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Mr Kevin Stevenson
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Dear Mr ~~Stevenson~~ Kevin

AASB ED 237 *Financial Instruments: Expected Credit Losses*

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to provide comments to the Australian Accounting Standards Board (AASB) on Exposure Draft 237 *Financial Instruments: Expected Credit Losses.*

HoTARAC commends the International Accounting Standards Board (IASB) on their endeavours to address the issue of timely recognition of credit losses and the introduction of a single approach for all debt instruments. HoTARAC considers the current proposals an improvement on the two previous exposure documents on this topic and acknowledges IASB's attempt to simplify its approach for non financial institutions.

While HoTARAC's preference is for earlier recognition of credit losses through modifying the current incurred loss model to remove the loss trigger, if the IASB's proposals are to proceed HoTARAC recommends addressing:

- the degree of management discretion in their application;
- the double-counting on initial recognition;
- their operational complexity and the accompanying extensive disclosure requirements; and
- the lack of clarity in determining what is a significant deterioration in credit risk.

HoTARAC believes that these issues, at least partially, stem from the decision to retain the dual measurement model for expected credit losses. The majority of HoTARAC suggests that the IASB give serious consideration to the single measurement model proposed by the United States' Financial Accounting Standards Board.

HoTARAC's detailed comments and responses to questions from the exposure draft are attached.

If you have any queries regarding HoTARAC's comments, please contact Peter Gibson from the Australian Department of Finance and Deregulation on 02 6215 3551.

Yours sincerely

Grant Hehir
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

18 June 2013

General Comments:

HoTARAC agrees that a single impairment model for financial assets is desirable. HoTARAC also agrees that there is a need to review the current model to ensure the timely recognition of credit losses. HoTARAC considers the current proposals to be an improvement on the 2009 Exposure Draft. HoTARAC particularly welcomes the removal of the requirement to perform dual calculations required under the 'good book'/'bad book' approach, the removal of the ambiguous term 'foreseeable future', the simplification for trade and lease receivables and the use of the '30 day rule' rebuttable assumption to establish a clearer demarcation between recognition points for 12 month and lifetime expected credit losses. However, HoTARAC notes that the application of the '30 day rule' will potentially mean frequent reallocation of financial assets between the two measurement bases.

However, HoTARAC reiterates its concerns that the proposals introduce expectations of future events into the measurement of financial assets, a departure from the measurement of other assets and liabilities. Accordingly, HoTARAC does not support the proposal of the incorporation of expected credit losses into measurement, preferring the current incurred loss model, modified to eliminate the need for a loss trigger.

In terms of practical application, HoTARAC observes that a considerable degree of management judgement is required in assessing future events and economic conditions, deterioration in credit risk and determining the 'reasonable' interest rate used in discounting for the time value of money. In HoTARAC's view, this opens the door to potential manipulation of results, for example through the cherry-picking of economic forecasts and favourable interest rates.

The information that is 'reasonably available' under paragraphs B5-B8 is also likely to vary considerably between entities. In addition to adding to the costs of preparation, this may also result in the undesirable outcome of identical or similar instruments being measured differently depending on which entity is measuring them. This will be a particular concern with the dual measurement bases, where entities could use fundamentally different measurement bases for identical financial instruments depending on their assessment as to whether there has been a significant deterioration in credit risk.

In HoTARAC's view, some of the practical difficulties in application could be addressed through the use of a single measurement model along the lines proposed by the Financial Accounting Standards Board (FASB) in their exposure document *Financial Instruments – Credit Losses* ("the FASB model"). HoTARAC considers the FASB model to remove the subjectivity inherent in assessing where there is a 'significant deterioration' in credit risk and to be operationally simpler to apply. HoTARAC also observes that the use of a lifetime model is proposed as a simplification for trade and lease receivables and a majority of HoTARAC jurisdictions believe that serious consideration should be given to whether this approach can be extended to simplify the complexity of the overall proposals. HoTARAC further recommends that the time value of money always be discounted using the effective interest rate, again removing a subjective judgement associated with the proposals.

HoTARAC notes the IASB's concerns over the potential double count of credit losses on initial recognition, but believes this could be addressed by the 'gross up' method discussed in BC25 and supported in the alternative view of Mr Cooper. In line with HoTARAC's recommendation for the discount for the time value of money above, the increase in the gross carrying amount should be amortised using the effective interest rate.

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?

(a)

(i) HoTARAC does not agree that limiting credit losses to those arising from default events possible within 12 months reflects the economic link between the pricing of financial instruments and their credit quality at initial recognition. HoTARAC believes that the initial pricing of an instrument will reflect the expectations of credit loss and agrees with the alternative view of Mr Cooper that including a loss allowance on initial recognition will understate value (and overstate provisions for loan commitments and financial guarantees) and not faithfully represent the transaction.

(ii) HoTARAC agrees, but would prefer a single measurement base.

(b) HoTARAC agrees. However, as noted in the general comments, HoTARAC believes this could be addressed through the use of the 'gross up' method.

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)?

(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

(a) HoTARAC does not agree. HoTARAC's majority preference is for the single impairment model along the lines of that proposed by the FASB. HoTARAC believes the dual measurement approach adds unnecessary operational costs to measuring expected credit losses.
HoTARAC also observes that the proposals require a relative assessment of whether there has been a significant change in credit risk against credit quality at initial recognition (paragraph B12). This may result in circumstances where instruments with similar credit risks are allocated to different measurement bases.

(b) HoTARAC agrees that the current model is preferable to the approaches taken in the 2009 ED and the SD.

(c) The majority of HoTARAC jurisdictions agree.

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?

(a) The majority of HoTARAC does not agree that the scope is adequate, as it should also cover all other financial liabilities, except those at fair value through profit or loss. In addition, as entities do not recognise their own performance risk in their financial liabilities held at amortised cost, the holder and issuer of a financial instrument will apply different valuation bases.

(b) HoTARAC agrees, subject to the other comments made regarding accounting for expected credit losses.

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?

HoTARAC considers the 12-month expected credit loss operational; however this will involve considerable implementation costs, particularly for entities that are not financial institutions. The HoTARAC majority reiterates its preferences for the lifetime expected model, applied from recognition. HoTARAC considers the lifetime expected credit losses operationally simpler to apply.

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?

(a) As outlined in the General Comments above, the majority of HoTARAC believes a single measurement model, along the lines of that proposed by the FASB, should apply.

(b) HoTARAC considers the proposals to provide clearer guidance than the previous exposure draft. However, HoTARAC notes the term 'significant' is not defined in the exposure draft and would be a matter for individual judgement. In HoTARAC's view, the scope of the exposure draft and its application to a wide range of financial instruments and entities could cause considerable difficulties in practical application.

(c) HoTARAC agrees, subject to the other comments articulated in this response.

(d) HoTARAC agrees with the proposed simplification. However, HoTARAC's strong preference is that if the expected credit loss model is to proceed, implementation costs be reduced through the use of a single measurement model.

(e) HoTARAC agrees, subject to our other comments.

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?

(a) HoTARAC considers this method to be the most appropriate under HoTARAC's favoured incurred loss model in line with the current requirements of IAS 39.

(b) HoTARAC agrees and notes that this is the same as the current requirements under IAS 39.

(c) HoTARAC agrees. While HoTARAC has concerns on the proposals, instruments with similar risks should be consistently measured.

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?

(a) HoTARAC appreciates the removal of back-testing disclosure (BC109), but considers the proposed disclosure requirements excessive as the requirements of the ED are likely to lead to several pages of disclosures. In part, this reflects the complexity of having the dual measurement approach of 12 month and lifetime expected credit losses and the requirements to justify appropriate classification of financial instruments. HoTARAC observes that the disclosure requirements seem to be a mechanism to explain the subjective judgements used by management and that this may indicate fundamental flaws with the proposals. While this may make the proposals more auditable, it will also increase the time and effort required for preparers and auditors. In HoTARAC's view, disclosures could be simplified by adopting a single measurement base (obviating the need for explaining movements in financial assets between the three buckets) and taking the effective interest rate for the time value of money (i.e. reducing subjectivity). In HoTARAC's view, this will alleviate much of the burden for preparers and avoid information overload for users.

(b) HoTARAC notes that the compilation and disclosure of the information required may be particularly onerous for entities that are not financial institutions and do not currently have the necessary systems in place. HoTARAC considers this particularly pertinent given the scope of the application of the proposals.

(c) HoTARAC believes the proposed disclosures are extensive.

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?

HoTARAC agrees, subject to our other concerns with the proposals.

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.

(a) HoTARAC agrees that it is preferable to have a single model for financial instruments, but has concerns over the proposed extension of the model, particularly to financial guarantee contracts for the operational reason outlined in response to 9(b).

(b) HoTARAC does not view the proposals for loan commitments as posing a more significant operational challenge than their application to financial assets. However, HoTARAC observes that a number of entities that are not financial institutions provide financial guarantees and will be required to devote considerable resources to meeting the proposed requirements.

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?

(a) HoTARAC agrees with a simplified approach for trade receivables.

(b) HoTARAC agrees.

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?

HoTARAC's preference is for a single measurement model as outlined in response to Question 1. HoTARAC favours the application of the 'gross up' method, similar to the FASB's approach for purchased credit-impaired assets to maintain the general principle of the proposals that credit losses should be separated from interest.

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?

(a) As the mandatory effective date of IFRS 9 is presently 1 January, 2015, HoTARAC suggests that should the proposed requirements be implemented, they should be deferred for at least another two years following IFRS 9's effective date. For many users, the initial work that will be required to implement the proposal will be so onerous that earlier application will not be possible.

(b) HoTARAC agrees, subject to the comments on timing, above.

(c) HoTARAC agrees.

Question 13

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

HoTARAC agrees that:

- the proposal will overcome the weakness in the current model of delaying recognition of credit losses (BC170).
- changes in the fair value of a financial instrument results in a combination of risks. However, HoTARAC recommends that the current expedient under paragraph AG84 of IAS 39 of using the fair value to measure impairment for financial assets held at amortised cost be explored for entities that are not financial institutions for which the recognition of credit losses is a less critical measure of performance.

HoTARAC disagrees that the IASB's proposal:

- will improve comparability (BC182). As outlined in the general comments, this may be impaired by the different information available to entities applying the model.
- best balances the costs and benefits (BC190 and BC203) for the reasons outlined in this submission. The single measurement model proposed by the FASB would mitigate implementation costs by sidestepping the need for the two measurement models, particularly for non financial institutions.

The majority of HoTARAC disagrees that the IASB's proposal is more appropriate than the US FASB approach of a lifetime expected credit loss (BC172). As outlined in response to Question 1, in HoTARAC's majority view, the US approach, although not ideal, is operationally simpler.

Response to AASB Questions:

General Comments

HoTARAC is concerned over the restricted timeframe allowed for consideration of the proposals given their complexity, the divergence from FASB and the fundamental conceptual changes they introduce. HoTARAC notes that respondents to the FASB are almost unanimous in requesting additional time to consider the proposals after a comment period of over four months. HoTARAC considers the comment period allowed by the AASB to be short and not conducive to the preparation of high quality responses, but appreciate the relief granted to HoTARAC by the AASB staff.

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

HoTARAC does not agree that the proposals would result in financial statements that are useful to users. HoTARAC's reasons and preferred model are outlined in response to the ED. While HoTARAC agrees with the need for the timely recognition of credit losses, the majority of HoTARAC believes that there are simpler alternative such as the FASB's approach.

HoTARAC is also concerned over the degree of discretion entities have in the application of the proposals, in particular in relation to the assumptions about future economic conditions, identifying a significant deterioration in credit risk and discount rates used in calculating the time value of money. HoTARAC believes that this compromises the objectivity of financial statements, reduces comparability and results in voluminous disclosure requirements.

2. 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, including GAAP/GFS implications;

(a) No comment.
(b) Non-marketable loans under GFS are carried at their nominal amount with no allowance account. As the proposals only change the timing of the recognition of credit losses, rather than the nature of the allowance account, this will not result in new harmonisation differences but may impact on the quantum of existing differences. The proposal to include 12 month expected credit losses on initial recognition will result in financial assets being recognised at below market value creating a GAAP/GFS divergence for financial instruments within the scope of the proposals GFS measures at market value. The proposal to recognise expected credit losses on loan commitments and financial guarantees may result in an additional or larger harmonisation differences as these are either not recognised under GFS or recognised at market value.

3. whether the proposals are in the best interests of the Australian economy; and

HoTARAC does not offer any comments on whether the proposals are in the best interests of the Australian economy.

4. unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether

quantitative (financial or non-financial) or qualitative.

The major benefit of the proposal is the potential for more timely recognition of credit losses. The costs to preparers will be the resources used in assessing credit losses in line with the proposals and the extensive disclosure requirements. The costs to users will be the additional complexity, the lack of comparability between different financial instruments, information overload and difficulty in understanding the extensive disclosures.