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The Chairperson
IFRS Interpretations Committee
30 Canon Street
London
EC4M 6XH

IFRIC CONCLUSION ON IMPAIRMENT OF ASSETS RECLASSIFIED FROM AFS

Dear Chairperson,

In the May IFRIC update you stated that *The Committee received a request for guidance on how an entity should account for the impairment of financial assets with a fixed maturity after they have been reclassified from the available-for-sale ('AFS') category to loans and receivables.*

The Committee noted that paragraph 50C of IAS 39 requires that the fair value of a financial asset on the date of reclassification becomes its new cost or amortised cost. A new effective rate of interest is then calculated and applied to the financial asset. This is the rate that discounts the estimated future cash flows to the new carrying amount of the financial asset. <u>The Committee also noted that, when an impairment loss is recognised, applying the requirements of paragraph 54 of IAS 39 would result in all gains or losses that have been recognised in other comprehensive income being reclassified from equity to profit or loss.</u>

The Committee noted that IAS 39 provides sufficient guidance on financial assets that are reclassified from AFS to loans and receivables and that it does not expect diversity in practice. Consequently, the Committee [decided] not to add this issue to its agenda.

This interpretation, even though only published by way of an update, is completely contradictory to current industry practice that evolved since October 2008 and whether intended or not, your statement could result in hundreds of millions of losses being recognised through the profit or loss account of financial institutions (most of these resulting in the holding of AFS assets during the financial crisis when prices were deeply depressed and fair values very difficult to ascertain). It seems that the IFRIC may not have considered this issue with enough sensitivity and diligence given the very serious implications of this opinion to a very important sector of the economy.

It further does not help that many large audit firms refer to the reasons for IFRIC agenda refusals as implied standards in themselves, and it might be useful to clarify the status of such decisions going forward (especially as such decisions would not go through the scrutiny that a change to a standard would be subject to).

The amendment made to IAS 39 during October 2008 was done, as you are aware, with great speed and no due process and under immense political pressure. Impairment of reclassified assets was never specifically addressed and it is widely accepted that the reference to par 54 was done in the context of ongoing recognition of interest through p/l. Following par 54 for interest recognition of the frozen AFS reserve, combined with the new EIR on a reclassified asset, resulted in interest recognised at an effective rate that equalled the original EIR when the asset was first recognised (rather than the EIR at reclassification date).

It therefore resulted in a p/l impact that was equal to the p/l impact if the asset was initially classified as a loan and receivable on initial recognition, rather than as an available for sale asset.

This approach makes a lot of sense as the intention was to have a loan and receivable asset and not to have a hybrid AFS/loan and receivable asset. However, applying par 54 for impairment purposes results in the accounting for an AFS asset even though the asset has been reclassified as a loan or receivable, which contradicts the intention of reclassification in the first place.

Unlike for interest recognition, par 54 does not actually deal specifically with impairment in isolation, it does so by reference to par 67. Par 67 only refers to AFS assets. Since the assets are no longer AFS assets, par 67 should be irrelevant and therefore leave users of the standard perplexed at the intention of the IASB.

To summarise the problem:

1. The reclassification amendments did not scope in impairment – this is a well known flaw of the changes and the IASB is addressing this in IFRS 9.

2. Paragraph 54 was written pre the October 2008 amendment and therefore did not foresee reclassification of assets – the paragraph had the intention to deal with two things – the one was held to maturity reclassification due to tainting (irrelevant) and the other was a very rare exception that you would stop using fair value for an AFS asset as it was impossible to calculate the fair value – even with a model (this by the way was only available to non-quoted investments in equity). In the latter case, there was an historic AFS reserve to get rid off although the asset was no longer accounted for at fair value – very similar to the reclassification amendments. The difference is that under reclassification, the asset changed both its measurement (from fair value to amortised cost) and its classification whilst under the old rules these assets were still classified as AFS assets, but only the measurement changed.

3. Since these equity assets were still AFS assets, it follows that their impairment needed to follow the AFS rules and therefore the reference to par 67, that deals with impairment of AFS assets only.

4. Because the impairment rules were not scoped into the reclassification changes, par 54 was never amended and we ended up with an answer that could not be applied. The reclassification amendments suggested that you follow par 54 for the treatment of the historic AFS reserve (which is what the industry has done and this works well, though complex), but par 54 only deals with non-impaired historic reserves and for impairment refers you to paragraph 67. This made sense at the time as the standard says pretty much that if you want to know how to deal with an AFS asset that is impaired, go to the section of the rules that deal with AFS asset impairment (par 67). The issue is however that we are not dealing with an AFS asset, we are dealing with a Loan and Receivable asset and therefore paragraph 67 cannot be applied as it solely refers to assets that are classified as AFS. The logical approach is therefore to refer to the rules for the impairment of loan and receivable assets and treat the historic reserve as part of the loan and receivable asset for this purpose, which is what the entire industry has done.

5. If you were going to follow the impairment reference in par 54, which is clearly just there because the IASB did not scope in the changes to the impairment rules when the reclassification amendment was rushed through, you would end up with the scenario that an impaired loan and receivable asset would be accounted for exactly the same as if it was not reclassified – which is precisely the opposite of the intention of the reclassification rules. It is common sense that if you have a solution that gives you an AFS answer for an asset that had been reclassified to loans and receivables, there is no point in the reclassification rules – that approach is against the spirit of the

changes in the standard and will lead to inconsistencies in the treatment of loans and receivable assets.

I can only urge the IFRIC to revise its stance on this or at least publish explanatory notes on how the decision was reached within the context of the intention of the reclassification rules. It might be that the impact on the financial services industry was not explained in full detail when the request was made and therefore the issue was not given the correct amount of attention and investigation that it deserved.

I would be happy to engage with you on this issue should you need any further clarification on the issues raised in this letter.

Kind regards,

Graeme Tosen
ACA, CA(SA), CFA, FRM