Federation of European Accountants
Fédération des Experts comptables Européens

Sir David Tweedie
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International Accounting Standards Board
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Ref.: BAN/HvD/LF/ID

Dear Sir David,

Re: FEE Comments on IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment*

(1) FEE (the Federation of European Accountants) is pleased to provide you with its comments on the IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the "ED").

(2) As a founding organisation of EFRAG we have also contributed to the EFRAG consultation process by submitting on 22 June 2010 the FEE comments on EFRAG's Draft Comment Letter of 22 February 2010. EFRAG has issued its final Comment Letter on 29 June 2010. We have considered the EFRAG Final Comment Letter in our response and make reference to the EFRAG comments where relevant.

(3) In general, like EFRAG, we support the IASB's development of an alternative model to the incurred loss impairment model, in particular if it takes into account more relevant information about credit losses.

(4) Conceptually, like EFRAG, we are also broadly in agreement with the proposals of the ED to include a provision for the expected losses which are inherent in portfolios. Similarly, we support the requested disclosures as long as these are aimed at enhancing the selected accounting model rather than trying to deal with its shortcomings. One of the aims of the new financial instrument standard has been to reduce complexity. However, in our opinion the practical implementation of the proposals in the ED will lead in the opposite direction.

(5) Consequently, we have significant concerns with the ED. Particularly, we are concerned with the following key issues:

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(i) **Operability of the proposals:** A practicable alternative to the proposals in the ED would be the introduction of the distinction between "good book" (performing assets) and "bad book" (individually impaired/defaulted assets) as currently used by the banking industry. This may require only limited changes to the current provisioning model for incurred losses (bad book) and replacement of the current portfolio impairment model by an expected loss model for performing assets in the good book (as can be seen in paragraphs 44 and 46 of the Appendix to this letter there are some mixed views on this subject).

(ii) **Integral approach to credit losses and interest income**: we propose "decoupling" these two performance measures in line with the May update of the IASB Expert Advisory Panel proposals resulting in presentation of interest income and both initially and subsequently identified credit losses separately in the income statement (paragraphs 24, 35, 36 and 53 in the Appendix to this letter).

(6) We also note that the discussion regarding the operational challenges is ongoing. Therefore, the comments in this letter are made in that context. We may provide additional views once new proposals on how to overcome the operational challenges are available.

Due process

(7) We share EFRAG's views in that additional guidance or amendments to the ED should be subject to due process, in particular since the IASB Expert Advisory Panel (EAP) is still considering how the ED can be made operational.

Financial statements and prudential reporting

(8) The primary objective of financial statements is to provide decision useful information to investors and other capital market participants.

(9) Regulatory reporting and general purpose financial reporting have different objectives. In our view, the primary contribution of financial reporting to financial stability is to restore market confidence with requirements aimed at providing transparency about the financial position at a particular date and performance in each reporting period. We refer to the FEE Policy Statement of March 2009 "Dynamic Provisioning for Financial Instruments".

(10) In common with EFRAG, we consider that general purpose financial reporting might assist regulators to achieve their objective of ensuring financial stability. However, additional requirements needed by regulators should be covered through prudential filters rather than altering the accounting if objectives differ. We would support a solution where the regulatory needs are satisfied through separate reserves in equity and/or relevant disclosures.

Our further significant concerns with the ED are summarised as follows:

Measurement principles

(11) We agree with EFRAG that estimating the amount and particularly the timing of future cashflows reflecting expected credit losses will be demanding and in most cases virtually impossible.

(12) We share EFRAG's concern that the degree of management judgement in estimating cashflows represents a challenge because such judgement may not necessarily be supportable by observable data and might provide scope for abuse.

(13) In exercising judgement to determine the level of expected cashflows, regard might be given to generally accepted industry practice.

(14) Regarding the question of whether there are any simplifications that could be made to the ED in terms of improving the auditability of the model, we refer to paragraph 5(i) and 5(ii) above. The input into the model is also a key issue. The more information there is across industries on this, the better the potential to enhance the reliability of judgement. Ensuring consistency in the judgement is very important. Given that the potential judgements are very wide, it will be difficult to ensure comparability. For this reason, we believe that improved disclosures on observable data like loan impairment or defaults are going to be key.

(15) In addition, although there might be various approaches used in exercising judgement when estimating future losses, any approach should start with analysis of historical data (see paragraph 41 in the Appendix to this letter). It would be useful to see what the EAP is thinking in this respect.

(16) We fully support recognising a change in estimates immediately in the income statement once incurred impairments/defaults exceed the expected levels. For our discussion of the treatment of changes in the expected losses of the performing financial assets see paragraphs 44, 45 and 46.

(17) We agree with EFRAG that the treatment of financial assets that are to be renewed or extended (for instance credit card receivables, overdraft facilities and renegotiated loans) is not adequately addressed in the ED and practical solutions for these products are needed.

Operational challenges

(18) In our comment letter to the IASB on their Request for Information ("Expected Loss Model") Impairment of Financial Assets: Expected Cash Flow Approach (11 September 2009), we agreed with EFRAG that the expected loss model will involve significant operational challenges in Europe. It is onerous in data collection since data needs to be collected for the whole portfolio, not only for the impaired loans. We understand like EFRAG that the operational challenges remain a significant concern for preparers. In particular, as noted earlier, estimating the timing of future cashflows reflecting expected credit losses in the longer term will be very demanding and in most cases virtually impossible.

Non-financial institutions

(19) Like EFRAG, we believe that the way the ED is drafted is not clear on how it will apply to non-financial institutions, particularly where holding short-term receivables. We are not convinced that the ED proposals would fit with this type of instrument.

(20) In our view, there is a difference in the business model between financial institutions and most corporates (non-financial institutions) in relation to this type of financial asset. As noted by EFRAG, for many non-financial entities short-term trade receivables are not held to generate interest revenue. The impairment costs associated with such receivables are typically seen as a business expense rather

than as a reduction in sales volumes. It should be made clear in the standard that the initial measurement of short-term trade receivables (usually generated from the sale of goods or services) is based on the provisions of IAS 18 Revenue (see paragraphs 25 and 26 in the Appendix to this letter).

Other matters

(21) The comments in the present letter are not intended to pre-empt the debate on the forthcoming replacement of IFRS 4 on Insurance contracts, given that the IASB is currently in the process of developing the expected Exposure Draft.

Our responses to the questions in the Invitation to comment of the ED are included as an Appendix to this letter.

For further information on this letter, please contact Leyre Fuertes, Project Manager.

Yours sincerely,

Hans van Damme
President

Objective of amortised cost measurement

Question 1

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?

(22) The objective of amortised cost measurement in the ED is clear and is supported by us.

Question 2

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?

Objective of amortised cost

(23) We agree with EFRAG that an objective of amortised cost should be to provide information about the effective return on a financial instrument by allocating interest revenue or interest expense over its expected life.

(24) As further explained in paragraphs 35 and 36, including the initial estimate of the expected credit losses can represent an operational issue because entities usually store contractual and accounting data in a separate system from the system of expected losses data information. The update on the IASB Expert Advisory Panel (EAP) discussions, issued on 26 May 2010, indicates how the resulting operational challenges linked to the allocation of initial expected credit losses could be resolved by "decoupling" – separately sourcing the information in accounting systems and in risk systems. We support the "decoupling" approach referred to by the EAP as a practical solution to this operational problem.

Non-financial institutions

(25) Like EFRAG, we believe that the amortised cost model proposed is not clear on how it will apply to non-financial institutions, particularly the holding of short-term receivables. We are not convinced that the ED proposals would fit with this type of instrument. Indeed, as pointed out by EFRAG, the proposal to provide information about the effective return appears to assume that financial assets are always held for the purpose of earning revenue. However, most non-financial institutions hold short-term receivables as primary financial assets whose purpose is not to derive interest revenue therefrom.

(26) In our view, there is a difference in the business model between financial institutions and most corporates (non-financial institutions) in relation to this type of financial assets. As noted by EFRAG, for many non-financial entities, short-term trade receivables are not held to and do not generate interest revenue. It should be made clear in the standard that the initial measurement of short-term trade receivables (usually generated from the sale of goods or services) is based on the provisions of IAS 18 Revenue and that the subsequent changes in estimates of credit losses in short-term trade receivables are recognised as a business expense according to paragraph 18 of IAS 18 and not as a reduction of revenue.

Consistency and objectivity of the expected credit losses

(27) We also note under Question 4 that there might be some concerns over the consistency and objectivity of the expected credit losses charge that is expected to be spread over the life of the instruments because it is not observable and is estimated. Some of the issues that preparers might encounter include having to make the assessments for all loans and not only loans that are expected to be impaired. As a result, it might also be significantly harder to compare the information between entities.

(28) In our opinion, the above concerns highlight the need for enhanced transparency through disclosures and addressing the issue of non-observable estimates and consistency over time and across industries.

Measurement principles

Question 3 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?

(29) FEE supports, in common with EFRAG, principles-based accounting standards.

(30) We agree with the broad comment from EFRAG that the way the ED is drafted can be difficult to understand since a significant amount of information, which we believe to be useful and relevant in understanding the objectives and principles of the ED, is included in the Basis for Conclusions. Therefore, we agree with EFRAG that the ED would benefit if some of the discussion in the Basis for Conclusions was incorporated in the body of the final standard.

(31) We support like EFRAG the intention of the EAP to address the operational aspects of the proposals, and found the update on the EAP discussions issued on 26 May 2010 useful. Nevertheless, we share some of the concerns raised by EFRAG about the due process. In particular:

(i) It is still not clear what the conclusions of the EAP findings will be and what will be their impact on the ED proposals;

(ii) In addition, there appear to be key outstanding operational challenges under consideration. It would be useful if a further report from the IASB EAP was made available before the deadline for comments. We would appreciate being able to consider any subsequent findings.

(32) Ideally, clear principles and objectives within an IFRS facilitate its practical and consistent application in relevant circumstances. As noted in paragraph 30 above, certain "implementation guidance" needs to be moved from the Basis for Conclusions to the actual (eventual) IFRS. However, the perceived need for extensive implementation guidance and a number of worked examples should (in the context of IFRS/revised IFRS generally) prompt the question as to whether the principle/s and/or objectives in question are sufficiently clear, consistent and appropriate. Serious doubts, or indeed a negative response, should trigger reconsideration of the proposals. It may be that the proposals are too theoretical

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and need to be redrafted in terms that better relate to how entities will apply them in practice.

(33) In this ED's context, the worked examples do not, in our opinion, necessarily assist the practical application of the proposals.

Question 4

(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?

(34) In our view, there is a real practical issue with these principles because currently no banks perform these from a systems' point of view. If we expect these principles to be implemented properly, it will take some time and this will result in an additional practical problem. A better approach may be to redraft the requirements more in terms of keeping with how entities will be able to implement them.

Effective interest rate

(35) Regarding the proposed measurement principle that the amortised cost shall be calculated using the effective interest rate (EIR) including any expected credit losses, we understand that entities usually store contractual and accounting data in a separate system from the system of expected losses data information, and that as a result implementation of such principle will represent an operational challenge.

(36) As noted earlier, the update on the EAP discussions issued on 26 May 2010 suggests how the resulting operational challenges linked to the allocation of initial expected credit losses could be resolved by "decoupling" – separately sourcing the information in accounting systems and in risk systems. We support the "decoupling" approach as a practical solution to this operational problem.

Expected cash flows

(37) We agree with EFRAG that estimating the amount and particularly the timing of future cashflows, including credit losses, will be demanding and in most cases virtually impossible. The complexities of the reflection of the expected timing of missing cashflows in the effective interest rate would be significantly increased for long-term loan portfolios, for the performing part of the existing loan portfolio and for single large loan exposures outside any homogeneous portfolio. We believe that the separate treatment and presentation of the credit losses and separate quantification of the expected and incurred credit losses could contribute to a practical solution, as well as providing useful information about losses actually arising in a particular period.

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Use of management judgement

(38) We share EFRAG's concern that the degree of management judgement in estimating cashflows represents a challenge because such judgement may not necessarily be supportable by observable data.

(39) In exercising judgement to determine the expected cashflows, generally accepted industry practice in terms of measurement may be relevant, as well as guidance in the standard so that judgements should be supported by verifiable data.

(40) Regarding the question of whether there are any simplifications that could be made to the ED in terms of improving the auditability of the model, the input into the model is also a key issue. The more information there is across industries on this the better the potential to enhance the reliability of judgement. Ensuring consistency in the judgement is very important. Given that the potential judgements are very wide, it will be difficult to ensure comparability. For this reason, we believe that improved disclosures of observable data are going to be key. Disclosure of movements between "good" and "bad" portfolios (see paragraphs 44 and 45) would enhance transparency.

(41) In addition, although there might be various approaches used in exercising judgement when estimating future losses, any approach should be based on historical data as a start, which as a second step would be adjusted to reflect current and expected future conditions to the extent that these can be verified.

Probability-weighted expected values

(42) Regarding the proposed measurement principle that the estimates for the cash flow inputs are the probability-weighted expected values, we would support the "expected values" element.

(43) We query whether the suggested "probability-weighted" approach would be practical in all cases. In certain circumstances it could prove complex to attain. We would prefer to keep a more principles-based approach and suggest to eliminate (what we see as a constraint for some entities) the requirement for the approach to be probability-weighted. While we still acknowledge that some entities might very well opt for a probability-weighted approach and that some portfolios might need such treatment, others such as smaller banks might welcome simplification in this area. We note the findings from the EAP that applying the proposed approach is operationally challenging for smaller banks and non-financial entities. Our suggestion could help in the efforts for simplification for smaller banks, non-financial entities and treatment of single large exposures.

Recognition of changes in estimates

(44) We fully support recognising a change in estimates immediately in the income statement once impairments/defaults exceed the expected levels. However, a majority of our constituents consider as inconsistent spreading expected losses on initial recognition of assets, yet take any changes after that date immediately to the income statement. They would like to see certain "smoothing mechanisms" that would remove volatility resulting from changes in loss estimates of the performing part of portfolio from the income statement. At the same time, a minority supports the IASB proposals of recognition of all justified subsequent changes in expected losses immediately in the income statement.

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(45) A practical solution for such "smoothing mechanism" based on the introduction of the "good book" (performing assets) and "bad book" (individually impaired/defaulted assets) could be the introduction of different approaches to provisioning to these two books. Such solution might potentially require only limited changes to the current provisioning model for incurred losses (bad book) and replacement of the current portfolio impairment model by an expected loss model for performing assets (good book). The identified problem of the current model in the "good book" is that a slight overstatement of initial loss expectations would result in recognition of material gains already on first re-measurement. Therefore, we propose to consider whether the changes in loss expectations for the "good book" should be recognised in the income statement immediately or over the duration of the portfolio. In any case, we fully support the immediate recognition of the loss expectations and actual losses in the "bad book" in the income statement. Consideration should be given to the EFRAG proposal to limit the "over the duration" approach in the case that net interest margin is not sufficient to absorb the impairment charge.

(46) Should the changes in loss expectation in the "good book" be recognised over the duration of the portfolio, it would require resolution of the crucial question: how much provision should be transferred from the "good book" to the "bad book" on impairment/default of a particular loan? In our view, this issue is inevitably judgemental, with the "right answer" within a range between the full retention of the provision in the "good book" and the full transfer into the "bad book". However, in total, there should be sufficient provision to cover losses in the "bad book" and expected losses in the "good book". Clearly, under a standard that required full immediate recognition of any changes in loss expectations in the income statement, this issue would not arise.

(47) The proposed approach in the ED causes practical problems in the case of open portfolios. As noted in the EAP update (issued on 26 May 2010), when revisiting expectations of losses on an open portfolio, it will be hard to assess whether any changes relate to the old loans that were already in the portfolio or as a result of the new loans added since the previous expected losses estimate. Therefore, we would appreciate further guidance on this issue in the final standard.

Revolving financial assets

(48) We agree with EFRAG that the treatment of financial assets that are to be renewed or extended (for instance credit card receivables, overdraft facilities and renegotiated loans) is not adequately addressed in the ED. Our solution outlined above would equally be applicable to solve this particular issue.

Objective of presentation and disclosure

Question 5

(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?

(49) Like EFRAG, we believe that in the case of non-financial institutions when holding short-term receivables, the presentation and disclosure objective may not be appropriate.

(50) As noted in paragraph 25 above, the proposal to provide information about the effective return appears to assume that financial assets are always held for the purpose of earning revenue. However, most non-financial institutions hold short-term receivables as primary financial assets simply to cover the period between delivery and cash settlement. We agree with EFRAG's proposal that the IASB relates the objective of presentation and disclosures to providing information about the effective return where such information is relevant.

Presentation

Question 6 Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

(51) We broadly think, like EFRAG, that the proposed presentation requirements have some merits. In particular, the split of information as proposed into gross, initial expected losses, net and subsequent loss adjustments would provide some insight, at least to understand the quality of the initial expectations. However, we need to balance the operational challenges. In addition, information about the total quantum of losses (and their timing) should not be lost as a result. We also refer to the proposal to "decouple" the interest and credit loss information as described in paragraph 5 of our covering letter.

(52) Furthermore, it might not necessarily be easy to arrive at clear conclusions just because the information is split up. The information might still be difficult to interpret properly and to compare.

(53) In our opinion, banks will have the information to meet the requirement in 13 (a) (gross interest revenue, calculated using the effective interest method before taking into account expected losses). A practical method however, will need to be found to spread initial loss estimates. We believe that this information will add value to users and should not be that onerous to prepare. It would be helpful to disclose the gross interest revenue separately in the profit and loss, as it is currently the case, with the expected credit loss charge "decoupled" in a separate line directly below net interest income. In addition, the total quantum of losses in a period should also be disclosed, if initial expected losses are presented separately from other loss information.

(54) We agree with EFRAG that when interest revenue is not of particular relevance, as could be the case for some non-financial institutions, the proposed presentation requirements may not be appropriate. As noted in paragraph 50 above, we support EFRAG's suggestion to the IASB to relate the objective of presentation and disclosures to providing information about the effective return where such information is relevant.

Disclosure

Question 7

(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?

(55) We support the possible enhanced disclosures where it provides objective data, which should result in better transparency. Particularly, we support the requested disclosures as long as these are aimed at enhancing the selected accounting model rather than trying to deal with its shortcomings.

(56) We believe that the disclosure of stress testing information might be useful in certain circumstances but it is likely that there will be sensitivities linked to this disclosure. While in practice entities usually perform back testing, stress testing is not compulsory and relevant key disclosures should be required only if used for management or regulatory purposes. In any case, it might be more relevant and appropriate disclosing information about back testing. It might prove difficult to find a proper balance between preparers and users' needs on disclosures. However, in our view, as a minimum the back testing method should be disclosed. However, we do not think stress testing is only relevant to impairment and would suggest that, if there are to be disclosures about this, it should be considered whether management commentary is not the better place for such disclosures than the audited financial statements.

Effective date and transition

Question 8

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?

(57) Generally, it seems that the three-year lead-time is reasonable. Final review of the effective date should also take into account the solution to the operational challenges and its impact on the final standard that might simplify the implementation process.

(58) In principle, we would prefer a required single effective date for the whole IFRS 9. In that respect, the current transitional requirements of IFRS 9 should be amended to facilitate this.

Question 9

(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.

(59) In our view, the proposed approaches as suggested by EFRAG in their final comment letter to the expected loss model would significantly simplify the transition.

(60) There is information value in having the comparative figures but the costs of restating comparative information will only be understood once the proposals including simplifications are implemented.

Question 10

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

(61) We agree with EFRAG and support the proposed disclosure requirements in relation to transition.

Practical expedients

Question 11

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

Question 12

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?

(62) A concern that we have regarding this model is how overdrafts and credit card loans should be dealt with. In our view, it would be inappropriate to provide for an amount that does not yet “exist”.

(63) We note that loan commitments are outside the scope of the proposals. In our view, the question is whether they should be scoped out.

(64) In principle, we note that the simpler the model the less needs there are for practical expedients. The need for practical expedients demonstrates the complexity of the current proposals. We would encourage both principles-based accounting standards and simplification as much as feasible.

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