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Mr. Simon Riley
Director, Standard Setting
Hong Kong Institute of
Certified Public Accountants
37/F, Wu Chung House
213 Queen's Road East
Wanchai, Hong Kong

Dear Mr. Riley,

Re: Invitation to Comment on IASB Exposure Draft of Financial Instruments: Expected Credit Losses

I refer to your letter dated 13 May 2013 inviting for comments to the above Exposure Draft.

In the wake of financial crises, the current incurred loss impairment model for financial instruments has been criticised for delaying the recognition of losses and for not reflecting accurately credit losses that are expected to occur. In response to requests from G20, the IASB and FASB have been working jointly to develop a more forward-looking impairment model that reflects expected credit losses. The agreed model has been simplified to reflect feedback from interested parties. The IASB and FASB then published separately their diverged models for public comments. The Boards would discuss comments on both proposals to see whether their expected loss models could be more closely aligned.

In order to address the weaknesses of the existing incurred loss model, the IASB proposes in its new model the recognition of expected credit losses apart from incurred credit losses. It is no longer necessary to wait for the occurrence of a

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credit loss event to make impairment provision. Instead, a 12-month expected credit losses is to be recognised on initial recognition of the financial instruments and on reporting dates. Then subsequently a lifetime expected credit losses is to be recognised when the credit risk has increased significantly since initial recognition. The information to be used for the measurement of expected credit losses would be broadened to cover not only past events but also current conditions and reasonable and supportable forecasts.

Under this IASB proposed model, there is a rebuttable presumption that the lifetime expected credit losses criterion is met if contractual payments are more than 30 days past due. Trade and lease receivables will be subject to a simplified approach whereby for trade receivables constituting a financing transaction, lifetime expected credit losses will be recognized at initial and throughout the asset's life. For trade receivables not constituting a financing transaction and for lease receivables, an option is available to measure the loss allowance at an amount equal to lifetime expected credit losses at initial recognition and throughout the asset's life.

The proposed model will apply to financial instruments not accounted for at fair value through profit and loss (e.g. financial assets measured at amortised cost and at fair value through other comprehensive income, debt securities and trade receivables, irrevocable loan commitments and financial guarantees, and lease receivables).

Regarding IASB's proposed model, I agree in principle that impairment provisions should reflect changes and significant deterioration in credit risk, and that it will provide more useful information if assets with credit quality significantly deteriorated are distinguished from those with better credit quality. However, while it makes sense to provide for a lifetime expected credit losses when the credit risk has deteriorated significantly, I fail to see the need for providing a 12-month expected credit losses on initial recognition of the financial instrument and on reporting dates when there is no evidence to show any increase in credit risk. Credit risk if any that may exist at initial should have already been reflected in the acquisition price of the asset. I share the alternative view and have reservation over such provision. Indeed, the IASB acknowledges that there is no conceptual justification for the 12-month time horizon (i.e. BC 61). It also acknowledges that the 12-month expected credit losses proposal would result in an overstatement of expected credit losses for financial instruments, and a resulting understatement of the value of related financial assets, both at and immediately after initial recognition of those financial instruments (i.e. BC66).

Furthermore, under the simplified approach for trade receivables and lease receivables, lifetime expected credit losses will be recognised at initial recognition and throughout the asset's life. Under the rebuttable presumption that when payments are more than 30 days past due, a significant increase in credit risk will be deemed to have occurred necessitating the provision of lifetime expected credit loss. In this connection, many entities will have to provide for exceptionally large amount of impairment losses on adoption of the IASB proposed model. I have concern that as a result the financial statements may not be able to reflect the true performance of the businesses.

I understand that the proposed move from incurred loss model to expected loss model is for good purposes to enable more timely recognition of credit losses, to be more forward-looking thus providing better investor protection. However, estimations, forecasts and judgements will come into play for the measurement of expected credit risk and for the determination whether the credit risk has significantly deteriorated. I therefore have concern that the move to expected loss model will provide more room for earnings management, and that the financial statements will be more susceptible to human judgemental errors or even wilful manipulations on the part of company management, bearing in mind it may not be at all easy to challenge the estimations and judgements made by the company management.

Having said the above, I must point out that for taxation purpose however, the deduction for impairment loss is governed by the provisions of the Inland Revenue Ordinance and is on an "incurred" basis. For under Section 16(1) of the Inland Revenue ordinance, outgoings and expenses shall only be deductible to the extent to which they are incurred. And under Section 16(1)(d), the bad debts incurred should be proved to the satisfaction of the assessor to have become bad during the basis period for the year of assessment, and doubtful debts to the extent they are estimated to the satisfaction of the assessor to have become bad during the basis period.

I welcome the proposed disclosure of comprehensive information under the IASB proposed model which will be useful to users of financial statements. It is hoped that after deliberating comments from stakeholders, the Boards could refine their models to reduce divergence and achieve consistency in accounting. In any event, I would appreciate it very much if you could keep me informed of the development in the accounting for expected credit losses in financial instruments.

Yours sincerely,

(Mrs WU LAM Choi-wah)
for Commissioner of Inland Revenue