THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

28 August 2009

Our ref: ICAEW Rep 90/09

Your ref:

Sir David Tweedie
Chairman
The International Accounting Standards Board
First Floor
30 Cannon Street
London, EC4M 6XH

By email: iasb@iasb.org.

Dear David

REQUEST FOR INFORMATION ('EXPECTED LOSS MODEL') IMPAIRMENT OF FINANCIAL ASSETS: EXPECTED CASH FLOW APPROACH

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the Request for Information *('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach*

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW REPRESENTATION

ICAEW REP 90/09

REQUEST FOR INFORMATION ('EXPECTED LOSS MODEL') IMPAIRMENT OF FINANCIAL ASSETS: EXPECTED CASH FLOW APPROACH

Memorandum of comment submitted in August 2009 by The Institute of Chartered Accountants in England and Wales, in response to the International Accounting Standards Board Request for Information *('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach,* published in June 2009.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to respond to the Request for Information on *('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach* published by the International Accounting Standards Board in June 2009.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms and public sector bodies.

MAJOR ISSUES

5. We welcome the Board's decision to examine alternatives to the incurred loss approach to impairment of financial assets as an appropriate response to one of the issues arising from the credit crisis. We agree that in seeking to replace IAS 39 it is important to consider alternatives. However, we are concerned that the Board may be moving towards a change without full consideration of the issues.

6. We note that the Request for Information specifically does not seek views on the relative advantages and disadvantages of alternative impairment approaches. However, although it may appear sensible to look at whether adopting the expected loss model is feasible before considering its relative merits, we fear from the list of criticisms of the incurred loss model that the Board's preliminary view is already to make this change. We do not think that is appropriate to consider the feasibility of adopting the expected loss model without also considering whether it would represent an improvement on existing practice.

7. Our view is that the expected loss model is, at best, no more valuable than the current model, and it would be very expensive to implement. In fact, there are significant disadvantages of the expected loss model. It is more subjective and thus open to abuse and may as a result reduce comparability between entities. It undermines the usefulness of the income statement as it is not compatible with many of the key performance indicators with which

users of bank accounts are familiar. Moreover, it does nothing to reduce the supposed procyclicality of the current rules. Indeed, it would accelerate the recognition of losses at exactly the time capital is under threat.

8. In the circumstances, although we have addressed the limited questions set out in the Request for Information, we have also addressed the putative criticisms of the incurred loss approach in the appendix.

9. On the basis of the description of the expected loss approach in the Request for Information, we do not believe it constitutes an acceptable replacement for the current approach.

10. Rather than pursuing a model in which, in our view, the disadvantages outweigh any advantages, the IASB should review the existing incurred loss approach. There are likely to be amendments that can be made to clarify the requirements, reduce any difficulties in applying the model in practice such as identifying appropriate trigger points and thereby avoid delays in the recognition of losses.

SPECIFIC QUESTIONS

Question 1: Is the approach defined clearly? If not, what additional guidance is needed, and why?

11.. We do not think that the approach is clearly defined. There are a number of areas where the result of applying the expected loss approach would appear to produce less useful information than the current approach, which suggests that either the description in the Request for Information is misleading or that far more information is required as the Board's intentions. We set out some of our concerns below.

- *Lack of historical data.* There will be many occasions when historical data is unavailable: for example, for new product classes or specific types of asset or where data is only available on a portfolio basis. It is not clear how entities would be expected to make expected loss calculations in the absence of reliable data. Moreover, where big-ticket loans are being assessed individually, in the absence of historical data it is not clear whether there would be any expected loss.

- *Use of market data.* It is unclear whether expectations are required to be based on market information where this is available. For example, do observed credit spreads on corporate bonds reflect expected credit losses or should these be based upon historic average default rates for similar assets of the same terms and credit rating?

- *Effect on the income statement.* In the unlikely event of losses occurring as expected, actual losses would not be recognised in the accounts. Where losses do not occur as expected, the impairment charge would be replaced by a catch up adjustment to reflect the difference between experience and expectations and the consequential change to future expectations. We believe that this approach would reduce the amount of useful information provided to users. If the underlying intention is to smooth the recognition of loan impairments in order to address the alleged problem of procyclicality -

and we do not accept that a case has been made for this - we believe it would be best addressed through capital adjustments rather than by a distortion of the income statement.

- *Effect on key performance indicators* Although presentation is not discussed in the proposals, they would not result in the creation of loan loss allowances and it seems likely that interest income would bear some, if not all, of the recognised impairment charges. Interest margin and loan loss allowance coverage ratios are key performance indicators for banks and this information will either not be available or would be adversely impacted by the proposals.

- *Information deficiency.* As noted, the expected loss approach will result in losses not being reported when they occur. Information about whether past expectations were over or under optimistic compared with current expectations is not as useful as reflecting the total losses relating to the portfolio in a given year. The resulting catch up adjustment is difficult to understand.

- *Less comparability between entities.* The proposed approach introduces a great deal more subjectivity and inherent uncertainty into the determination of future cash flows. Under the current approach, expected future cash flows following an impairment trigger can be assessed reasonably reliably, because of the limited period over which the predictions are being made and the ready availability of historical data. The proposed approach will require reliable estimates of future losses over the entire life of the loan, with no reference data on which to base the estimate. It is also unclear whether expected cash flows are supposed to be probability weighted or not and this could result in diversity in practice.

- *Trade receivables.* It is not clear how the approach would be applied to short-term trade receivables outside the financial services sector. IAS 18 makes clear that revenue is recognised only when it is probable that the economic benefits associated with a transaction will flow to an entity. It follows that revenue is not recognised when it is not probable that there will be an inflow. We understand it is the IASB's belief that an expected loss approach to impairment would reduce or defer revenue recognition. However, entities typically do not expect credit losses at the point of delivering goods or performing services, so the 'day one' loss expectation at the level of an individual sale would be zero. In other words, an inflow of economic benefits is considered probable when contractual obligations have been fulfilled. On this basis, the expected loss model does not appear to conflict with existing guidance on revenue, but it would be helpful if the IASB could either confirm this or articulate the differences.

Question 2: Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

12. We believe it would be possible to apply the approach, although whether it would involve 'undue' cost is a matter of opinion. However, it could only be applied on the basis of its inherent limitations: ie, that it is subjective, that the

resulting numbers could only be broad approximations and that the timing of losses would not be recognised.

13. We believe entities would face a number of challenges, including the following.

- As noted above, there is a potential problem arising from the lack of historical data and use of market data. We believe that there will be many instances where entities do not have historical loss data for certain assets held at amortised cost. Pricing decisions do not necessarily require explicit calculations of life time expected losses.

- The approach could only be operationalised by in effect holding large amounts off balance sheet to be released into income, so as to recognise interest in line with the effective interest rate (EIR). The control and reconciliation problems facing diverse international businesses would be significantly increased.

- Incurred loss numbers are generally used for internal reporting. Given that expected loss numbers are inherently less reliable, they may be seen as unsuitable for internal reporting purposes. Entities may well be obliged to maintain dual systems for internal and external reporting, leading to ongoing incremental costs. In addition, if information about actual losses or write offs in the period were required as supplementary disclosures, this would add to the complexity of reporting without necessarily providing any better information than is currently available.

- For holders of corporate bonds, it is likely that the calculations will need to be performed on an individual asset, rather than a portfolio basis, which will require extensive system enhancements.

- Substantially increased disclosures would be needed to underpin the assumptions made in applying the model.

Question 3: What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

14. We do not have first hand information about costs, and we believe it would be more helpful to the Board if our constituents provided specific information on an individual basis. Our broad assessment is that for most financial institutions the cost of implementing the approach would be around one half to two-thirds of the cost of originally implementing IFRS. This is based on the view that most of those costs arose from implementing the original provisions related to EIR, impairments and hedging, and that two of these would need to be implemented anew under the proposals. We note above that there could well be additional ongoing costs.

15. Given the deficiencies of the approach and the costs of implementing it, we do not believe that it meets acceptable cost/benefit criteria.

Question 4: How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

16. We do not believe that either of the two approaches to the amortisation of upfront costs is technically superior. We believe approach B is preferable in practical terms, as it allows entities that do not calculate the EIR to amortise upfront costs with a reasonable approximation to interest receipts by applying source data on interest to the accounting numbers.

17. With regard to impairment, we again do not see convincing technical arguments in favour of one approach rather than the other. In practice, we think approach B would be easier for entities to implement.

18. We note that the IASB staff have published examples illustrating possible ways of applying an expected cash flow approach to variable rate instruments. In the time available we have not been able to address this new material, but consider that the complexity underlying the calculations for a single instrument illustrate the likely difficulties of applying any approach to large portfolios.

Question 5: How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

(a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?

(b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?

19. We believe that in practice impaired assets are often removed from a portfolio of performing assets. We believe that this is a satisfactory approach. We do not believe any eventual standard should prescribe a method of dealing with this situation.

Question 6: What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

20. Our views on some simplifications that may be necessary are included in the responses to other questions. In particular, we believe entities would end up holding large amounts of expected future losses off balance sheet to be released into income, so as to recognise interest in line with the effective interest rate, which will have significant operational and control challenges.

21. We also have concerns about transitional provisions. Since the challenges of adopting the approach at all are considerable, the challenges of trying to apply it retrospectively could be even greater. It may be that determining loss expectations for the past would involve unacceptable hindsight. A prospective approach which resulted in loans being treated differently depending on when they were originated would also result in difficulties for

both preparers and users. There does not appear to be an obvious method to transition from the current approach to the proposals.

APPENDIX: COMMENTS ON THE CRITICISMS OF THE INCURRED LOSS APPROACH

1. Interest revenue is overstated in the periods before a loss event occurs.

We do not believe this to be the case. Interest is generally recognised as it is received. We question the wisdom and accounting propriety of deferring revenue on performing loans to cover future losses on non-performing loans.

2. If a loss has been incurred it is not always clear when the loss event took place.

This may well be true, but provided the loss is recognised it doesn't matter when the loss event took place. The potential problem area is in properly identifying losses incurred but not reported (IBNR). We are not aware that this is indeed a problem in practice, but it could anyway be addressed by additional material in the standard. Moreover, this criticism highlights a bigger problem that applies equally to the expected loss model. Just because an impairment trigger is met does not mean that the loan is necessarily impaired, and any assessment of the potential loss is bound to be highly subjective.

3. The approach is internally inconsistent because expected losses are implicit in the initial measurement of the asset, but not taken into account in determining the effective interest rate used for subsequent measurement.

We do not agree with this. Expected losses are not implicit in the initial measurement of an originated loan. The treatment of primary and secondary loans is inconsistent, in so far as while both are recorded at their transaction value only the secondary market price specifically factors in expected loss.

4. Incurred losses lag probable losses, which creates an information deficiency.

We agree that there is an information deficiency from the lag between probable and incurred losses. However, as noted above, we believe that this is addressed through the reporting of IBNR losses, with additional information available from management commentary and risk disclosures.

Moreover, we see a far more pernicious information gap arising from the expected loss method. The incurred loss approach recognises impairments during the reporting period and reflects conditions at the balance sheet date. This is straightforward and understandable. The expected loss approach hides losses in interest, which compromises the income statement and provides less information about margins, actual losses and allowance coverage ratios.

5. In some cases, a loss is recognised in profit or loss even though the original expectations have not changed.

It is difficult to see why this is a criticism. Losses may be recognised to reflect an actual change in circumstances, whether or not expectations have changed. This clearly provides useful information about events occurring during the period and conditions at the balance sheet date. We question whether accounting that attempts to anticipate such changes in circumstances before they actually occur is more useful.

6. Changes in credit risk are not recognised because of the thresholds required to be crossed before recognising any impairment loss.

We believe it is appropriate not to recognise losses where changes in credit risk do not result in changes in expectations of future cash flows. Any changes in credit risk are a potential impairment trigger and thus those that give rise to impairment will be identified under the existing requirements.

7. It is not clear when to reverse a previously recognised impairment loss.

We do not see how this is a problem, given that impairment losses on amortised cost assets automatically reverse when expectations of future cash flows improve or recoveries are made. We accept that in some circumstances some banks may not reverse immediately, through considerations of prudence. If there is a problem, it is equally applicable to the expected loss model. Indeed, IAS 39 currently requires incurred losses to be measured on an expected cash flow basis, so the implication in the criticism is that the existing standard is not being applied properly.

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