5 July 2013

International Accounting Standards Board
30 Cannon Street
London
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United Kingdom
Email: CommentLetters@ifrs.org

Dear Sir/Madam

SAICA SUBMISSION ON THE EXPOSURE DRAFT ON *FINANCIAL INSTRUMENTS: EXPECTED CREDIT LOSSES*

In response to your request for comments on the exposure draft on *Financial Instruments: Expected Credit Losses*, attached is the comment letter prepared by Accounting Practices Committee (APC) of The South African Institute of Chartered Accountants (SAICA). This comment letter results from deliberations of the APC, which comprises members from reporting organisations, regulators, auditors, IFRS specialists and academics.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours faithfully,

Sue Ludolph
Project Director – Financial Reporting

cc: Paul O'Flaherty (Chairman of the Accounting Practices Committee)
Prof Danie Coetsee (Deputy Chairman of the Accounting Practices Committee)

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GENERAL COMMENTS

We welcome the revised proposals on the expected credit loss model. We recognise the efforts made by both the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (the "boards") in making significant improvements in operationalising the proposals since the publication of the first exposure draft in 2009. We continue to support the expected loss approach over an incurred loss approach as well as the development of a single converged model.

We recognise that the proposed model is not conceptually pure, but we acknowledge the need for a practical solution which is simple in its application, easy to understand and provides decision useful information to users of the financial statements. We believe that the proposals outlined in the exposure draft are largely successful in creating a practical approach to determining expected credit losses.

SPECIFIC COMMENTS

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?

Economically, our constituents are of the view that where the credit risk of an instrument is appropriately priced for on initial recognition, an entity would not suffer economic losses unless there is a deterioration in credit quality from the initial assessment. By raising an expected loss provision on day 1, the receivable is no longer reflected at fair value initially. Based on this, constituents were of the view that recognising either a 12 month expected credit loss or a full lifetime expected credit loss on initial recognition is not conceptually pure.

However, our constituents understood the rationale of the IASB in developing this approach, and accepted that, while not conceptually pure, it balanced operational simplicity with the objective of recognising expected (as opposed to incurred) losses. Accepting that the initial allowance is intended as a simplified proxy for unutilised credit premium, constituents accept that the proposed model acknowledges the economic link between the pricing and the credit quality of an instrument on initial recognition, and that any change in this credit quality should reflect an economic impact in an entity's financial statements.

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We are supportive of the proposals outlined in the current Exposure Draft (ED) as we support the practical expedient created in the proposed model and resolution of a large number of the implementation issues created under the previous EDs. We further agree that the recognition of a loss provision equal to lifetime expected credit losses after a significant deterioration in credit quality appropriately reflects the effects of changes in the credit quality subsequent to initial recognition.

We believe a 12-month expected loss approach is simpler to understand. The measure can leverage off the Basel loss measure enabling entities to use existing systems in determining expected losses.

During deliberations, our constituents noted the following concerns with the proposals:

- The income statement is meant to be a performance statement and the proposals will not be representative of the performance of the business due to the initial loss recognition. Constituents accepted that this was a necessary consequence of the operational simplifications referred to previously.
- The proposed model could give rise to a noticeable distortion and irrational margins in the results of lending entities or segments which are in a growth phase. This problem may be further compounded by the lack of credit information where these are new products or industries.
- The approach is subjective when assessing both the expected losses and instances of significant deterioration in credit risk. This in turn raises some concern around consistency and comparability. However, constituents acknowledged that this is a general concern under any expected loss model.
- A constituent noted that objective credit information is limited. Entities may encounter difficulties in tracking individual loans and predicting losses even over a shorter period. Consequently, the proposed approach may prove as subjective as a full lifetime expected credit losses model under certain circumstances.
- The model is inconsistent at initial recognition between instruments carried at fair value and instruments carried at amortised cost due to the 12-month expected credit losses recorded against amortised cost instruments at initial recognition.

(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?

As noted above, neither the 12-month expected credit loss model nor the full lifetime expected credit loss model is conceptually pure. We believe however that recognising a loss allowance at initial recognition equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments and is subject to significant complexity and subjectivity in its implementation. Such an approach would also similarly result in a more noticeable distortion in the results of entities which are in the start-up or growth cycle of a loan business. The problem will be further compounded by the lack of credit information where these are new products or lending activities in new industries, markets or segments.

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)?***

We agree that the proposals set out in the ED result in an appropriate balance between the underlying economics and the cost of implementation and largely addresses the concerns raised regarding implementation of the models proposed in the previous ED and the Supplementary Document (SD). As mentioned above, we do not believe that the model is conceptually pure, but agree with the need for a practical solution.
We concur that the proposed approach does achieve a better balance between faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD.

(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?***

We do not agree with the proposal 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 ED.

Question 3

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

The majority of our constituents agreed with proposed scope of the ED. We support a single credit impairment model for portfolios of financial assets carried at amortised cost, financial guarantees in the scope of the financial instrument standard and loan commitments that are not accounted for at fair value through profit or loss. We consider the inclusion of loan commitments and financial guarantees to be appropriate as these are often included by financial institutions in performing credit assessments and are included in assessing capital adequacy.

(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?

Consistent with our comment letter on the Classification and Measurement ED, we did not support the proposal for a third business model (FVOCI for debt instruments). We recommended that the IASB delay these proposals until the insurance project is finalised. However, if the IASB concludes that such a business model should be included, we would support the inclusion of this requirement in the ED.

We note that in Example 10, the initial entry to raise the 12 month expected credit losses is recognised in 'Other Comprehensive Income', which is dissimilar to the initial entry for instruments carried at amortised cost. We believe that if this distinction is intended in the way portrayed in the example, it should be clearly articulated in the body of the ED.

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?

We support the proposal to measure the loss allowance (or provision) at an amount equal to 12-month expected credit losses, because we believe that it will be more operational than previous models suggested.

Our constituents did however note that despite the model being operational the costs and resources required for implementation remain significant, especially for entities who do not have Basel II credit loss models in place.

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?

We 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.

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

We believe that additional clarification should be provided in determining what constitutes 'significant' credit deterioration.

The ED currently requires the contractual terms to be used when assessing expected losses as opposed to the behavioural patterns. Some constituents have indicated that they currently perform an assessment on the basis of behavioural patterns rather than contractual terms. In the view of these constituents, the behavioral patterns provide more useful information for users of financial statements, and are more consistent with the notion of 'expected' losses.

Other constituents noted that the principles above should apply only to irrevocable loan commitments. These constituents were more supportive of the contractual period.

In B29(b) guidance is provided on the determination of the effective interest rate for loan commitments. We noted the following issues:

- The ED states that the *"...discount rate that reflects the current market assessment of the time value of money and the risk specific to the cash flows..."* should be used for undrawn loan commitments and financial guarantees. It is unclear whether 'current' implies an assessment at the time at which the loan commitment is provided or whether the reference is to continuous reassessment based on changes in the market rate of interest.
- In addition, the paragraph states: *"...However, if the risk-adjustment is included by adjusting the discount rate, the adjusted discount rate will be lower than the risk-free rate."* We question whether this should be a higher rate than the risk-free rate as opposed to a lower rate than the risk-free rate.

(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?

We 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')).

(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?

Whilst the operational simplifications are welcomed, we would prefer the reference to 'investment grade' to be removed. The principle of 'investment grade', whilst being globally recognised terminology, poses challenges in its application, specifically in emerging economies. We therefore propose that reference should rather be made to 'low credit risk' which will remain open to application. Some constituents were comfortable including the term in 'investment grade' but would require further guidance on how to apply this, particularly as regards international and domestic grades.

The use of the '30 days past due' criteria may be interpreted differently in various industries and we therefore suggest that reference be made to 'one installment past due'. In addition we believe that additional guidance should be provided on how to rebut the '30 days past due' presumption.

The ED proposes that the entity should discount the expected credit losses using a discount rate between the risk free rate and the effective interest rate. The potential for use of different rates may reduce comparability and create the opportunity for managed margins. We propose the use of a single rate, preferably the effective interest rate. Alternatively, we suggest wording the rate as the 'rate that approximates the effective interest rate'.

The application guidance in B27 indicates that the cash shortfall is based on the cash flows under the contract compared to the expected cash flows. As expected cash flows may be discounted at the risk-free rate, it is perceivable that the entity could recognise a gain purely as a result of discounting different legs of the calculation at different rates. We suggest that the IASB clarifies its intention in this regard.

(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?

We agree with proposal that the model should 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.

We suggest the inclusion of additional guidance on the accounting for the move from full lifetime expected credit losses with interest on the net amount to full lifetime expected losses with interest on the gross receivable amount. Specifically, guidance relating to the changes in interest from the one to the other (i.e. catch up interest due to moving from net interest to gross interest) should be provided.

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?

We agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition. Furthermore, we 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. We believe the principles are consistent with those of revenue recognition and recoverability of interest revenue.

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (ie 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?

We agree in principle with the proposal that the interest revenue approach should be symmetrical (i.e. that the calculation can revert back to a calculation on the gross carrying amount), however, as stated previously, there is a lack of understanding from our constituents as to how the calculation will be performed in practice. We suggest that additional guidance should be provided.

Question 7

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

We are generally supportive of the proposed disclosure requirements as we believe these are likely to provide decision-useful information to users of financial statements. However, our comments below identify areas where disclosure requirements could be improved as well as where there may be a duplication of disclosures in terms of IFRS 7 – *Financial Instruments: Disclosures*. We propose that the IASB review these items in an effort to remove duplication.

We note that there could potentially be an overlap between paragraph 36(b) of IFRS 7, and paragraph 40(a) of this ED with respect to the disclosure requirements applicable to collateral held as security.

In addition, based on the current wording in paragraph 38, we envisage that the disclosure requirements in relation to the modifications could be onerous for entities as the information relating to modified instruments is generally not maintained in this manner.

We note that paragraph 44 makes reference to a minimum disclosure requirement of ‘three grades’. Some clarification should be provided for as to what is meant by or required by the reference to ‘three grades’.

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

As discussed under our response to question 7(a), we anticipate that the disclosure requirements on the modifications of financial assets to be onerous.

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

In our opinion, we believe that the proposed disclosure requirements will provide decision-useful information to the users of financial statements and therefore on this basis we do not propose any additional disclosure requirements.

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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?

The ED proposes that for a modification that does not result in a derecognition under IFRS 9 – *Financial Instruments*, the gross carrying amount should be recalculated on the basis of the renegotiated or modified contractual cash flows and a modification gain or loss should be recognised in profit or loss. While we support the principle, it remains unclear what the distinction is between extinguishment (i.e. substantial modification) and modification. Guidance to clarify this distinction would be useful. We also suggest that the guidance on the computation of modification gains or losses contained in IE57 be included in the body of the standard.

Furthermore, we do not believe that guidance on modifications should be provided in the impairment ED, but rather as part of the 'classification and measurement' section of the final standard.

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?

We agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts. Modeling over the contractual period of a loan/advance may prove challenging and operationally it may be more appropriate to model this over the behavioral patterns as opposed to purely on the contractual terms (for example credit cards). As previously mentioned, there were differing views from our constituents in this regard.

(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.

We do not foresee that any significant operational challenges 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.

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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?

We agree with the proposed simplified approach for trade receivables and lease receivables.

(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?

We agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component.

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?

The current wording of paragraph 14 suggests that further lifetime losses should be recorded on initial recognition of credit impaired assets. We understand that the intention of the IASB was not for additional losses to be recorded as these have been included in the transaction price. We therefore propose that the wording be clarified.

Some constituents were of the opinion that as the credit losses have not been paid for on the net amount, the instrument should initially be allocated to stage 1 (financial instruments that have not deteriorated significantly in credit quality since initial recognition) and consequently the net amount should be assessed on the basis of 12-month expected credit losses. In their view, a purchased impaired loan, which performs in accordance with expectations at the time of purchase is a performing loan, and should only be treated as a stage 2 (financial instruments that have deteriorated significantly in credit quality since initial recognition but that do not have objective evidence of a credit loss event) loan when it evidences further deterioration.

Additional guidance should be provided on how to account for amounts recovered in excess of the original purchase price adjusted for time value of money.

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.

We believe that entities would require a 3 year lead time as the implementation of the proposals would require significant changes to information systems and collation of relevant data. We note that most analysts generally require detailed comparative information for at least 3 years on the implementation of new accounting standards.

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

We agree with the proposed transition requirements. The guidance provided in paragraph C2(b) should however be clarified as regards to when retrospective application is applied and when not.

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

We agree with the proposed relief from restating comparative information on transition.

Question 13

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

We acknowledge that the IASB has gone a long way in developing a practical expected loss impairment model which we believe will be operable with sufficient lead time.

Other comments

We have noted that recently issued EDs, together with existing IFRS guidance, makes reference to a number of thresholds such as 'significant', 'more than insignificant', 'major', 'substantial' and 'material' etc. It is unclear as to how these terms correlate and we would urge the IASB to clarify the meaning of these terms.

We noted that no guidance has been provided on the accounting for inflation linked debt instruments. In practice, there remains significant divergence in the computation of the amortised cost carrying amounts and recognition of interest. We therefore request that the IASB consider inclusion of guidance on this matter.

We request that the IASB provide additional guidance on principles of modification and extinguishment, specifically in terms of distinguishing between modifications and substantial modifications (i.e. extinguishment), and accounting for the difference arising in each instance.