IAASB International Auditing and Assurance Standards Board

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June 28, 2013

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Hans,

Re: Comments on IASB's Exposure Draft on Financial Instruments: Expected Credit Losses

I am pleased to provide comments on the IASB's March 2013 Exposure Draft *Financial Instruments: Expected Credit Losses* (ED). These comments have been developed by the International Auditing and Assurance Standards Board (IAASB)'s IASB Liaison Working Group (the Working Group), with a particular focus on auditability or verifiability, and reviewed by the IAASB Steering Committee.

I understand that the IASB's main objective in developing these proposals has been to provide users of financial statements with more useful information about an entity's expected credit losses on its financial assets and its commitments to extend credit. In doing so, the proposed expected credit losses model would be more forward-looking and requires an entity to consider a broader range of information than the existing incurred loss model. I believe this can be an important contribution to financial stability.

Incorporating forward-looking information into accounting estimates is not completely new. However, the Working Group feels that the "expected credit loss approach" proposed in this ED will impose significant challenges to both management and auditors due to increased estimation uncertainty. Because of these challenges, the Working Group recommends that the IASB provide more robust guidance about the nature and scope of information that management should consider when estimating expected credit losses (including, for example, the extent to which macro-economic trends should be considered). Such guidance would also enable auditors to have a clearer sense of what to expect of management in this area, and the nature and extent of audit evidence that should be obtained.

It would also be useful for the IASB to consider providing an explicit requirement for management to document its judgment process (including the rationale for important management judgments) in estimating expected credit losses. Further, the Working Group believes that the IASB should enhance some of the proposed disclosure requirements in the ED regarding credit risk rating grades and the use of cross-referencing, to address potential auditing challenges. Detailed comments are provided in the Appendix of this letter.

I hope that you will find the comments helpful. If you require any clarification or would like to discuss this letter further, please do not hesitate to contact me or Mr. Tomokazu Sekiguchi, the Chair of the Working Group (t.sekiguchi@asb.or.jp).

Yours sincerely,

Prof. Arnold Schilder
Chairman, IAASB

Cc. Mr. Prabhakar Kalavacherla, Member and Liaison Representative, IASB

Appendix

IASB EXPOSURE DRAFT -
FINANCIAL INSTRUMENTS: EXPECTED CREDIT LOSSES
Comments of the IAASB's Working Group

I. OVERALL COMMENTS

CHALLENGES FOR MANAGEMENT AND AUDITORS RELATING TO INCREASED ESTIMATION UNCERTAINTY

Issues Description

The ED proposes to introduce the "expected loss approach" to replace the "incurred loss approach" in the existing IAS 39 *Financial Instruments: Recognition and Measurement*. The ED also proposes to require an entity to estimate the lifetime expected credit losses for a purchased or originated credit-impaired financial asset, and for a financial instrument of which the credit risk has increased significantly since initial recognition. Such a requirement would introduce a high level of estimation uncertainty, and require management to exercise significant judgment when estimating the expected credit losses. For auditors, obtaining sufficient appropriate audit evidence relating to those judgments would become more challenging.

Under the International Standards of Auditing[1] (ISAs), for accounting estimates that give rise to significant risks, among others, the auditor shall evaluate the following:

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate;

(b) Whether the significant assumptions used by management are reasonable; and

(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

In addition, if the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls over the estimation process[2]. In this context, it is important for management to maintain robust internal controls over its estimation processes, and to be able to demonstrate how management considered alternative assumptions and methods as well as why they determined their estimates are reasonable. Considering that these assumptions are by nature subjective and can be explained in many different ways in hindsight, it would be helpful for management and auditors if the judgment process were to be documented.

Further, the ED requires an entity to consider the best available information, including information about past events, current conditions, and reasonable and supportable forecasts of future events and economic conditions at the reporting date. The Working Group appreciates the explanation about what constitutes the best available information, as it would be helpful to minimize the question as to the nature and scope of the information to consider when estimating the expected credit losses. However, going forward, it seems that the population of financial assets that fall under the scope of the ED would be very large, especially for financial institutions. In addition, contractual periods of financial instruments that are within the scope of the ED would sometimes be very long (for example, contractual periods of mortgage loans

[1] Paragraph 15 of ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

[2] Paragraph A50 of ISA 540

are sometimes 30 years or even longer.) Therefore, the Working Group anticipates that obtaining sufficient appropriate audit evidence regarding the many significant judgments made by management, including the reasonableness of the assumptions about the macro-economic trends would be quite challenging.

Actions that the IASB May Wish to Consider in Addressing the Issues:

The Working Group recommends that the IASB provide further application guidance that sets out the nature and scope of information to consider when estimating expected credit losses, and incorporate into its standard a documentation requirement about the judgment process that has been used in estimating expected credit losses.

II. COMMENTS ON A SPECIFIC QUESTION IN THE ED

QUESTION 7: DISCLOSURE REQUIREMENTS

Issues Description

Paragraph 31 of the ED permits cross-references in meeting disclosure requirements, and paragraph 32 notes that such cross-references may be made to other documents outside the financial statements. The Working Group believes that the IASB should clarify the condition as to when and how cross-referencing can be made. This is important, because normally, documents containing information cross-referenced from the financial statements would be subject to audit procedures as part of the financial statement audit.[3]

In addition, paragraph 44 of the ED requires an entity to disclose, by credit risk rating grades, the gross carrying amount of financial assets and the amount recognised as a provision for loan commitments and financial guarantee contracts in a grade. The Working Group is aware that financial institutions maintain and use more granular credit risk rating grades than the number of minimum grades required by the ED (i.e., three grades). However, it would not be common for entities other than financial institutions to maintain internal credit rating grades. Therefore, without a clear set of criteria as to how to determine credit risk rating grades, the Working Group believes that obtaining sufficient appropriate audit evidence as to the credit rating determined by management would be quite difficult. Obtaining sufficient appropriate audit evidence would be particularly challenging because, in such situations, credit risk ratings would be provided only for financial reporting purposes, and the process would entail significantly subjective judgments. Accordingly, consistent application of the requirement would benefit greatly from a robust set of criteria that facilitates sound judgments by entities and provide auditors with clearer benchmarks against which to audit.

Actions that the IASB May Wish to Consider in Addressing the Issues:

The Working Group recommends that the IASB require that financial statements not include a cross-reference to information in another document unless that information is clearly identified and separated from other information in that document. In addition, the Working Group recommends that the IASB provide a clear set of criteria as to the credit risk rating grades, if it were to require such disclosures.

[3] For example, paragraph A46 of ISA 700, *Forming an Opinion and Reporting on Financial Statements,* states that the auditor's opinion would cover notes or supplementary schedules that are cross-referenced from the financial statements.