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International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Grant Thornton International Ltd
Grant Thornton House
22 Melton Street
London NW1 2EP

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ED/2013/3 Financial Instruments: Expected Credit Losses

Grant Thornton International Ltd is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft 2013/3 *Financial Instruments: Expected Credit Losses* (the ED). We have considered the ED as well as the accompanying draft Basis for Conclusions.

Summary of our views

We recognise the need to implement a more forward-looking model for recognising impairment on financial assets in the wake of the global financial crisis and calls from the G20 and others for reforms in this area. We therefore support the Board in its efforts to develop such a model.

From a conceptual point of view, we believe the model in the 2009 Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the 2009 ED) would reflect expected credit losses in a manner that faithfully represents the economics of lending transactions. However, we also recognise that the 2009 ED's proposals were widely considered to be excessively complex from an operational standpoint. An alternative is therefore necessary. The challenge for the Board is then to develop an approach that achieves a suitable balance between the objectives underlying the 2009 ED and the operational simplifications necessary to ensure the final Standard is operational and delivers benefits commensurate with its costs.

We believe the model proposed in the ED strikes a reasonable balance between these objectives. We also agree that the ED would be an improvement on the existing incurred loss-based model. We recognise the Board's efforts to address the operational difficulties associated with the 2009 ED and the 2011 Supplementary Document *Financial Instruments: Impairment* (the SD) and to introduce practical expedients that would reduce implementation costs for preparers.

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That said, we are not convinced that the three-stage model proposed in the ED strikes the most appropriate balance. Our principal concern is that we do not believe the recognition of a loss on initial recognition of a debt instrument (a 'day-one' loss) to be representative of the economics of lending activities. The pricing of a debt instrument will itself typically include an element of compensation for the initial expectation of credit losses. Recognising a portion of these initial expected credit losses upon initial recognition will not then reflect the economic link between the pricing and the initial credit quality when the financial instrument has been priced at market terms. While we recognise the model proposed in the ED would result in a lower day-one losses compared to the model proposed in the Financial Accounting Standards Board's proposed Accounting Standards Update *Financial Instruments – Credit Losses*, we nevertheless disagree with the recognition of any day-one loss.

We find the Board's suggestion that recognising this allowance in profit or loss will act as a proxy for yield adjustment required by the model proposed in the 2009 ED to be unconvincing (for the same reasons as expressed in the Mr Cooper's Alternative View).

We also note that the 12-month period is somewhat arbitrary and lacks a robust conceptual basis. While we acknowledge that this proposal mitigates the operational challenge of estimating lifetime expected losses for all in-scope financial assets, it creates other complexities. These include the boundary issue between the 12-month and expected lifetime losses categories and the need to track assets between those categories. These problems are further complicated by the fact that certain key terms, such as default, are not defined. We acknowledge however that some entities are already required to measure an amount similar to the ED's definition of 12-month losses to comply with prudential regulations. For those entities the proposal will be useful from an operational perspective in that it allows them to build on information that they already use for credit risk management purposes.

We also have some concern that the use of a 12-month expected credit loss allowance may result in the recognition losses too late for certain types of financial instrument that are designed in such a way that the probability of default is skewed towards the end of the instrument's life.

In view of these concern our preferred solution would be the implementation of a single-stage model that avoids the recognition of a day-one loss and that is capable of being applied to all financial assets within the ED's scope.

Expanding on this, we believe that if the application of an impairment model results in a day-one allowance, such determination really means that the contractual return on the investment is not consistent with management's estimated return at acquisition. We believe that rather than recognise a day-one allowance for credit losses in profit or loss the entity should instead reduce its effective yield such that the discounted cash flows expected at acquisition are equal to the amount of the day-one carrying amount of the loan. As a result, we believe that the measurement objective of interest income at initial recognition should be to reflect the initial expected rate of return implicit in a debt instrument.

We believe an approximation of the yield adjustment that was a feature of the 2009 ED could however be made without introducing excessive or insurmountable operational challenges by using current methods of amortising loan origination costs for these premiums. Such an approach would be similar to the 'gross-up method' referred to in BC25 of the ED. We therefore recommend that the Board considers exploring this potential path in more detail.

Finally we reaffirm the importance of the Board's and the Financial Accounting Standards Board's (the FASB) efforts to reach a converged solution on credit losses. We acknowledge the challenges of reaching a converged solution given the Boards' different constituencies. We nonetheless strongly encourage the Boards to use best endeavours, taking into consideration the feedback received on both proposals, to come to a solution that eliminates or minimizes the current differences in the two Boards' proposed approaches.

We expand on these comments in our answers to the invitation to comment questions.

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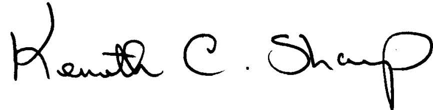
If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gti.gt.com or telephone + 44 207 391 9510).

Yours sincerely,



Kenneth C Sharp
Global Leader - Assurance Services
Grant Thornton International Ltd

Responses to Invitation to Comment questions

Objective of an expected credit loss impairment model

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?

As noted in our covering letter, we question whether the approach proposed in the ED is the most appropriate way of implementing a more forward-looking approach to the recognition of credit losses. Our main concern is that the ED's proposals would result in a day-one loss in profit or loss. In our view this does not reflect the economic link between the pricing of a financial instrument and the credit quality at initial recognition when the financial instrument is priced at market terms.

In addition, although an approach that recognises a loss allowance at an amount equal to a portion of expected credit losses initially mitigates the operational challenge of estimating lifetime expected losses for all in-scope financial assets, we believe it would create other complexities and potential for inconsistent application.

Basing the model on the assessment of a combination of both relative and absolute deterioration of credit quality will (as the ED acknowledges) result in a cliff effect whereby a deterioration in credit quality below a certain point is not recognised in the financial statements while a deterioration above that point tips the instrument into an entirely different category for the purpose of measuring impairment. We question whether this provides the most useful information to users of the financial statements. Our preference would be for a single-stage credit loss model that would be applied to all financial assets within the scope of the ED.

We also have concerns over the proposal to recognise a loss allowance at an amount equal to 12-month expected credit losses initially for financial assets that have not deteriorated significantly in credit quality since initial recognition or that have low credit risk at the reporting date. Although we agree that a model that reflects the effects of changes in the credit quality of a financial assets is desirable, we believe that it will result in the recognition of expected losses at too late a stage for certain types of financial asset. Examples of such assets include certain interest-only mortgages and syndicated loans that have been specifically designed to give considerable flexibility to the borrower in the initial years of the loan term. We understand that in some areas of the world, the incurred loss model has been interpreted in such a way as to enable losses on such instruments to be recognised at a relatively early stage (reference to a loss emergence period being used as justification for an incurred loss being recognised).

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(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?

We believe it would be inappropriate for the recognition of a loss allowance at an amount equal to lifetime expected credit losses to result in a day-one loss in profit or loss. For the reasons we have already expressed, we do not believe this would faithfully represent the underlying economics of financial instruments.

We believe the approach proposed in the ED is preferable to that proposed in the FASB's model in that it would result in a lower day-one loss being recognised. However, we consider neither the Board's nor the FASB's approach to be the most appropriate implementation of an expected loss model. As mentioned in our covering letter, our preference would be for an approach similar to the 'gross-up method' expressed in BC25 of the ED, which would be based on lifetime expected losses and which would be applicable to all financial assets.

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?

Conceptually, we believe the model in the 2009 ED would implement an expected credit loss approach in a manner that faithfully represents the economics of lending transactions. However, in our response letter on the 2009 ED we noted the operational challenges of implementing that model and expressed our concerns that the resulting costs may outweigh the benefits.

We acknowledge that the ED's proposals aim to achieve a more reasonable balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD. We also agree that the model proposed in the ED mitigates the operational challenge of having to estimate the full expected cash flows for all financial instruments by limiting the measurement of lifetime expected credit losses to financial instruments that have significantly deteriorated in credit quality after initial recognition.

As noted in our covering letter, however, we question whether recognising a loss allowance at an amount equal to 12-month expected credit losses strikes the most appropriate balance between these objectives.

From the perspective of achieving a faithful representation of the underlying economics, the 12-month period is somewhat arbitrary and lacks a robust conceptual basis. From an implementation perspective, the proposal avoids the operational challenge of having to estimate the full expected cash flows for all financial instruments but we think it will create other operational challenges. As mentioned previously, various issues will result from the boundaries between the two categories. Entities will need to track assets according to whether expected credit losses should be recognised on the basis of 12-month or lifetime losses and account for movements between those categories, which will be costly. The lack of a definition of 'default' may also result in inconsistent application. Factors such as these will add to the complexity of the model. We also have some concerns over whether it will result in the recognition of losses at too late a stage for certain types of financial instrument, as mentioned in our answer to question 1 above.

More generally, we believe that recognising a day-one loss as proposed in the ED will not faithfully reflect the economic link between the pricing and the initial credit quality of a financial asset when that asset has been priced at market terms. As noted in the Basis for Conclusions accompanying the ED, where an instrument is entered into on market terms the initial credit loss expectations are reflected in the initial pricing of the instrument. As a result the profit for a lending business will be understated at origination and then overstated in subsequent periods as interest revenue is recognised using full contractual cash flows, which ignores expected credit losses.

We acknowledge that the operational problems associated with the approach in the 2009 ED mean that that approach could not be pursued without significant simplifications. We believe however that an approximation of the yield adjustment that was a feature of the 2009 ED could be made without introducing excessive or insurmountable operational burdens by using current methods of amortising loan origination costs for these premiums. Such an approach would be similar to the 'gross-up method' expressed in BC25 of the ED. We therefore recommend that the Board considers exploring this potential path in more detail.

Scope
Question 3

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

We agree with the ED's proposed scope.

We support the proposal to include certain financial guarantees and loan commitments within the scope of the proposed Standard because we understand that many financial institutions manage credit risk on these instruments in the same way that they manage credit risk on loans. Applying the same impairment approach to these instruments should serve to better reflect the way such entities operate while also reducing the operational burden.

(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?

We agree (in the event that the FVOCI measurement category is introduced into IFRS 9). This is because the FVOCI category would apply to financial assets held within a business model whose objective is both to collect the contractual cash flows and to sell. The proposal would result in fair value information on the balance sheet and amortised cost information (including expected credit losses)n profit or loss. This seems consistent with the business model objective for FVOCI assets. We agree that is appropriate and simpler to measure interest income and expected credit losses for FVOCI assets consistently with amortised cost assets.

We also recognise that an alternative of retaining the incurred loss model used for available-for-sale investments under IAS 39 *Financial Instruments: Recognition and Measurement* was heavily criticised during the financial crisis, and that a degree of compromise is therefore needed.

We note however that achieving this outcome involves recognise initial and subsequent changes in the expected credit losses in other comprehensive income (OCI). Although this is possibly unavoidable it does raise further questions over what amounts recognised in OCI purport to represent.

12-month 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?

We believe that this question is most relevant to preparers, and that the Board should therefore give the most weight to their views.

For our part we see no particular reasons why an approach of measuring the loss allowance at an amount equal to 12-month expected credit losses would not be operational. Recognising loss allowances equal to 12-month expected credit losses for financial assets that have not deteriorated significantly in credit quality since initial recognition or that have low credit risk at the reporting date will, as the Board says, avoid the operational challenges associated with having to estimate the full expected cash flows for all financial instruments. In addition, some entities will be able to adapt calculations they have used for regulatory purposes in calculating these amounts. We believe then that the proposals are operationally simpler than those suggested in the 2009 ED and SD.

Assessing when an entity shall recognise lifetime expected credit losses
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?

As mentioned above, our preference would be for an approach similar to the 'gross-up method' referred to in BC25 of the ED, which would be based on lifetime expected losses and which would be applicable to all financial assets.

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

Notwithstanding our conceptual concerns with the proposals, and our preference for the gross-up method mentioned above, we believe that at an overall level the proposals provide appropriate principles-based guidance on when to recognise expected credit losses.

As previously noted, there will of course be some questions of interpretation due to way the proposed model produces a cliff effect. The interpretation of a significant increase in credit risk in relation to paragraph 5 of the ED and 'low' credit risk in relation to paragraph 6 of the ED will for instance be key judgements. Even use of a phrase such as 'investment grade' lends itself to interpretation, with different ratings agencies themselves having differing opinions over the credit quality of instruments. We recognise however that some degree of interpretation will always be necessary when dealing with principles-based standards.

(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. While we consider that a change in an instrument's credit quality depends in part upon the change in credit losses expected on that instrument, requiring entities to also assess changes in expected credit losses would add considerably to the cost and complexity of the proposals. In view of this, we regard the proposal as a reasonable operational simplification.

(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?

In the context of the model proposed in the ED we agree with the operational simplifications.

(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 disagree with the proposal for re-establishment of a loss allowance at an amount equal to 12-month expected credit losses when conditions improve.

We acknowledge this proposal would achieve a certain symmetry for changes in credit loss expectations. We however believe that the informational benefits are questionable in this context. In particular, we note that re-establishing a loss allowance based on 12-month expected credit losses means a 'reverse-cliff effect' is experienced. We also believe that the two-way movement between stages will add operational complexity. Entities would also need to continue monitoring the change in credit risk relative to its original credit risk. Given that it is possible for instruments with similar levels of absolute credit risk to be accounted for differently in accordance with the ED, it would seem preferable to permit or require entities to continue measuring the allowance based on lifetime expected losses once the threshold in paragraph 5 of the ED has been crossed.

Should the Board decide to continue with this proposal, we suggest adding an example to illustrate the mechanics.

Interest revenue
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?

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. This is on the basis that we believe it is no longer appropriate to continue to report interest revenue on a gross amortised cost basis when the likelihood of collection falls below probable, or some other suitable threshold.

(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 in principle with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition. We agree with the Board's conclusion that there are some financial assets for which the credit quality has deteriorated to such an extent that presenting interest revenue on the basis of the gross carrying amount that reflects the contractual return would no longer faithfully represent the economic return. Should the Board proceed with the proposals in the ED, however, we believe additional guidance will need to be given on how the boundaries within the lifetime expected loss category interact.

In the context of a credit deterioration model, it would for example be helpful to specify a level at which net interest should be applied. The current guidance concentrates more on evidence of impairment. We would prefer a threshold that focuses on the absolute level of credit risk or extent of deterioration taking account of all reasonable and supportable information.

(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 disagree.

While a symmetrical approach is superficially attractive, we believe it would add to the complexity of the proposals without necessarily resulting in better information. As discussed in our answer to 5(e) above, entities will not only need to track instruments in order to determine whether the threshold in paragraph 5 of the ED has been crossed, they will also need to continue monitoring the change in credit risk relative to the original credit risk of the instrument adding to the costs of implementation. Given that the original expected cash flow model proposed in the 2009 ED was acknowledged to be the most conceptually pure approach, the challenge for the Board is to achieve the right balance between the original objectives that were behind that model and the compromises needed to make a new approach operational. In that light, it would seem a reasonable simplification to allow entities to continue to recognise interest on a net basis once they have first done so.

Recognising interest on a net basis will also result in a higher yield being recognised where expectations of the credit quality of an asset improves, as cash received in respect of a credit-impaired asset will reduce its amortised cost. It could be argued that this presents more meaningful information than reverting back to a different measurement basis.

Should the Board decide to continue with this proposal, however, we suggest adding clarification in the form of illustrative examples to explain how the mechanics of moving from accounting for interest on a net basis to a gross basis work.

Disclosure

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 agree with the intention of improving transparency that lies behind the proposed disclosure requirements but find that the disclosures themselves are overly prescriptive and detailed.

We recognise that an expected credit loss model will require more judgement compared to the existing incurred loss model. We agree then on the need for appropriate disclosures if users are to properly understand the effects of credit risk on an entity's results. Overall however it appears to us that the disclosures have been shaped by the requirements of financial institutions. While some simplifications have been included for trade and lease receivables, we question whether the extent of remaining disclosures is appropriate for non-financial institutions, particularly given that many commentators have remarked in recent years upon the need to reduce the level of clutter in financial statements.

We would prefer a less prescriptive approach that sets objectives, emphasises materiality, and provides detailed examples specific disclosures that could be provided in order to achieve the overall objectives as set out in paragraph 28 of the ED.

We also make the following more specific points:

- paragraph 38 could be more clearly drafted. We presume the disclosure requirements are intended to apply only to modifications of financial assets on which lifetime expected credit losses are recognised as a result of a significant increase in credit risk and assets held under the simplified approach where modification has occurred when more than 30 days past due (or the equivalent number of days where the rebuttable approach has been taken). We further question the necessity of providing the information in 38(b) for non-financial institutions
- the requirements in respect of collateral (paragraph 40) appear unduly onerous. We say this on the basis that they could be interpreted as requiring entities to disclose in a meaningful way all instances where collateral has deteriorated. It is also unclear from what date the deterioration in credit quality of the collateral is to be assessed from.

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

We question the appropriateness for non-financial institutions of paragraph 44's requirement to disclose the gross carrying amount of financial assets by credit risk rating grades. In particular we question the logic of always presenting at least three credit risk rating grades even if an entity uses fewer credit risk rating grades internally. If an entity uses less than three credit risk rating grades internally, then it would seem misleading to suggest otherwise to the reader. We also question how this requirement would be applied by an entity which has, for example, a stated policy of only holding AAA-rated assets.

At a more general level, we note that the increased levels of disclosure will add considerably to entities' operational costs. We question whether the benefits from providing this information will exceed the cost for non-financial institutions given that the criticism of impairment accounting during the financial crisis appeared to be levelled almost entirely at financial institutions.

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

As noted above, although we generally support the proposed disclosures, we believe that some of the detailed requirements are excessive and will not serve to reduce the clutter in financial statements that many commentators have remarked upon in recent years. We are reluctant then to suggest additional disclosures.

One area where the Board might look to include additional disclosures however is that of experience adjustments. Given that judgement of expected losses will be a crucial factor in the proposed approach, including information on experience adjustments would allow users to better understand the quality of earlier estimates and form their own view on the reliability of the information currently being presented to them.

Application of the model to assets that have been modified but not derecognised
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?

We agree with the proposed treatment. We note however that it may not always be clear under IFRS 9 (or IAS 39) whether a modification should result in the derecognition of a financial asset. We note that a submission was made to the IFRS Interpretations Committee (IFRIC) on this issue in May 2012 but the IFRIC decided against adding it to its agenda. As a result, the issue remains unclear. We recommend then that the Board considers clarifying the accounting for modifications of financial assets when finalising IFRS 9.

Application of the model to loan commitments and financial guarantee contracts
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 are aware that many financial institutions manage loan commitments and financial guarantee contracts in the same way that they manage loans, and that they will therefore wish to apply the same impairment model to those assets. We therefore support the Board's efforts to apply a single expected credit loss model to loan commitments and financial guarantee contracts.

We question however how practical it will be to apply the proposed model's two stage process to loan commitments and financial guarantees. While we would prefer one model to be applied to all financial instruments, we suggest that (within the context of the ED's proposed model) the Board should consider whether measuring lifetime expected credit losses may be a simpler approach for these loan commitments and financial guarantees.

We also note that the proposals may not produce the most meaningful information for some loan commitments. Where a lender can withdraw a loan commitment with no or little notice for example, the requirements the ED can be interpreted such that no provisions for credit losses, or very small levels of provisions, will be recognised. This may not provide the most useful information however where the lender does not have the information on when it is actually advisable to withdraw the loan commitment.

Should the Board proceed with its proposals then, we suggest it would be helpful to include an illustrative example in the final standard which clarifies:

- how the term 'present contractual obligation to extend credit' should be interpreted
- how the assessment of 12-month losses should be made.

(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.

This is a question which should primarily be answered by preparers. However we believe operational problems might arise from needing to prepare information based on contractual obligations rather than on internal reporting which may be based on expected behaviours.

Exceptions to the general model
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?

Within the context of the ED's proposed model, we agree with the proposed simplified approach for trade receivables and lease receivables.

As mentioned in our previous comment letters, we believe there is a need for practical expedients if the costs of implementing a new model are not to exceed the benefits from doing so. Although the simplified approach will result in less comparability between entities, we consider that applying the full impairment model to lease receivables and trade receivables would not achieve an appropriate balance between costs and benefits. In addition most trade receivables have short maturities so that in practice lifetime expected credit losses are likely to be similar to the figure for 12-month expected credit losses. We therefore agree with the proposed simplified approach.

(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?

Within the context of the ED's proposed model, 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?

We agree with the proposal in the ED to carry forward the requirements in IAS 39.AG5 for an entity to include the initial expected credit losses in the estimated cash flows when computing the effective interest rate.

Effective date and transition
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 a lead time of three years to implement the standard should be provided in view of the extensive changes that some entities may need to make to their information systems and the way in which they collect data. Accordingly we believe the mandatory effective date of IFRS 9 should be deferred beyond the current 1 January 2015 date. Entities should however be allowed to apply the Standard earlier if they wish to.

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

We agree in general with the proposed transition requirements which seem to provide a reasonable balance between the costs of implementation and the provision of useful information to users.

As a drafting matter, paragraph C2(a) is confusingly worded. We suggest it would be simpler to state that, when this situation applies, 12 months' expected losses are recognised if credit risk is low and full lifetime losses if credit risk is more than low at the reporting date. The effect of making this change would be that entities would not need to consider periods prior to the beginning of the earliest comparative period.

(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. Although allowing relief from restating comparative information will reduce the usefulness of the financial statements for users, it offers a significant relief for preparers. Given the costs of implementing the proposals would be extensive for preparers, particularly financial institutions, we believe this is an acceptable operational compromise.

Effects analysis
Question 13

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

While we have expressed reservations over the optimality of the proposed model, we agree that it will remove IAS 39's current incurred loss threshold and so result in the more timely recognition of expected credit losses at an overall level. We appreciate the Board's efforts to undertake fieldwork during the comment period for the ED and note that the results from this feedback may well provide the most relevant information on the effects of the proposals. More generally, we appreciate the Board's efforts to more formally integrate the effects analysis process into the standard setting process.

Other substantive points

We consider the proposal in B29(a) of the ED that an entity shall determine as the discount rate "any reasonable rate that is between (and including) the risk-free rate and the effective interest rate" somewhat questionable.

While we acknowledge that the intention behind this proposal was to allow preparers to choose a rate that is suitable for the level of sophistication of their systems and their operational capability, we find it to be overly flexible. We note in particular that in some emerging market economies, substantial differences may exist between the effective interest rate for an instrument and the risk-free rate for those economies.

We suggest that a better way of achieving the aim that was behind the proposal would be to establish an objective of measuring expecting losses consistent with the effective interest rate, while allowing some flexibility and/or practical expedients in how an entity implements that objective.

Should the Board decide to proceed with this proposal as it is currently worded, we believe guidance will need to be provided on how 'reasonable' is to be assessed.

Other editorial matters

We briefly outline below some editorial matters which came to our attention when reading the ED:

- we suggest that the Board considers amending paragraph 5 of the ED in such a way as to require an entity to switch to the recognition of lifetime losses when 1) significant deterioration has occurred; and 2) credit risk is not low given the importance of the exemption in paragraph 6 of the ED
- in Appendix A, the definitions of effective interest rate and credit-adjusted effective interest rate in referring to ‘purchased or originated credit impaired financial asset’, conflate the actual definition of the terms and the scope of their application
- we note that paragraph B29 requires an entity to use a different discount rate for measuring financial guarantees and loan commitments than is used for other financial assets. We question why this is the case as it means that the discount rate and therefore the allowance for expected credit losses will change when the loan is drawn down.