from the Accounting bodies is required to ensure a consistent approach is applied to similar assets. As an example the table attached in Appendix 1 identifies the various methods that are applied by Baycorps peers.

As a result of the different measurement methods, Baycorp has performed some analysis of our own portfolio, if measured under the different methods noted above. If applying a Weighted Average Cost of Capital discount rate, Baycorps asset base could be up to 35% higher than reported at our last balance date, with the corresponding difference reflected in the profit & loss.

Each of the respective entities can argue their approach is a correct interpretation of the current standards, while also recognising the classification of the type of debt as a financial asset is in fact the cause of the difference in accounting treatments.

Baycorp (Aust) Pty Limited ABN 16 086 072 004
Level 6, 6 Parkes Street Parramatta NSW 2150 Australia. Locked Bag 5031 Parramatta NSW 2124 Australia
T 61 2 9806 2400 **F** 61 2 9806 2547
www.baycorp.com.au

Significant inconsistencies exist in the current application of accounting standards to the PDL industry in Australia. We recommend that the AASB takes the opportunity to review this application. In particular, we question:

- the use of a company-based WACC as an appropriate discount rate for individual PDL assets, when at initial recognition, such PDL assets would have very different EIR%; and
- the use of old AGAAP revenue recognition, rather than IFRS financial asset methodologies.

The Preferred Outcome

Baycorp would prefer to see distressed debt relating to the consumer Receivables Management industry classified and measured at amortised cost. Whilst these debts are credit impaired, the PDL assets on an individual and portfolio basis, are atypical of financial market products in the debt market space including distressed debt.

From an operational perspective as well as a cost of acquisition, the business profits from the optimal use of its tools and resources. Advancement of call centre operations and technology, optimal use of legal avenues and smart analysis of data are significant drivers of business profits.

Our experience has shown a fair amount of predictability in outcomes as we improve our understanding of ledgers with time and the periodic cash recovery forecasting cycles capture impaired situations with reasonable promptness. The current economic environment has resulted in testing situations similar to players in the mortgage or retail loan markets. A consequence of the current standards, which will not be alleviated by the proposed changes, is that there has been a significant disconnect between accounting profits and cash profits. This severely impacts the underlying value of our business to shareholders, investors and bankers, and cannot be under-estimated.

The above factors in aggregate leave us with the opinion that amortised cost is the most appropriate accounting treatment for PDL assets for the following reasons:

a) conservative approach in pricing of debts. Use of higher discount rates and more conservative cash recovery forecasts with higher risk portfolios;
b) Evaluation of impairments through six monthly reforecasts of estimated cash recoveries (improves with experience and understanding of the ledgers);
c) Yield based recognition of income effectively unwinds the estimated cash recoveries discounting on a recognised cash collected basis with gaps resulting in impairment recognition;

The above approach is in synchronisation with the underlying operations model of the business which is buying these debts at optimal price, using effective call centre operations, legal avenues for more difficult cases and exploiting smart technology in communications and establishing contact to maximise our profitability.

The business does not invest in PDL assets with a view to make profit on sale in a secondary market. Secondary sale of purchased debt ledgers are rare in the Australia and New Zealand markets, and would more typically be associated with the sale of the related business.

Baycorp (Aust) Pty Limited ABN 16 086 072 004
Level 6, 6 Parkes Street Parramatta NSW 2150 Australia. Locked Bag 5031 Parramatta NSW 2124 Australia
T 61 2 9806 2400 **F** 61 2 9806 2547
www.baycorp.com.au

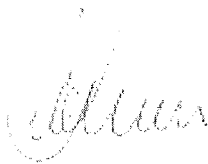
Further, it may, in fact, be appropriate not to treat PDL assets as financial assets at all, but rather treat them as a form of stock in trade, where the asset is acquired, value added through operational effort, and profit generated from the conversion of that effort into additional cash.

Conclusion

It may be an unintended consequence that this type of financial asset is captured within the realms of the Exposure Draft. We seek some definitive guidance as to the accounting treatment for these types of assets that can be applied across our industry as a whole.

We have provided this response without addressing any specific question or questions raised in the Exposure Drafts put forward. We hope that these comments will be helpful. If there are any areas that you would like to discuss, please feel free to contact me on +61 2 9806 2590.

Yours sincerely



Mike Morris
Chief Financial Officer

Baycorp (Aust) Pty Limited ABN 16 086 072 004
Level 6, 6 Parkes Street Parramatta NSW 2150 Australia. Locked Bag 5031 Parramatta NSW 2124 Australia
T 61 2 9806 2400 **F** 61 2 9806 2547
www.baycorp.com.au

BAYCORP

Appendix 1: Approach to Carrying Values – Baycorp and Peers

Entity	Classification	Cashflow	Discount Rate Methodology	Useful Life	Income Recognition
Baycorp	Loans and Receivables	Expected Future Cashflows	Asset-derived IRR	5 Years	Effective Interest Method
Peer 1 (ASX-listed)	Fair Value through P&L	Expected Future Cashflows	Weighted Average Cost of Capital	6 Years	AGAAP Cash
Peer 2 (ASX listed)	Available for Sale	Expected Future Cashflows less Expected Costs of Recovery	Margin above pre-tax Weighted Average Cost of Capital	7 Years	AGAAP Cash
Peer 3	Loans and Receivables	Expected Future Cashflows	Asset-derived IRR	5 Years	Effective Interest Method

Baycorp (Aust) Pty Limited ABN 16 086 072 004
Level 6, 6 Parkes Street Parramatta NSW 2150 Australia. Locked Bag 5031 Parramatta NSW 2124 Australia
T 61 2 9806 2400 **F** 61 2 9806 2547
www.baycorp.com.au