Staff Paper

Project: **Financial Instruments: Impairment**

Topic: **ED Session – Comment Letter Summary**

Purpose of this paper

1. In November 2009 the IASB published the exposure draft *Financial Instruments: Amortised Cost and Impairment* (the ED). The 8-month comment period ended on 30 June 2010 and, by that date, the IASB had received 149 comment letters.

2. This paper provides a **summary** analysis of the comment letters that were received by the comment letter deadline, and identifies the main themes in the comment letters.

3. We continue to receive responses. In total 179 responses have been received as of the date of the posting of this paper. If we identify additional key themes in the letters received since 30 June, we will provide an update to the IASB at a later meeting.

4. As the re-deliberations move forward, we will provide more detailed analysis of the comments received on each of the issues.

5. This paper does not provide a quantitative review of responses or attribute comments to individual respondents. Moreover, this paper does not address drafting suggestions received from respondents.

6. Appendix A provides an overview by type of respondent (reflecting comment letters received through 15 July 2010).

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

7. The IASB also undertook significant outreach activities during the comment period. The main themes arising from the outreach activities with preparers, auditors and regulators are consistent with those identified in this paper.

8. The IASB outreach also included targeted outreach with users of financial statements. This included individual meetings, group meetings and a user questionnaire. The staff will provide a summary of that feedback in a separate paper.

9. In addition, the IASB with the US Financial Accounting Standards Board (FASB) set-up an Expert Advisory Panel (EAP) consisting of credit risk experts to consider the operational issues arising from the proposals. Agenda paper 13B discusses a summary of the EAP discussions.

Key themes

10. Almost all respondents are in favour of the project to improve and simplify accounting for financial instruments. They are supportive of a move to an expected loss model for impairment requirements. Many favour focussing on impairment of financial assets, rather than addressing the broader issue addressed in the ED of amortised cost measurement.

11. Overall, the staff have identified the following main themes:

    (a) Strong support for moving towards an expected loss (EL) impairment approach (12-16).

    (b) The expected cash flow (ECF) approach in the ED is too difficult to apply operationally (17-24).

    (c) Certain measurement principles are too prescriptive or inconsistent with other parts of the ED (25-30).

    (d) Lack of special consideration for non-financial entities which may have mostly non-interest bearing financial instruments, and for investment-grade bond portfolios (31-34).

(e) Presentation and disclosure requirements are too onerous and voluminous which causes information overload (35-37).

(f) Practical expedients are generally welcome, but need to be more flexible, and certain definitions are too restrictive (38-41).

(g) Convergence with US GAAP as well as following due process requirements are important (42-45).

Main themes identified

Strong support for moving towards an EL impairment approach

12. Many respondents agree that the incurred loss model has failed to provide useful and timely information about the performance and position of financial institutions in the recent past. Many cite, and agree with, the weaknesses of an incurred loss impairment approach identified in the ED's Basis for Conclusions.

13. As a result, many respondents agree that an impairment model measured using EL is an appropriate methodology (although not necessarily the ECF approach proposed in the ED – see below). Supportive reasons given include that an EL approach:

    (a) better reflects the economics of a lending transaction than an incurred loss impairment approach;

    (b) reflects how financial institutions manage credit risk, and hence aligns more closely with risk management systems than an incurred loss impairment methodology; and

    (c) will allow for credit losses to be recorded earlier as there is no need for any impairment trigger.

14. Respondents overwhelmingly reject an impairment approach based on fair values or a 'through-the-cycle' impairment approach mainly for the reasons noted in the ED's Basis for Conclusions.

15. A few respondents suggest maintaining the current incurred loss impairment approach and suggest that additional guidance might help. Reasons given for keeping an incurred loss approach include:

    (a) that an incurred loss approach is well understood, and that diversity in application can be addressed by increased and/or improved application guidance;

    (b) that an EL approach is inconsistent with both the IASB Framework and a cost-based measurement method;

    (c) unease with the significant subjective management estimations that would be required using an EL approach. Many felt that such estimations would lead to earnings management thereby impacting the reliability (and auditability) of financial statements and hence the usefulness of information to investors; (although most respondents, and users in particular, note that the proposed disclosures alleviated some of these concerns); and

    (d) the cost and/or operational complexity of an EL approach (see below).

16. Some respondents discuss whether the proposed ECF (or, more generally, an EL) approach would be pro-cyclical. Most state that any EL approach would be pro-cyclical. Although a few highlight this as a reason for not moving to an EL approach, the overwhelming number of respondents state that any appropriate impairment approach for financial reporting purposes would of necessity be pro-cyclical. Therefore they argue that impairment for financial reporting purposes should not be confused with prudential regulatory objectives or requirements.

The ECF approach is too difficult to apply operationally

17. Most respondents comment on, and express concern with, the operationality of the ECF approach. Many also state that the costs of implementing the ECF approach would be significant, and express the view that the costs would outweigh any benefits. Some state that the ECF approach, as drafted, could not be practically implemented.

18. Many cite the work of the EAP (agenda paper 13B describes the operational issues found by the EAP in more detail). Operational concerns include:
    (a) application to open portfolios;
    (b) lack of historical data;
    (c) integrated EIR calculation; and
    (d) requirement to maintain loss data relating to origination (arising from the EIR allocation mechanism proposed in the ECF approach – see below).
19. Some propose ways in which some of the operational challenges might be addressed, and some propose revised (or different) EL impairment approaches.
20. These suggestions will be presented in detail to the IASB at later meetings.
21. One common suggestion is that the EIR approach in IAS 39 *Financial Instruments: Recognition and Measurement* should not be changed. Expected losses should be dealt with outside of the EIR calculation (that is, should be allocated over the life of the loan using another mechanism).
22. Operational reasons given include that the ECF approach requires the risk and accounting systems to be integrated. For example, expected future cash flows are required to be discounted using the discount rate calculated at origination, which includes initial expectations of credit loss. These risk and accounting systems are not currently integrated. Using an allocation mechanism other than the integrated EIR calculation would significantly reduce the implementation costs and ongoing operational burden. (See agenda paper 13B for more detail).
23. Other (non-operational) reasons for dealing with EL outside of the IAS 39 EIR calculation include that the estimates that are used in the IAS 39 EIR calculation are of a higher ‘quality’ than estimates of expected losses because EL requires

estimations over the life of the instrument[1], and that credit risk is managed separately from the inputs required for the IAS 39 EIR calculation today.

24. Many respondents agree that estimating the EL over the life of the instrument is difficult (some say impossible), and may not result in an accurate estimate depending on the length of life of the asset. However, rather than keeping the IAS 39 EIR calculation, some suggest to place a range for how far out one would estimate expected losses (eg 3-5 years). Another suggestion is to estimate the EL for that range, but then apply an average loss rate to the remaining expected life of the instrument/portfolio.

Measurement principles

25. Whilst some respondents agree with the treatment proposed in the ED to immediately recognise changes in estimates of EL in the statement of comprehensive income, most respondents feel this is inconsistent with the objective of the amortised cost measurement. They suggest that it may be more appropriate to allocate the change in estimate over the remaining life of the asset. Another suggestion is to take a partial 'catch-up' by immediately recording amounts that would have been recorded from the beginning of the instrument's life, and allocating the remainder over the remaining life of the asset.

26. Many respondents comment that the probability weighted average method for calculating EL is difficult and should not be the only method permitted. Several respondents suggest that a 'best estimate' or 'most likely' outcome approach may be better in certain situations (eg in the case of a single instrument instead of a portfolio of homogenous loans). The majority agreed that the standard

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[1] Some respondents noted that there is an accounting principle in US GAAP that provides for EL modelling similar to the ED. It is found in American Institute of Certified Public Accountants' Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3). Respondents state how difficult the SOP 03-3 model is to apply, and that many entities have never upgraded their systems in order to automate the requirements. They still keep the complex calculations on Excel spreadsheets.

should provide a principle, and that the probability-weighted average method could be one example of how to calculate EL. However, an entity should have flexibility to determine the best method for calculating its EL.

27. Many respondents note that the proposed approach may only be applicable for a portfolio of instruments because it may not be practically applied to a single financial instrument. Reasons provided for this argument include that a single financial instrument is issued only with the intention of receiving all the future cash flows.

28. Also, many respondents suggest that the wording in the ED is unclear as to whether the approach requires one to consider future information when estimating ECF. They find paragraphs 4, 7, 8, and B8 (at a minimum) in the ED confusing because they do not explicitly refer to the consideration of future events.

29. The majority of respondents agree that a 3-year lead time would probably be appropriate provided the operational issues described above could be overcome. Some respondents did not answer the question in the ED because they did not feel the current proposed approach could be applied regardless of the lead time.

30. A few respondents also comment that all parts of the IAS 39 replacement project should be implemented at the same time, and that early adoption of one part of the project should not be permitted.

Non-financial institutions, non-interest bearing financial instruments, and bond portfolios

31. Many respondents (especially those from non-financial institutions and those with a professional interest in non-financial institutions) comment on a need for a different approach for non-interest bearing financial instruments (eg short-term trade receivables) and non-financial institutions, in general. Reasons cited for a need for a separate, or further simplified approach, include:

(a) The recent financial crisis was not caused by the application of the incurred loss impairment approach to such instruments, or by such non-financial institutions.

(b) Short-term trade receivables are not created for the purpose of collecting interest.

(c) Disclosure and presentation requirements in the ED are too onerous and do not provide useful information for these types of instruments.

(d) Non-financial institutions (and even some smaller financial institutions) do not have the resources or the systems infrastructure to implement the ECF approach as drafted. Moreover, respondents felt the ECF approach would not provide a better result than the current incurred loss impairment approach for such institutions.

32. Most of the respondents that commented on the treatment of short-term trade receivables in the ED also provided their concerns on the proposed treatment of related revenue. They state that allocating the expected losses against revenue when first recording the receivable is inconsistent with the treatment for the other financial assets in the ED which allocate the expected credit losses over the life of the asset. They also state that the losses incurred on trade receivables are a business expense and should be shown separately from revenue.

33. Whilst most respondents that commented on the treatment of non-interest bearing short-term financial assets agree that such instruments should not be treated the same as financial assets created solely as a result of lending transactions, they provide different suggestions for how to resolve the treatment. Some suggestions received included:

(a) provide more practical expedients (for example related to presentation and disclosure); or

(b) scope out such transactions, and maybe even non-financial institutions in general, from the final standard.

34. Some respondents discuss a situation where an entity holds investment-grade bond portfolios. Based on published reports, they state that these types of bond portfolios have a historically low default rate. They argue that requiring the approach in the ED with all the proposed disclosures does not provide useful information for what is likely to be an immaterial amount of EL.

Presentation and disclosure requirements

35. Many responses received state that the presentation and disclosure requirements are too onerous and may not provide relevant or useful information for certain types of instruments or entities (eg non-financial institutions as discussed above). Also, many respondents suggest that the proposed disclosure requirements will create information overload for investors. In particular, the disclosures that are most contested are:

    (a) Stress testing – many respondents feel that the definition of stress testing is not clear enough in the proposal to ensure that the disclosures made would be comparable across entities (ie what constitutes the type of stress testing that should be disclosed). There is also concern that stress testing should not be included in the notes to the financial statements, but rather in management commentary because of its inherent unauditability.

    (b) Vintage information – many respondents feel that the vintage information is only relevant for certain types of loans (eg mortgage loans) and is not operational for open portfolios. Furthermore, they felt this information would become irrelevant if a model that is more operational with open portfolios is further developed.

    (c) Loss triangle disclosure – many respondents feel that the requirement in paragraph 19 is unclear. They feel that additional guidance is needed on what is a ‘class’ of financial assets, and on what is meant by ‘cumulative’ write-offs. Further, respondents state that the information needed for this type of disclosure is not currently maintained.

36. Many respondents feel that the objective for disclosures in paragraph 11 of the ED is appropriate. However, several feel that there should be flexibility in what sorts of disclosures are appropriate for each entity to meet that objective. Many respondents feel that providing the minimum requirements in paragraphs 13-22 of the ED creates a checklist for disclosures, but that the standard should not provide such a checklist.

37. Many respondents feel that the requirement in paragraph 13(a) of the ED to present gross interest revenue calculated using the effective interest method before taking into account the allocation of the initial estimate of expected credit losses is inappropriate. They feel that this requirement causes an entity to have to perform two amortised cost calculations: one including EL and the other excluding EL.

Practical expedients and definitions

38. Many respondents agree that due to the complexity of the model, certain practical expedients are a welcome addition. However, most of those that agree also note that the requirement in paragraph B15 of the ED that the entity may use a practical expedient if its overall effect is immaterial removes the practicality of the expedient. They argue that having to meet the immateriality requirement essentially means one has to perform both methods in order to show the immateriality.

39. Many respondents comment that the definition of ‘write-off’ is too restrictive. They note that there may be financial assets for which the entity has no reasonable expectation of recovery, but the entity may not have ceased enforcement activities. For example, in some jurisdictions, the enforcement activities may take several years, but not permitting the entity to write off that asset may cause losses to be recorded too late.

40. Many respondents comment that the definition of ‘non-performing’ is also too restrictive. They note that entities should be permitted to define a non-performing asset in accordance with its own internal policies, and that the IASB

should not provide a bright line which may not be consistent with the local jurisdiction or industry.

41. Many respondents comment that ‘classes of financial instruments’ should be better defined in order to ensure that disclosures are presented consistently across entities.

Convergence with US GAAP and due process

42. A number of respondents (especially, but not only, respondents from the US) comment on the need to arrive at a converged model with the FASB.

43. They indicate that it is too soon after the FASB’s release of proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* to properly evaluate both models, but that having different models would cause great difficulty.

44. Some state that, even if the classification and measurement models are different, the boards should attempt to arrive at a common impairment approach.

45. As noted previously many respondents also mention the work done by the EAP. Some respondents state their concerns related to the future of the impairment ED and want some assurance that proper due process will be followed in the coming months related to the impairment project. Several respondents state that they would like the opportunity to comment on the final decisions made by the IASB as a result of the operational and other simplifications which may be written into a final standard arising from the EAP meetings and from comment letters.

Appendix A: Statistics for comment letter respondents

A1. As of 15 July 2010, 179 letters had been received. The following shows the different geographic regions and types of organisations which responded.

A2. The 'International' description below represents accounting firms and other organisations representing an international constituency. Other corporate responses were allocated to the geographic region of their headquarters.

Geographic Region	Number
Africa	6
Asia-Pacific	36
Europe	91
North America	24
South America	3
International	19
TOTAL	**179**

Type	Number
Accountancy Body / Organisation	26
Accounting Firm	9
Miscellaneous	5
Financial Institution Preparers	
Company	33
Representative Bodies	27
Other Preparers	
Company	16
Representative Bodies	12
Regulator	9
Standard Setters	23
User	10
User / Preparer	9
TOTAL	**179**

A3. The 'Accountancy Body / Organisation' description includes associations, institutions, etc made up of various accounting or auditing groups.

A4. The 'User / Preparer' description includes organisations that describe themselves (or their members) as being responsible for analysing financial information, as well as preparing it. Most insurance organisations described themselves in this category.