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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sir David

FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT

The ICAEW is pleased to respond to your request for comments on the Exposure Draft *Financial Instruments: Amortised Cost and Impairment*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Dr Nigel Sleigh-Johnson
Head of Financial Reporting Faculty
T +44 (0)20 7920 8793
F +44 (0)20 7638 6009
E nigel.sleigh-johnson@icaew.com



ICAEW REPRESENTATION

FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT

Memorandum of comment submitted in June 2010 by ICAEW in response to IASB consultation paper ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*, published in November 2009.

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INTRODUCTION

1. The ICAEW welcomes the opportunity to comment on the consultation paper ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*, published by the IASB.

WHO WE ARE

2. The ICAEW 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, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has 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. We ensure that these skills are constantly developed, recognised and valued.

MAJOR POINTS

Overall Assessment

4. The ICAEW supports the IASB's efforts to improve financial instrument accounting and achieve convergence with the Financial Accounting Standards Board (FASB). We agree with many commentators, including the Financial Crisis Advisory Group and the Basel Accounting Task Force, that accounting standard setters should explore incorporating a broader range of available credit information, including more forward looking information, in determining loan loss allowances, to allow an earlier identification of credit losses. However, as an important caveat, whilst we continue to support the use of financial statements by regulators to assist in achieving their objectives, we believe that additional regulatory needs must be met through the use of prudential filters only, without alteration of general purpose financial statements.
5. The expected cash flow model is one way of achieving the aims mentioned above. However, as we stated in our response to the *Request for Information* in August 2009, we are not convinced that the model set out in the ED is the best way of improving existing practice in terms of the relevance, reliability and understandability of the information it provides. Whilst it is based on one view of the economic theory of loan origination and may, therefore, have some conceptual merit, its application is likely to be so complex that the resulting output will be difficult to understand and explain. In addition, the cost of implementation would be substantial and take significant time.
6. We therefore agree with the alternative view expressed in the ED that it does not pass a reasonable cost/benefit test. We also share the concerns expressed by others about whether the results of the model can be audited, and hence whether the results are verifiable and meet the qualitative characteristics of financial reporting, particularly that of understandability. Nevertheless, we consider that the IASB, together with the Expert Advisory Panel (EAP), will be able to build on some of the conceptual theory to develop a model that meets the objectives, but is more operational and therefore understandable.

7. We appreciate that the IASB is aware of concerns about implementation and operation and welcome the creation of the EAP to provide input into these issues. However, as a matter of principle, we believe that financial reporting standards should be capable of being implemented as written and should not rely heavily on the development of alternative methodologies or practical simplifications to achieve a result that is materially consistent with the requirements of the standard. Not only is this confusing to preparers and users of the financial statements, it undermines the integrity of the standard setting process and leads to charges of undue complexity. We agree that the IASB should seek to reduce the complexity in financial instrument accounting rather than increase it. Effective interest is an area which is already subject to unnecessary complexity and many preparers have been forced to develop 'work arounds' in practice. Basing impairment on these complex methodologies is not, in our view, consistent with creating an operationally-effective standard, even if consistent with an economic theory.
8. The IASB and FASB are taking different approaches to the G20 requirements to improve financial instrument accounting, with the FASB issuing a single exposure draft and the IASB adopting a phased approach, with IFRS 9 *Financial Instruments* on classification and measurement issued as a final standard. We support the IASB's mixed measurement approach. We may comment on the FASB ED and may have further comments on the IASB ED when we have had time to consider it together with the FASB proposals. In addition, our views may evolve as other organisations, such as banking federations and regulators, develop different impairment models. We assume that both Boards will consider all such feedback in the round and we may have further comments as we monitor the debate.
9. It should be possible to build on some of the concepts underlying the ED to develop a model that would meet both the desire to allow earlier identification of credit losses and for a model that is operational, understandable and verifiable. The work of the EAP will be important in this respect. We welcome the publication of the summary of their discussions to date which should help inform the IASB of issues which need to be addressed in the final standard. However, it may be that the recommendations of the EAP should be subject to due process, particularly if they are incorporated into the standard either directly or as implementation guidance. Since this is a highly complex area with many competing interests, we urge the IASB to be open to significant changes in the ED that are helpful in ensuring that the requirements are understood and capable of practical implementation by a wide variety of entities. We would prefer a lasting solution to be developed that is well supported rather than the introduction of a costly and poorly-understood model, finalised to meet a deadline, particularly since required implementation would be three years after issue (a lead-time which we support).
10. It should also be recognised that the business models used by non-financial service entities are different from those used by the financial sector. The standard should be suitable for implementation by all reporting entities and result in meaningful information for both types of entity.

Fundamental concerns

11. In summary, we have the following fundamental concerns with the ED:

- The ED is based on the idea that it is possible to estimate reliably the amount and timing of future expected cash flows over the life of all loans, regardless of whether there are specific indications that the borrower may be unable to make the contractual payments. While it may be possible for estimates of potential future losses to be made, particularly for large portfolios with past history, the timing of the missing cash flows cannot be predicted. This undermines the rationale for using effective interest as the mechanism for spreading initial loss estimates. It could also cause practical difficulties in proving that the loss rates that can be estimated are consistent with the specific requirements (see paragraphs 24 to 28 below).
- The ED requires estimates of future losses to be based on probability-weighted outcomes. We have concerns about the application of this method to single, high value items as expressed in the proposed IFRS to replace IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. We do not believe that this concept is used in practice for developing loss expectations for loan portfolios for risk management or financial reporting or could be successfully implemented, given that the timing of missing cash flows cannot be predicted. Rather, entities may be able to determine life time expected losses by considering past loss experience. This measure will be risk sensitive, but it would be difficult for entities to determine whether such estimates are consistent with the requirements for assessing 'probability weighted' outcomes determined by considering the range of possible outcomes and their associated probabilities (see paragraph 15 below).
- The ED is unclear about the unit of account. At one extreme, we can readily understand that there are expected losses inherent in large portfolios of homogenous loans from the date of their origination. In our view, the expected losses arise in the portfolio as a whole, rather than in any individual loan in the portfolio. However, at the other extreme, we are not convinced that expected losses can be reliably identified in large, unique loans in the absence of some indication of impairment. The ED does not address this issue and the related issue of whether it should be applied to closed or open portfolios, where it is acknowledged that closed portfolios would greatly increase the operational challenge (see paragraphs 17, 28 and 33 below).
- It is not clear what the impairment allowance created by the ED would represent as it would be a mixture of initial expected losses recognised over time and immediate adjustments for changes in expectations. An understanding of an entity's credit risk management is best provided by setting out how provisions are created and utilised over time. It is possible that actual losses may occur before sufficient provision is created, leading to negative impairment allowances. While this may be consistent with the theory in the ED, we are concerned as to whether this result would be understandable (see paragraph 17 below).
- A concept underlying the ED is that the interest rate charged is explicitly or implicitly linked to the credit risk of the borrower. While this seems a reasonable assumption, we are not convinced that this is necessarily how pricing operates in practice or that there is sufficient linkage of pricing, risk and accounting systems to facilitate the practical application of the concept. Pricing is driven more by market rates than the credit worthiness of an individual borrower (see paragraphs 15 and 26 below). At most points in the economic cycle lending rates are determined by

general market trends. Market rates and margins/spreads were low in 2005/06 and elevated in 2007/08/09. This effect is likely to mean under provisioning using interest rates at boom times and over provisioning at depressed times, reinforcing pro cyclical.

- We support the use of judgement in determining appropriate allowances but are concerned that the ED lacks clear and practical guidelines around which management should exercise judgement, particularly how managements' views on possible future economic conditions should impact the assessment of expected losses. In the absence of clear guidelines, we are concerned that the results could be open to manipulation as managements' views on the future change. We are also concerned that undue optimism or pessimism in setting these expectations could result in volatility that is not related to actual economic conditions and give rise to concerns that the results are, therefore, more procyclical than the existing incurred loss approach (see paragraph 15 below).

Timing of recognition of losses

12. At the end of a loan's life, the total cash flows received and any losses are known with certainty. The accounting is trying to recognise the losses in a manner that best reflects the objectives of financial reporting where financial statements are produced periodically and loans are at different stages of their lives:

- Initial estimates of losses when loans are originated could be recognised up front.
- Initial estimates of losses when loans are originated could be spread over the expected life of the loan.
- Where initial loss estimates are recognised, changes to these estimates could either be recognised immediately or spread over the remaining life of the loan.
- Actual losses could be recognised when there is evidence that they have occurred, consistent with the current approach in IAS 39 *Financial Instruments: Recognition and Measurement*.

Each possibility has some support and underlying rationale, depending on what is seen as the more important accounting objective and the best way of reflecting the business operations:

- Up-front recognition approaches are seen by some as preventing overstatement of the asset and reporting more transparency about the total amount of expected losses. While we do not support such an approach we believe that the IASB should consider whether disclosure of the total expected losses in portfolios would provide useful information where the losses are being spread over time.
- Recognition of losses when they happen has support from those who believe that the current approach in IAS 39 is not fundamentally flawed and could be modified to meet the aim of ensuring more prompt recognition of losses. We have sympathy with these views and would support the IASB in exploring whether such an approach would be able to meet the concerns raised by some following the recent economic crisis. An advantage of basing the new standard on a modified IAS 39 approach would be that this could be implemented sooner than a standard requiring a more fundamental change. However, we understand that this is not the approach being taken by the IASB.

13. While the spreading approach in the ED has some conceptual merits, it is inherently the most complex approach and gives rise to many of the difficulties with the proposal as drafted. Spreading initial loss estimates will be difficult in practice, particularly for variable rate instruments. It is likely that any practical expedient developed to spread initial estimates will only approximate a level yield approach, and these limitations should be recognised in the final standard.
14. Some believe that, if initial loss expectations are spread, re-estimates of expected losses should also be spread. We have concerns about the information value of immediate cumulative catch-up adjustments if they relate not only to changes in credit risk in the period, but also to changes in managements' predictions of future conditions which may be only indirectly linked to a loan's performance. Therefore we have some sympathy with this view, although we appreciate the conceptual merits of immediate recognition of changes in initial estimates. We also have concerns about whether and how actual defaults in a period should change estimates of expected losses. Since the timing of losses is difficult - if not impossible - to predict, it will be difficult to decide whether a higher loss rate than expected in a period is a result of expected losses happening earlier than anticipated, or whether this is an indication that there are higher inherent losses in the portfolio than originally expected. These concerns would be eased if:
- Appropriate guidance is provided to clarify how management judgement should be applied to ensure that loss estimates are based on evidence and capable of verification, and
 - Actual losses, however defined, are recognised in full immediately when they occur.

We expand on both these points in the section below. If they are addressed, we believe that an approach that spreads initial loss estimates with a cumulative catch up adjustment for changes to these estimates and recognises actual losses when they occur would provide more useful information than the approach set out in the ED. It may also raise fewer operational concerns.

Possible way forward

15. While we have concerns with the ED as drafted, we support the IASB's review of the impairment requirements and the development of a single method that can be applied to all financial assets carried at amortised cost. We agree that the method should incorporate more forward-looking credit information and should seek to avoid losses being recognised too late. In developing a model that can be practically implemented, the IASB should take the following into account:
- Impairment should be separate from effective interest. Mixing the two is not only confusing for presentation of the results, it leads to some unnecessary operational challenges.
 - The notion of expected loss should be clearly explained, rather than focusing on estimating future cash flows. It should be recognised that expectations become less certain the further into the future they need to be made. One way of addressing this problem is to include some idea of looking only as far forward as reasonably possible, which may be less than the lifetime of long-lived assets. In addition, it should be made clear how much of the estimate is based on past

experience, whether the past experience should be modified for current conditions and whether possible future conditions should also be taken into account. In practice the determination of expected losses for many banks is likely to be based on current Basel requirements and use, taking (at least as the starting point) historical average loss rates for different types of portfolio. Consideration will need to be given to the length of the historical period used (for example, the expected life of the loans in the portfolio) and whether and how this should be adjusted for current conditions, such as changes in underwriting criteria or economic conditions. In the absence of sufficient evidence to assist verifiability, we do not consider that future possible economic conditions should be included in developing loss expectations.

- We understand that loans are generally considered to be either performing ('good book') or non-performing ('bad book'). This concept may have been linked to whether there were indications of impairment and, therefore, to the incurred loss approach, but it also seems to support more effective credit risk management as more time can be devoted to non-performing loans. It would be helpful to build on this approach. It is also supported by the fact that there is a wealth of experience in determining expected cash flows for loans where there are indications of impairment, but less for performing loans. We support an approach that results in immediate recognition of the full amount of the loss for loans that become non-performing. This ensures losses are recognised in full when they arise and is a retention of incurred loss information, which provides useful information about conditions at the balance sheet date. Therefore these losses should be presented separately from the build up of allowance for expected loss and the effect of any changes to initial loss expectations.
- For performing loans, we are content for initial expectations of losses to be spread, if (a) practical mechanisms can be developed to do this, (b) there is sufficient guidance to ensure loss expectations can be verified and (c) losses that have occurred in the non-performing book are recognised immediately and separately presented. If losses are immediately recognised in full for non-performing loans, negative allowances should not arise if actual losses are front ended or current economic conditions have changed significantly from initial expectations, leading to losses occurring. Provided the standard develops the notion of a non-performing book, we also agree that revisions to initial loss estimates for performing loans should be recognised immediately and presented separately from losses recognised on non-performing loans. This allowance would represent inherent losses that have not occurred at the balance sheet date and changes to expectations about these losses. The approach in the ED, which mixes expected and actual losses and results in a single cumulative catch up adjustment, does not provide transparent information about conditions existing at the balance sheet date.
- Some believe that changes to initial loss estimates should be spread, with a cumulative catch up adjustment required only where there is thought to be insufficient margin in a performing loan to cover the revised expected loss, as the loan is then effectively onerous. However, if losses are recognised immediately for non-performing loans, this situation is unlikely to arise in practice and would be difficult to define and make operational. Therefore, while the loan is performing, spreading the initial loss estimate and immediately recognising any revisions to the estimate should result in an appropriate income profile and should be operational. Under the model set out above, we expect that material revisions to the initial

estimate should be infrequent but provide important information to users when they happen.

- We believe that an approach that combines incurred loss with recognition of expected losses for performing loans would best meet all the requirements, since it avoids overstatement of income and allows immediate recognition of losses on non-performing loans, which avoids overstatement of loan assets. It may also help clarify the unit of account issue, since there is already experience of loans moving between performing and non-performing.
- In developing an approach that differentiates between performing and non-performing loans, it may be helpful to review and provide guidance on identifying the point at which a loan is considered to be non-performing and whether the notion of incurred but not reported losses should be developed to help clarify at which point a loan or a portfolio of loans is considered to be non-performing. Some may wish to use regulatory definitions to define non-performing. While this standardisation could help ensure consistency of treatment between different entities, it would be difficult to address variations in the nature of different types of loans by a 'bright line' rule. Since we believe that the chosen approach should be more aligned to how the loans are managed, we do not consider that using regulatory definitions is appropriate.
- Guidance on acceptable spreading methodologies should be developed. If the spreading of expected losses is not included as part of effective interest, this would help deal with floating rate loans. If not, a simplified methodology for these loans will be needed. It may be that straight line spreading is no better or worse than other methods or that actuarial models can be developed. While the IASB is not considering updating the IFRS for SME's in the short term, it may help to consider how SME and other less sophisticated companies would implement the new standard, since this may help ensure that the requirements are no more complex than they need be.

Practical implementation

16. The standard should be suitable for implementation by all reporting entities to ensure that trade receivables and other financial assets at amortised cost that are not loans and advances are accounted for in a way that is understandable to preparers and users and capable of being audited. Deduction of credit losses from sales income does not clearly present the business model for most companies. The business models used by non-financial services entities are different from those used by those in the financial sector. Trade receivables are not key interest-earning financial assets for most nonfinancial reporting entities. In most cases, it is unlikely that the effect of credit losses on initial recognition of sales revenue will be material. If the issue here is revenue recognition, it should be dealt with in that project and included in a standard that is designed to deal with a different business model.
17. The standard should be understandable and capable of being implemented as drafted without relying on detailed implementation guidance or practical expedients designed to overcome its flaws. In this respect, the ED, which is based on a cash flow model that cannot be implemented as drafted, is fundamentally flawed. Rather, the standard should clearly set out underlying concepts, recognising practical realities and not just economic theories, and be at a sufficiently high level that entities can make application choices that are the best use of their existing data and systems. For example, the standard should not require the use of either open or closed portfolios but then require

disclosures that can be met only by use of one methodology (see paragraph 33). Similarly, the standard should permit methodologies and disclosures based on portfolios or individual assets as determined for risk management purposes.

18. The IASB should take the time to consider whether there are areas not within the current scope of IAS 39 (for example, financial guarantees and some loan commitments) which raise similar accounting issues. The scope of the replacement financial instrument standard has not yet been considered, but this work will need to be done before it is finalised.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

19. While the description of the objective highlights the key point that amortised cost is about allocation of interest over time, it mainly sets out the mathematical calculation and is not sufficiently clear. This is particularly the case as, in practice, the effective interest rate is not usually calculated and the effective return is not explicit in the financial statements.
20. More importantly, since impairment losses are not interest revenue or interest expense, the objective does not articulate why estimates of expected credit losses should be included in the calculation initially, and why subsequent changes in estimates of expected losses are not included in the calculation. The description is not clearly based on historical cost and could be read as implying a current value which is akin to fair value without including all the inputs a market participant would include, such as liquidity. It is also not clear why the measurement is meaningful in the balance sheet as well as the income statement. We assume it is because it will best reflect the expected future cash flows from the asset in accordance with the business model of the entity, but some linkage to this idea would help underpin the model in IFRS 9.
21. We would not mix impairment and effective interest and, therefore, would say that the objective of amortised cost is to provide information about the cash flows expected to be received or paid from the financial instrument in accordance with the business model of the entity. We note that there is not an objective for fair value measurement set out in the Fair Value Measurement ED. We support setting out very clearly the measurement objective for both amortised cost and fair value, and it may be helpful to consider both, together with the objectives underlying IFRS 9, in developing the standard or the conceptual framework, which may be the appropriate place to determine the objectives.

Q2: Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

22. We agree that financial assets that contain basic loan features and are managed for the receipt of contractual cash flows should be measured at amortised cost because this measure, rather than a fair value measure, provides better information about the expected future cash flows that the entity will obtain from holding the instrument in accordance with the business model. The cost measure should result in an allocation of interest income over the expected life of the instrument and should result in the financial asset being stated at the best current estimate of its recoverable amount where this is less than the carrying amount. As set out in our answer to Question 1

above, we do not agree with the measurement objective as set out in the ED because it is unclear and mixes interest and impairment information.

Q3: Do you agree with the way that the exposure draft is drafted, which emphasizes measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why?

How would you prefer the standard to be drafted instead, and why?

23. We agree that a helpful way to draft the standard is to set out clear measurement principles and then provide application guidance, which helps readers to understand the principles but does not add to them or change them. Illustrative examples, particularly for presentation and disclosure, can be useful. However, we do not believe that the principles in the ED are set out clearly and we find it difficult to understand how the description of the principles produces the results in the worked examples on the IASB website, particularly for floating interest rate assets. The principles in the ED are too theoretical and difficult to apply even in illustrative examples where perfect information can be assumed. We suggest that the final standard should set out principles that are capable of implementation rather than relying on application guidance and practical expedients.

Q4: (a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

24. In theory, and putting aside impairment considerations, we agree that amortised cost should be calculated using the effective interest method, which results in a carrying amount determined at the present value of the expected cash flows discounted using the original effective interest rate. However, in practice, original effective interest rates are not generally calculated. We are aware that entities tend to spread costs and fees in a manner which approximates effective interest and do not agree that it is suitable to build on this practice to develop methodologies to deal with spreading credit losses. The standard should not be drafted in such a way that it cannot be applied in practice.
25. We believe that cash flow estimates should be best estimates. However, in our view we do not believe that entities are currently using probability-weighted possible outcomes to estimate the amounts and timing of cash flows. While probabilities of default are used, all possible outcomes and the probabilities are not explicitly considered. Making this a requirement will add unnecessarily to the complexity of the approach.
26. We do not agree that effective interest and impairment should be considered together. Since effective interest rates are not generally determined, there is no significant issue in practice in dealing with floating rate instruments. Combining the two concepts creates the complexities in dealing with floating rate instruments which contribute to the proposals failing to meet a reasonable cost: benefit test. We do not support a principle that involves looking at that part of the contractual interest rate that is reset and that part relating to credit risk.
27. Accordingly, we do not support the measurement principles as drafted. They are difficult to understand, will be difficult if not impossible to apply in practice and do not appear to result in the outcomes suggested by the IASB's worked examples. We

would prefer to leave the current practice for calculating effective interest unchanged. Paragraph 15 sets out some ideas that the IASB could consider in developing more suitable principles.

28. If the IASB continues to pursue the approach proposed in the ED, we note the following areas where the measurement principles are unclear:

- Should the calculation of expected cash flows be based on market conditions at the balance sheet date, current estimates of possible future market conditions or current estimates of market conditions during the economic cycle?
- Should the possible re-negotiation of a loan be included in the initial loss expectations or reflected in re-estimations when it occurs, or should re-negotiated loans be treated as new loans?
- It is unclear how the principles can be applied to open portfolios, which is typically how financial institutions manage their exposure to credit risk. In an open portfolio context it would be very difficult to separate initial expectations of losses on new loans from changes in expectations on existing loans. This further calls into question whether the approach in the ED can be made operational and whether this would result in information that is useful.
- In recognising initial expectations of credit loss over the life of the financial assets, the approach will result in the later recognition of losses than the incurred loss model for any portfolio which, by its nature, tends to experience incurred losses in the earlier years, as with many retail portfolios. It is unclear how this addresses the issue of 'too little too late' provisioning and how such an approach can be supported in practice given the inherent uncertainty around future credit losses.

Q5: (a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

29. In general, we agree that the description of the objective of presentation and disclosure is clear, although we are less certain that the second sentence of paragraph 12(b) will result in meaningful and understandable information. Such discussion may be more suited to management commentary.

30. We also agree with the presentation and disclosure objectives, although not with how they are put into effect in the ED.

Q6: Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

31. No. As set out in paragraphs 20 and 21, we do not agree that impairment should be mixed with effective interest.

32. We are not aware of any difficulties with the current, separate presentation of interest income, interest expense, net interest and impairment. Where material, cumulative catch up adjustments resulting from changes in assumptions underlying effective interest calculations, such as prepayment rates and loan lives, should be disclosed.

Following the approach we have suggested in paragraph 15 above for determining loan impairment, we support separate disclosure of losses arising in the period for non-performing loans and, if material, adjustments with respect to changes in initial loss expectations for performing loans.

Q7: (a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

33. Disclosures, in our view, should enhance the accounting model rather than attempt to address its shortcomings. Although we agree with the aim of the disclosure requirements, we have serious reservations about many of the proposed disclosures both in terms of whether they are practically possible and whether they are meaningful, as follows:

- We are not convinced that it would be possible to disaggregate gains and losses into changes in estimates of credit losses and other factors other than on a fairly arbitrary basis. It is not clear what further analysis would be possible or meaningful to prepare, particularly when thousands of different portfolios will need to be aggregated into classes to produce reasonably summarised and succinct information rather than raw data.
- A requirement for cumulative write-offs suggests that closed portfolios are needed, which would add unnecessarily to the cost and complexity of implementation. It is also not clear over what period this history would be required, for example, for the life of the entity or the portfolios? What is meant by a “qualitative analysis of the effect of changes in credit loss estimates”?
- We do not see how stress testing information is relevant to credit losses and do not consider it appropriate that such a disclosure requirement should be included in a financial reporting standard on financial instruments. It may be appropriate for reporting entities to discuss stress testing as part of management commentary, but this is not a suitable requirement for the scope of the audited financial statements.
- A requirement for vintage data would result in long lists of loans which will not necessarily reflect their risk characteristics or how they are managed or assessed for impairment. This additional cut of data would be expensive to produce and store and is not used universally. It is only useful where it is used as a management tool and, therefore, a blanket requirement would merely clutter financial statements with unhelpful costly data.

34. We agree that disclosures should focus on:

- Providing a movement over time of the impairment allowance to enable users to see how allowances are created and utilised;
- Explaining the assumptions underlying the impairment calculations, including a sensitivity analysis;
- Facilitating comparisons between non-performing loans and impairment allowance; and

- Explaining the write-off policy.

In addition, disclosures set out in IFRS 7 *Financial Instruments: Disclosure* that concentrate on explaining credit risk management policy and the credit quality of financial assets should be retained.

Q8: Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

35. We are not convinced that the ED as drafted is capable of practical implementation, regardless of the lead-time. In our view, it fails to meet a reasonable cost/benefit test and requires considerable simplification. A method that builds additional expected loss allowance for performing loans in addition to immediate recognition of losses arising on non-performing loans should meet concerns arising from the recent economic crisis and be capable of implementation with a reduced lead-time. If the improvements are critical in the light of the economic crisis, it would be preferable to build on existing practices, including risk practices such as Basel requirements, rather than pursuing an estimated cash flow approach that is entirely new, unproven and has significant operational issues.
36. At this stage, it is not clear what practical expedients will need to be developed to address the implementation issues and thus how long it will take to create the necessary systems and determine the opening position on transition. However, it seems likely that at least some entities will need at least three years lead-time. We recommend that the IASB should reconsider the transitional requirements in IFRS 9 to facilitate transition to all new aspects of financial instrument accounting at the same date. In particular, we believe that the IASB should reconsider the need for restated comparatives for IFRS 9 to facilitate alignment of transition to the complete standard.

Q9: (a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?

(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

37. No. We do not believe that the transition requirements are clear or can be practically achieved without the use of undue hindsight. The difficulty in determining achievable transition requirements is evidence that the ED as a whole may not be capable of practical implementation as drafted. Since reporting entities do not generally calculate effective interest rates, it seems unlikely that they will be able to determine what rate they would have used in the past or be able to use this rate in the accounting going forward. As for the general proposal, an opening estimate of expected and incurred-to-date credit losses would need to be determined and then somehow spread to approximate the use of an effective interest rate.
38. The alternative simplified transition approach that would use the original effective interest rate determined in accordance with IAS 39 seems more achievable. Since we are unconvinced that presenting the portion of initial expected credit losses allocated

to the period separately from changes in estimates of credit losses is meaningful, we would be content with the alternative transition approach.

39. Based on experience of transition to IFRS in 2005, we believe many entities would approach restating comparatives as a separate work stream from determining the opening balance sheet and posting this to the main accounting system for use going forward. While these separate work streams do not need to be performed sequentially, it obviously entails more work. This additional work adds to the cost and complexity of the transition and, if comparatives required for disclosure are not truly comparable, it is unlikely that the benefits exceed the costs. This is particularly the case if restatement is required for five or ten year summaries of results and financial position. Users seemed to be well served by the transition to IFRS in 2005 which provided reconciliations and explanations of the differences between closing and opening balance sheets without restated comparatives. Restating comparatives seems likely to add to the lead-time, costs and complexity of transition without corresponding benefit.

Q10: Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

40. We agree that the effect of transition on the opening balance sheet should be described and explained. If comparatives are restated, disclosure should also be required of the impact on the line items in the income statement and on net profit.

Q11: Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

41. No. We do not agree that financial reporting standards should be drafted in such a way that they can only be implemented using practical expedients. It is unhelpful to suggest that practical expedients are acceptable if the difference in outcome of that method is immaterial to that required in the standard. Entities will need to use both methods to prove immateriality either using actual data each period or in advance through sufficient modelling of possible circumstances. If it is not possible to use the method set out in the standard, the entity will find it difficult if not impossible to prove immateriality. While practice will no doubt develop that supports the practical expedients, this does not represent good standard setting. However, we agree that entities are likely to continue recording effective interest as at present, determine an initial estimate of credit losses, spread this estimate to approximate effective interest and then determine the effect of changes in estimates as gains and losses. This seems the only practical, high level, method of approximating the requirements of the ED. Since this is the case, it may be preferable for the standard explicitly to set out this process, thereby making it clear to all constituents how impairment is determined in practice.
42. We do not agree that expected losses for trade receivables should be deducted from revenue. While some debtors may not pay for their goods, companies should not be required to calculate an estimate of initial credit losses through the use of a matrix, or any other means. The better reflection of the business of the entity is to recognise credit losses when they occur. This practice has not caused any difficulties for entities and short-term receivables are a significantly different class of financial asset from loans which carry interest.

Q12: Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

43. As set out in our answer to Question 11, we do not agree that financial reporting standards should be drafted that can only be implemented using practical expedients. If the requirements of the standard cannot actually be achieved in practice, it will be impossible to determine whether an expedient closely approximates the requirements – all that can be determined is that the expedient is likely to be a reasonable method of approximating the required outcome in most circumstances. Since the underlying requirements are based on subjective and potentially unverifiable judgements, there seems little point in requiring high numerical correlation of an approximation. It would be preferable for the standard itself to support a practical methodology for non-financial institutions to address trade receivables or for any practical expedient to result in little change to existing practices which have not been found to be wanting.

E nigel.sleigh-johnson@icaew.com

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