DRAFT COMMENT LETTER

Comments should be submitted by 1 June 2010 to Commentletter@efrag.org

XX Month 2010

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir / Madam

Re: Exposure Draft *Financial Instruments: Amortised Cost and Impairment*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the ED). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

Note for EFRAG's constituents

The proposed replacement to the existing requirements in IAS 39 'Financial Instruments: Recognition and Measurement' on amortised cost and impairment of financial instruments will have a fundamental effect on the way financial assets carried at amortised cost are measured for credit losses. This draft comment letter reflects EFRAG's analysis of the proposals in the ED to date. The analysis is not yet complete and will continue as EFRAG explores the operational implications of the proposals and seeks input from constituents as well as monitoring the discussions being considered by the IASB Expert Advisory Panel (EAP).

We welcome any initial comments constituents may have, and would encourage them to engage with us in their debates about the proposals.

In the course of the comment period, EFRAG may issue a revised version of this draft comment letter based on the initial feedback received, as well as the outcome of outreach activities. However, it is expected that the revisions will primarily include considerations of an operational nature, rather than changes in the technical assessment. EFRAG will finalise its position based on its further analysis and on the input from constituents that it receives to this draft comment letter.

EFRAG supports the IASB's objective of developing an alternative to the incurred loss impairment model for financial assets that uses more forward-looking information about credit losses. We consider that the expected cash flow approach to determining impairment of financial assets proposed in the ED achieves this by requiring that:

(a) Entities measure impairment based on changes in estimates of <u>expected</u> credit losses. Expectations are by their nature forward-looking; and

(b) Estimates of expected credit losses are reviewed at each measurement date, resulting in the recognition of impairment losses in the period when there is an adverse change in those estimates. Unlike the incurred loss model, the expected loss approach proposed in the ED requires no threshold or trigger event for estimates or changes in estimates of credit losses.

EFRAG supports the IASB's decision not to proceed with the alternative impairment models (i.e. fair value and through-the-cycle approaches) discussed as part of its deliberations on the ED. In EFRAG's view, an impairment model based on fair value would not be consistent with a cost-based measurement principle. In addition, EFRAG does not support through-the-cycle provisioning for financial assets if the impairment provisions relate to anything other than financial assets recognised at the reporting date. We understand that some who call for impairment models to be less pro-cyclical support through-the-cycle provisions. Although we think it is possible to develop accounting standards that satisfy the similar needs of both prudential supervisors and capital market participants, EFRAG is strongly of the view that the primary objective of financial statements is to provide decision useful information to investors and other capital market participants. In our view, impairment provisions based on through-the-cycle average data may reduce pro-cyclicality but would be contrary to the needs of investors and market participants.

Conceptually EFRAG cautiously supports the impairment proposals in the ED for the following reasons:

(a) As stated above, the expected loss approach to impairment for financial assets eliminates the requirement for a 'trigger event' thus enabling entities to use a broader range of credit-related forward looking information and where appropriate, recognise impairment losses on financial assets earlier.

(b) The model allocates credit losses estimated on initial recognition of a financial asset on the same basis as interest revenue. This makes it clear that a portion of contractual interest received on a financial asset is in compensation for future credit losses. Under the proposals, revenue is withheld to cover expected credit losses unless there is a favourable change in those expectations.

(c) The measurement, presentation and disclosure principles in the ED work as a package. In particular, we strongly support the 'loss triangle' disclosures that compare the development of credit loss allowances (i.e. impairment provisions) over time against cumulative write-offs. We consider that over time these disclosures will provide users with good insight into the ability of entities to accurately estimate future credit losses and the level of actual write-offs.

However, despite this cautious support, EFRAG does have significant concerns about the proposals in the ED. These are summarised as follows:

(a) We are concerned about how the objective of amortised cost proposed in the ED relates to short-term trade receivables. For many entities short-term trade receivables are not held to generate interest revenue and the impairment costs associated with such receivables are typically seen as a business expense. The focus on 'effective return' creates a valid concern amongst many non-financial institutions about the relevance and decision-usefulness of the information that will be generated as a result of the proposals. EFRAG considers that the IASB should relate the objective of amortised cost to providing information about the effective return where such information is relevant. This focus on relevance should flow through to the proposed principles on measurement, presentation and disclosure.

(b) In terms of the measurement principles in the ED we have several significant concerns including:

  (i) Estimating both the amount and timing of future cash flows, including future credit losses will be difficult. We consider that the IASB should develop an overriding principle for the use of an expected cash flow approach that requires entities to produce their best estimate given the information available. The IASB may also need to consider whether further guidance is necessary to ensure the comparability of financial information;

  (ii) Management judgement is central to calculating expected cash flows including credit losses. Such judgement may not necessarily be supportable by observable data and therefore there may be concerns about its reliability and the potential for earnings management;

  (iii) The IASB should more fully explain why changes in estimates of expected credit losses should be recognised in profit or loss in the period of the re-estimate; and

  (iv) The treatment of financial assets that will be renewed or extended, such as credit card receivables, is not adequately addressed in the proposals.

In addition, EFRAG supports the creation of the EAP to address some of the operational challenges arising from the proposals in the ED. However, in EFRAG's view, its existence raises two concerns:

(a) The proposals in the ED have not yet been sufficiently articulated to be made operational. The fact that the IASB has considered it necessary to form the EAP is evidence to support this view. EFRAG is concerned that, without further guidance, a wide range of interpretations of the principles in the ED will be made in order to make them operational. This would impair comparability; and

(b) The proposals in the ED are likely to change significantly prior to the issuance of a final standard. This could be as a result of the output produced by the EAP and/or from suggestions received directly from constituents. Given the timing of when the IASB will consider and, perhaps incorporate some of this guidance into the final standard, EFRAG is concerned about due process. In particular, we are concerned that there will not be an opportunity for both our constituents and us to comprehensively review and comment on any amended proposals.

In a similar manner, EFRAG supports the inclusion of practical expedients in the ED. However, we are concerned that the 'materiality test' required to be met to be able to apply the practical expedient may diminish the value of its inclusion in the final standard. Therefore, we suggest the role of materiality in these circumstances is clarified.

Finally, we refer to our comment letter to the IASB dated 8 September 2009 in response to its Request for Information *('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach* ('the Request for Information'). In that response, we expressed the following initial view:

"...implementation of an Expected Cash Flow Approach will involve significant operational challenges in Europe, such as the need for systems changes and new control processes over an increased use of management judgement involved in estimating future cash flows, and the lack of relevant historical data. However, that is not in our view a reason at this stage to abandon work on such an approach, because we think it could also result in potential benefits. What we think the challenges do mean however is that care needs to be taken to try to 'get the requirements right' at the outset, so that further expensive changes are not required later."

We understand that the operational challenges identified in our response to the Request for Information remain a significant concern for many preparers. Based on this understanding and on the concerns raised above, we consider that the IASB has not yet got the 'requirements right' in respect of the impairment proposals in the ED, although conceptually we think it is heading in the right direction. We wait to see whether the IASB, through its work with the EAP and through its due process, can reduce the gap between the conceptual benefits of the proposals and the significant operational concerns.

If you wish to discuss our comments further, please do not hesitate to contact Marius van Reenen, Kristy Robinson or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
EFRAG's response to the questions asked in the ED

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?

Notes for EFRAG's constituents

1 *The ED proposes that the objective of amortised cost measurement is "to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument".*

2 *The proposed standard clarifies that amortised cost is a measurement basis that combines current cash flow information at each measurement date with a valuation of those cash flows that reflects conditions on initial recognition of the financial instrument. Furthermore, the cash flows include fees, points paid or received, transaction costs and other premiums or discounts as well as the initial estimate of expected credit losses on a financial asset.*

EFRAG's draft response

EFRAG's view:

- The description of the objective of amortised cost measurement in the ED is clear.
- The description of 'effective return' could be clarified by emphasising that current cash flow information is based on future expected cash flows.

The IASB's description of the objective of amortised cost measurement

3 Subject to our response to Question 2, EFRAG supports the fact that the ED has articulated and grouped the objectives and principles of amortised cost measurement together in one place.

4 In addition, we consider that the description of amortised cost in paragraph 3 of the ED is clear.

5 However, paragraph 4 of the proposed standard elaborates on the effective return. We think that drafting of this paragraph could be made clearer. We suggest that the second sentence of paragraph 4 is amended to emphasise that "current cash flow information" is based on estimates of future expected cash flows. The following wording could be added to effect this change:

> "...amortised cost is a measurement that combines **current estimates of future cash flows** at each measurement date with a valuation of those cash flows that reflects conditions on initial recognition of the financial instrument."

6 A further improvement would be to move this sentence to the end of the section as it is in effect a summary of the measurement concept.

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?

Notes for EFRAG's constituents

See the description under Question 1.

EFRAG's draft response

EFRAG's view:

- EFRAG agrees that one objective of amortised cost should be to provide information about the effective return on a financial instrument i.e. the allocation of revenue.
- EFRAG considers that the objective of amortised cost should also be to provide information about the future cash flows that will arise from the financial instrument – i.e. its measurement in the balance sheet.
- The application of the objective to short-term trade receivables should be more carefully considered.

7 Subject to our comments below, EFRAG broadly agrees with the proposal in the ED that an objective of amortised cost should be to include information about the effective return on a financial instrument, through the allocation of interest or expense over its expected life. However, EFRAG considers that the objective as described in the ED is too focused on the allocation of income and expenses. EFRAG believes that amortised cost is a relevant (and legitimate) measurement basis that also provides information about the instrument's capacity to generate or absorb cash flows in the future. A so called 'balance sheet view'.

8 On this point EFRAG notes BC14 of the Basis for Conclusions to IFRS 9 *Financial Instruments* that states "almost all respondents to the exposure draft supported the mixed attribute approach, stating that amortised cost provides relevant and useful information about particular financial assets in particular circumstances because it provides information about the entity's likely actual cash flows." [emphasis added]

9 From this paragraph, it is clear that the objective of amortised cost should also be to provide information about the actual cash flows that are likely to arise from a financial instrument. We consider that this information should be incorporated into the objective of amortised cost as set out in paragraph 3 of the ED.

10 Separately we are concerned about how the objective of amortised cost proposed in the ED relates to short-term trade receivables. The requirement to provide information about the 'effective return on a financial asset assumes that an entity holds a financial asset for the purpose of earning revenue from it. This may generally be the case for financial institutions, but for other entities whose primary financial assets are short-term trade receivables, the notion of effective return on financial assets has less relevance. For many of these entities, providing deferred payment terms over a short period is part of the process of selling their product. Short-term trade receivables are not held to generate interest revenue and the impairment costs associated with such receivables are seen as a business

expense. The focus on 'effective return' embodied in the objective of amortised cost in the ED therefore creates a valid concern amongst many non-financial institutions about the relevance of the information that will be generated as a result of the proposals.

11 EFRAG considers that the IASB should relate the objective of amortised cost to providing information about the effective return where such information is relevant. This objective should flow through to the proposed principles on measurement, presentation and disclosure. We have therefore provided more detailed comments on this view in our response to Question 6 on presentation (paragraphs 79-81), Question 7 on disclosures (paragraph 89(a)) and Question 11 on practical expedients (paragraph 121).

MEASUREMENT PRINCIPLES

Question 3

Do you agree with the way that the exposure draft is drafted, which emphasises 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?

Notes for EFRAG's constituents

12 *The IASB has tentatively agreed that the proposed standard should provide a clear objective, emphasise principles and provide concise application guidance. In addition, certain issues will be discussed with the Impairment Expert Advisory Panel (EAP) and the status of its decisions has not yet been made clear. These issues include, but are not limited to, the determination of the initial spread, practical aspects of applying the effective interest method and interaction with Basel II.*

13 *No illustrative examples have been included in the ED. The IASB, however, has published examples on their website. These have been prepared by IASB staff for illustrative purposes only and do not form part of the ED.*

EFRAG's response

EFRAG's view:

- A significant amount of information that is useful and relevant in understanding the objective and principles of the ED is included in the Basis for Conclusions. Therefore, EFRAG suggests that it would be beneficial to bring some of the discussion in the Basis for Conclusions into the body of the final standard;
- We support the formation of the EAP and the other outreach activities being conducted by the IASB, but we are concerned about the due process implications of any amendments to proposals in the ED that will result from this work.

14 EFRAG supports robust principles-based accounting standards and therefore, agrees with the approach followed in the ED. However, we note the concerns raised in our responses to questions 1, 2, 4 and 5 relating to the objectives and principles proposed in the ED.

15 However, in EFRAG's view a significant amount of information that is useful and relevant in understanding the objective and principles in the ED is included in the

Basis for Conclusions. EFRAG notes that only a standard and its application guidance can be endorsed for use in Europe. As a result, we are conscious that a final standard and its application guidance should be comprehensive and stand on its own.

16 The new impairment model proposed in the ED is a significant change to existing requirements in IAS 39 and, in EFRAG's view, these proposals should be given more prominence in the body of the standard. Therefore EFRAG suggests that it would be beneficial to provide some discussion (albeit brief) about the expected loss approach possibly following paragraphs 5 or B3(c) of the ED. We think including a direct reference to the new impairment model will more clearly articulate the significance of the new provisions.

17 In addition, EFRAG considers that some of the concepts that are developed or explained within the Basis for Conclusions could be moved to the main text to the extent that it provides guidance to better understand and implement the principles in the proposed standard. For example:

(a) BC 25 – "under the proposed approach impairment losses would result only after initial recognition of the financial asset from an adverse change in the estimate of expected credit losses";

(b) BC 34 – "measure an impairment loss as the difference between the carrying amount of the financial asset before the change in estimate and the present value of the expected cash flows of that asset after including the change in estimate. The effect of a change in estimate would be recognised in profit or loss in the period of the change";

(c) BC 35 – "Under the proposed approach a reversal of an impairment loss would result from a favourable change in the estimate of expected credit losses. ...there would be automatic reversals of impairment losses as the estimates change"; and

(d) BC 36 – "because the initial estimate of the expected credit losses for a financial asset is included in determining the effective interest rate there could be a gain from a favourable change in credit loss expectations even if no impairment loss had previously been recognised."

18 Further, we note the formation of the EAP and support its objective of addressing some of the operational challenges of an expected loss approach. However, its existence raises two concerns for EFRAG.

19 Firstly, EFRAG considers that the proposals in the ED have not yet been sufficiently articulated to be made operational. In our view, estimating expected cash flows is a similar process to fair value measurement and, as a result, EFRAG expects that a similar level of guidance regarding inputs and methodology may be necessary. It seems likely that the EAP will develop operational interpretations of the principles contained in the ED. The fact that the IASB has considered it necessary to form the EAP is evidence that the principles in the ED will need further articulation. Without further guidance, it is EFRAG's concern that in making the guidance operational preparers will make a wide range of interpretations. In addition, users may also interpret the impairment information differently. This would result in a lack of comparability.

20 Secondly, EFRAG is concerned about the due process surrounding the output of the EAP and the input received by the IASB from other constituents during the ED comment period. As stated above, we consider that on implementation of the proposals in the ED there may be a broad range of possible interpretations driven by operational considerations. We consider that some of the output of the EAP will narrow the range of those possible interpretations and may need to be incorporated into the final standard in some way. EFRAG is concerned that the nature of the proposals in the ED will be significantly impacted by the EAP's output. However, the EAP output is due to continue until June 2010. Given the timing of when the IASB will consider and, incorporate some of this guidance into the final standard, EFRAG and other constituents will not be able to comprehensively review and comment on the amended proposals in the ED.

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?

Notes for EFRAG's constituents

21 *To achieve the objective proposed by the ED, the IASB proposes three main measurement principles:*

(a) *Amortised cost shall be calculated using the effective interest method. Therefore it is the present value calculated using the following inputs:*

(i) the expected cash flows over the remaining life of the financial instrument; and

(ii) the effective interest rate as the discount rate.

(b) *The estimates for the cash flow inputs are the probability-weighted expected values.*

(c) *The effective interest method is the allocation mechanism for interest revenue and interest expense. The effective interest rate used for this purpose reflects the nature of the financial instrument's interest (type of interest formula), i.e. what part of the contractual interest rate (if any) is reset.*

Expected cash flows

22 *The ED clarifies that the expected cash flows are the probability-weighted possible outcomes of <u>both the amounts and timing of these amounts</u>. These cash flows shall be estimated considering:*

(a) *all contractual terms of the financial instrument (e.g. prepayment, options etc);*

(b) *fees and points paid or received between parties to the contract that are an integral part of the effective interest rate to the extent they are not included in the initial measurement of the financial instrument; and*

(c) *<u>for financial assets, credit losses over the entire life of the asset</u>.*

For financial liabilities, estimates of expected cash flows do not reflect the entity's own non-performance risk. That is to say, that an entity will not consider the possibility that it will default on any contractual payments in estimating the amortised cost of a financial liability.

23 *For the purpose of calculating the expected cash flows an entity may base the estimate on <u>either a collective or individual basis</u>, providing the approach provides the best estimate of future cash flows and does not result in the double-counting of credit losses.*

Effective interest rate

24 *"Effective interest rate" is defined (in Appendix A of the ED) as "the rate that (or spread that, in combination with the interest rate components that are reset in accordance with the contract) exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or financial liability". Therefore:*

(a) *for a fixed rate financial instrument the effective interest rate is the discount rate that results in a present value of the expected cash flows that equals the carrying amount (i.e. the initial measurement) of the financial instrument (initial effective interest rate).*

(b) *for a floating rate financial instrument that resets a benchmark interest component (e.g. LIBOR plus 100 basis points) the effective interest rate is not determined as a single constant rate. Instead, a combination of the spot (zero coupon) curve for the benchmark interest rate and a spread is used for discounting. This spread is derived by iteration so that the present value of the expected cash flows equals the carrying amount (i.e. the initial measurement) of the financial instrument (initial effective spread).*

25 *The effective interest rate, to the extent that it is not reset to current conditions, is used to reflect inputs in the initial measurement – this rate, in conjunction with expected cash flows, provides information on the effective return of the instrument. Contractual resets of the interest cash flows of a financial instrument alter the effective interest rate to the extent that the interest rate is adjusted (and in relation to the component or components affected).*

26 *The use of the effective interest rate distinguishes the amortised cost measurement from a fair value that would have used current market rate for discounting.*

The amortised cost model

27 *The proposed approach in the ED would require an entity to include the initial estimate of the expected credit losses for a financial asset in determining the effective interest rate, thereby spreading the expected credit losses over the expected life of the financial asset. This approach would not result in an impairment loss on initial recognition. This is because the initial amortised cost includes an assessment of future credit losses.*

28 *The approach would measure an impairment loss as the difference between the carrying amount of the financial asset before the change in estimate and the present value of the expected cash flows of that asset after including the change in estimate. A reversal of an impairment loss would result from a favourable change in*

the estimate of expected credit losses. This would mean automatic reversals of impairment losses as the estimates change.

29 *The implication of the proposed approach is that a gain could result from a favourable change in credit loss expectations even when an impairment loss had not been recognised in the past. This increase in the carrying amount represented a gain from an improvement in the quality of the financial asset, therefore the Board believes such a gain would be useful information and therefore saw no reason to preclude its recognition. The extent of such a gain is inherently limited to the difference between the initial carrying amount and the present value of the full contractual cash flows discounted using the effective interest rate.*

30 *The Board recognises that estimation of expected credit losses may necessitate the use of significant assumptions and judgement by management.*

31 *In relation to variable rate interest instruments the Board decided to require an entity to adjust the carrying amount in order to ensure that it unwinds to the remaining expected cash flows as this adjustment reflects the underlying economic phenomenon (interest rate indexed principal repayments) and is consistent with the notion of amortised cost. In clarifying this application, the Board rejected an approach that would reset the effective interest rate as they argued that it would result in a smoothing effect that is inconsistent with both the notion of amortised cost and the faithful representation of the underlying economic phenomenon.*

EFRAG's response

EFRAG's view:

- We agree with the IASB's decision not to develop an impairment model based on fair value or through-the-cycle approaches. In particular, EFRAG does not support 'through-the-cycle' provisioning as a basis for financial reporting of impairment losses if the impairment provisions relate to anything other than financial assets recognised at the reporting date.
- We broadly agree with the proposed measurement principles underlying the proposed impairment approach for the following reasons:
  - incorporates forward-looking information in the determination of credit losses;
  - eliminates the need for an incurred loss trigger; and
  - introduces a revenue recognition model that reflects the initial assessment of credit risk.
- However we have the following concerns about the measurement principles:
  - difficulty in estimating the timing and amount of expected credit losses over the entire life of the financial instrument;
  - increased use of management judgement involving unobservable inputs;
  - the basis for recognising changes in estimates of expected credit losses in profit or loss in the period of the re-estimate should be more fully explained;
  - recognition of 'impairment' gains could be seen to be counter-intuitive;
  - the treatment of revolving financial assets should be addressed either as part of these proposals or those relating to IAS 37.

Impairment of financial assets – Fair value and through-the-cycle approaches

32 EFRAG agrees with the reasoning set out in paragraphs BC15 to BC21 of the Basis of Conclusions for why the IASB did not propose an impairment model based on fair value. In EFRAG's view an impairment model based on fair value wouldnot be consistent with a cost-based measurement principle.

33 EFRAG also agrees with the IASB's reasoning in BC22 to BC24 of the Basis for Conclusions not to propose a through-the-cycle approach.

34 EFRAG recognises that the expected loss approach proposed by the ED will reflect management's current expectations about future cash flows arising from assets held at the measurement date. In good times, current expectations about future credit losses are likely to be more favourable. Likewise, in bad times, current expectations about future credit losses will be less favourable. As a result, the model will be inherently pro-cyclical but, in our view, this pro-cyclicality reflects economic reality.

35 EFRAG acknowledges that there have been calls from prudential supervisors and others for the accounting rules on impairment of financial assets to address the issue of pro-cyclicality. In this regard, some constituents have identified 'through-the-cycle provisioning' as a counter-cyclical approach that should be incorporated into the IASB's proposals on impairment.

36 The term 'through-the-cycle provisioning' covers several impairment methodologies all of which spread credit losses over an economic cycle. The IASB describes 'through the cycle provisioning' in paragraph BC 22 of the Basis of Conclusions as an approach 'whereby an entity estimates the impairment on a portfolio of financial assets using statistical parameters derived from historical credit loss data that cover a full economic cycle or several economic cycles.' These methodologies recognise impairments in good times for credit losses which, on past experience, will materialise when economic conditions worsen. An entity does this by estimating impairment based on credit loss experience covering a full economic cycle that may not necessarily reflect the characteristics of financial assets held at the reporting date.

37 EFRAG is strongly of the view that the objective of financial statements is to provide decision useful information to investors and other capital market participants. To be decision useful the financial statements should convey faithfully economic events at the measurement date or over the reporting period. As stated above, through-the-cycle provisioning (as described in the ED) may not do that. In this regard, EFRAG is of the view that there can be a distinction between the purpose of financial statements and the objectives of prudential supervisors. Having said that, we think it is possible that accounting standards can be developed that satisfy the needs of both prudential supervisors and capital market participants since they do have similar interests. For example, it can be argued that providing high quality information to capital market participants increases confidence in such markets. This in turn promotes stability. However, where there are divergent needs, the needs of investors and other capital market participants must take precedence.

38 As a result of the above views, EFRAG does not support 'through-the-cycle provisioning' as a basis for financial reporting of impairment losses if the impairment provisions relate to anything other than financial assets recognised at the reporting date. Including other information, such as impairment provisions based on through-the-cycle averages set by national regulators, does not reflect the characteristics of

the financial assets held at the measurement date. Such information should not be included in an entity's financial statements as this would be contrary to the needs of investors and market participants.

Impairment of financial assets – the proposed approach

39 EFRAG understands that the proposals in the ED do not change the amortised cost measurement principles currently in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) except to require that credit losses on financial assets are considered when estimating expected cash flows. As is currently the case, expected cash flows over the remaining life of the financial instrument are discounted using the effective interest rate in order to calculate amortised cost.

40 EFRAG notes that requiring credit losses to be included in estimating expected cash flows when calculating amortised cost is a significant change from the current requirements of IAS 39 and forms the basis for the IASB's new proposals on impairment.

41 Conceptually, EFRAG broadly agrees with the IASB's new proposals to measure impairment of financial assets.

42 Firstly, EFRAG supports the fact that the proposed impairment model results in more forward-looking information on credit losses being included in the measurement of financial assets. That is, under the proposals, entities measure impairment based on changes in forward-looking estimates of expected credit losses. We think this is decision useful because it enables entities to reflect, on a timely basis, a greater range of information about the quality of financial assets in their reported measurement.

43 Secondly, the proposals introduce a new model for recognising and allocating credit losses. EFRAG supports these proposals in two respects:

<u>Recognition of credit losses is not dependent on an 'incurred loss' trigger event</u>

44 Estimates of expected credit losses are reviewed at each measurement date, resulting in the recognition of impairment losses in the period when there is an adverse change in those estimates. Unlike the incurred loss model, the expected loss approach proposed in the ED requires no threshold or trigger event for estimates or changes in estimates of credit losses. Thus the new approach enables entities to use a broader range of credit-related information and, where appropriate, recognise impairment losses on financial assets earlier.

45 EFRAG understands that identifying when a credit loss has been incurred under the current requirements of IAS 39 can be a difficult and subjective. As a result differences in approach to determining when a loss had been incurred have resulted in a lack of comparability. In addition, failure to appropriately identify whether credit losses have been incurred has led in some cases in the delayed recognition of impairment losses and led to criticisms of the current IFRS incurred loss model.

46 The expected loss approach to impairment proposed by the ED does not rely on an incurred loss 'trigger event'. A change in estimate of future credit losses automatically results in re-measurement of a financial asset held at amortised cost. Combined with the presentation and disclosure proposals in the ED, continual re-

estimation and improved transparency will, in EFRAG's view, result in greater comparability.

Allocation of credit losses is consistent with measurement at initial recognition

47 The effective interest rate is used as a means for allocating the initially estimated credit losses over the life of the financial asset. In particular, we support the resulting pattern of interest revenue recognition where it reflects the entity's initial assessment of credit risk attributable to the financial asset by allocating that risk on the same basis as interest earned. The resulting pattern of interest revenue recognition makes it clear that some of the interest revenue may be paid in compensation for future credit losses.

48 In EFRAG's view, the proposed impairment model in the ED results in greater consistency between measurement on initial recognition (reflected in an instrument's pricing) and its ongoing measurement. The incorporation of expected credit losses in the measurement of financial assets measured at amortised cost is consistent with the manner in which many entities seek to earn a return on their financial assets and price them.

49 Unlike the incurred loss model, the expected cash flow approach provides that interest revenue charged to cover credit losses is recognised to the extent that those credit losses occur or are still expected to occur as originally estimated. EFRAG agrees with this representation since, in its view, information relating to the effective return on a financial asset should provide for the coverage of expected credit losses.

EFRAG concerns regarding the proposed impairment approach

Note for EFRAG's constituents

Below, EFRAG highlights several concerns about the proposals in the ED. Although EFRAG conceptually agrees with the measurement principles proposed by the ED, we are still in the process of determining whether the operational and other concerns outweigh the conceptual merits of the proposals.

We welcome any initial comments constituents may have.

50 Although EFRAG conceptually agrees with the measurement principles in the ED, our agreement is not without reservation. Our significant concerns are summarised as follows:

(a) It may be difficult to estimate future cash flow information without further guidance;

(b) Management judgement is central to calculating expected cash flows. Such judgement may not necessarily be supportable by observable data and therefore there are concerns about reliability and the potential for earnings management;

(c) Changes in estimates of future credit losses could significantly affect profit or loss in some periods. Given this could be a significant impact of the model, we consider that the IASB should more fully explain why changes in estimates of expected credit losses should be recognised in profit or loss in the period of the re-estimate;

(d) Counter-intuitively, gains may result due to an early favourable change in the estimates of future cash flows; and

(e) The proposals do not adequately address the measurement of impairment of financial assets that will be renewed or extended.

51 These concerns are discussed in more detail below.

Estimating expected cash flows

52 Paragraph 8 of the ED provides that expected cash flows, including expected credit losses for financial assets, relate to both the timing and amounts of cash flows on a probability-weighted basis. We believe that some reporting entities may need guidance on how to calculate probability-weighted expected cash flows. The EAP should be asked to assist in the development of such guidance. Such guidance could also include practical expedients that would provide relief to some entities.

53 We also understand that many entities, even sophisticated financial institutions may have difficulty in estimating the timing of credit losses over the life of a financial asset. Historically many entities have looked at expected credit losses in terms of loss of principal rather than losses arising as a result of delays in repayments of principal and interest. In addition, entities have not necessarily forecasted in what period the credit loss would occur. If they had forecasted the period of the loss, it was only for a short time horizon e.g. within one year. Again, we ask that the EAP consider this issue carefully and whether an alternative ‘expected loss’ basis may be workable. For example, a possible approach the IASB could investigate is for the amount of losses expected for a financial asset to be subtracted from its contractual cash flows using an appropriate allocation mechanism. This could give a reasonable proxy for the asset’s expected cash flows.

54 Given the complexity associated with estimating expected cash flows, we think it is important that the IASB develop an overriding principle for use of expected cash flows in the context of impairment of financial assets and elsewhere in IFRS. We think the objective should be for entities to produce their best estimate given the information available. This would mean that in some cases the best estimate might be arrived at using the probability-weighted expected cash flow approach proposed in the ED. This may be the case for a homogeneous portfolio of financial assets for which an entity has good historic and forecasted data. In other cases, for example for a single, long-dated loan to an emerging market counterparty, the reporting entity’s best estimate may not result from using the ED’s expected cash flow approach.

Use of management judgement

55 In EFRAG’s view, the impairment model proposed in the ED relies heavily on management’s ability to estimate future cash flows, including credit losses. Such estimates will be ultimately based on management judgement using inputs that in many cases would be considered unobservable. Examples of areas that may require significant management judgement include the timing of credit losses on long dated financial assets, estimates of the point in time in the economic cycle as well as the outlook for the economic cycle.

56 The IASB argues in BC30 of the ED that “estimation uncertainty and the necessity for management to use significant assumptions and judgement are not unique to the estimates of expected cash flows for the purpose of amortised cost

measurement of financial instruments". EFRAG broadly agrees with this statement as it can be argued that the fair value of a financial asset or financial liability that is based on significant unobservable inputs involves a similar level of judgement. In addition, we recognise that the existing incurred loss model requires judgement in determining when a loss has been incurred as well as estimating the amount of that loss. However, EFRAG notes that amortised cost is (and will be) used as the measurement basis for a significant percentage of assets held by some entities, in particular financial institutions. We therefore expect that the use of management judgement as a result of the proposals in the ED will become more pervasive and the impact on financial statements more significant.

57 There is also a concern that the approach will enable earnings management. Small changes to assumptions may allow management to meet certain targets or market expectations. It may be difficult to audit these changes as the information may be based on unobservable inputs.

<u>Profit or loss due to changes in estimates</u>

58 Changes in estimates of expected future cash flows, including those relating to expected credit losses, are recognised in profit or loss in the period of the re-estimate. Some events or circumstances may cause a change in an entity's estimates of expected credit losses to be extrapolated across a wide range of an entity's financial assets held at amortised cost. This could result in a significant impact to profit or loss in one period for example if there is a change in management's view of commercial or residential property prices.

59 Volatility in profit or loss due to change in estimates may well be an inevitable by-product of considering a wider range of credit loss information to determine impairment of financial assets. However given this volatility could be a significant, we suggest that the IASB should more fully explain why changes in estimates of expected credit losses should be recognised in profit or loss in the period of the re-estimate.

60 As an alternative, some EFRAG members suggest that any gain or loss relating to the current and prior periods should be recognised in profit or loss in the year of the change in estimate, while the portion relating to future cash flows should be amortised over the remaining life of the financial asset. These EFRAG members argue that this option has not been sufficiently considered or debated by the IASB.

Request for information

EFRAG would like to hear constituents' views on the alternative suggested by these EFRAG members. We would be interested to know whether constituents agree that this approach will appropriately reduce volatility in the profit or loss, and if the suggestion is reconcilable with the measurement principles proposed by the ED.

<u>Recognition of impairment 'gains'</u>

61 As a result of the proposals in the ED, it would also be possible to recognise an impairment 'gain' without having recognised an impairment loss in profit or loss in the past, as explained in BC36 of the Basis for Conclusions. This initially may seem counter-intuitive to some users of financial statements since the 'gain' has not reversed an impairment loss already recognised in prior periods.

62 We understand that such a gain will be offset by credit losses expected at initial recognition that will continue to be amortised over the life of the financial asset as a component of net interest revenue. Thus the revenue (net interest revenue and gains/losses resulting from changes in estimates) recognised on a financial asset measured at amortised cost should never exceed the gross contractual interest discounted using the original effective interest rate for that instrument. Given the recognition of gains could seem counter-intuitive it is EFRAG's view that such implications are best discussed in the standard or application guidance rather than in the Basis for Conclusions.

<u>Treatment of financial assets that will be extended or renewed</u>

63 As we stated in paragraph 38 of this letter concerning through-the-cycle provisioning, EFRAG believes that a provision for impairment of financial assets should only reflect the characteristics of financial assets held at the measurement date. However, EFRAG understands that many financial assets, such as short- and medium- term loans, are automatically extended or renewed by the lender's contractual option to continue to extend the lending for future periods. Examples may include credit card receivables and other loan facilities, where balances are periodically paid, redrawn or maintained. Although the lender in these circumstances may have the contractual right to withdraw the line of credit at any time, this ability may not exist in practice. This is because these assets will generally be managed as part of a homogenous portfolio, so although the lender expects a percentage of credit losses, it is impossible to identify individuals that will default before the event occurs. The lender therefore estimates and manages credit risk in these circumstances on the basis of the ongoing relationship with the borrower. Where the lender hedges this portfolio, it will also do so on the basis of the business relationship, rather than on the contractual maturity of the financial asset held at the balance sheet date.

64 The issue is slightly more difficult for financial assets where the renewal is not contractually agreed. In such situations a constructive obligation to renew may have been created by past practice. Some argue that this constructive obligation should be treated similarly to the contractual arrangements discussed in the above paragraph. However, the inclusion of such losses may not provide useful information, as it would relate to financial assets that do not exist at the balance sheet date. EFRAG believes this issue should be addressed by the EAP or by the IASB directly. Additional guidance may be needed.

65 In addition, the IASB should consider how the proposals in the ED relate to both existing provisions of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and as well as the proposed amendments to that standard. It is EFRAG's view that, it would be preferable to have consistency in the measurement approaches for undrawn loan commitments and similar instruments, managed along with or on the same basis as financial assets,.

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?

Notes for EFRAG's constituents

66 *The exposure draft proposes the following objective for presentation and disclosure:*

"An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effect of interest revenue and expense, and the quality of financial assets including credit risk."

67 *To achieve this objective the proposed standard suggests that certain standard minimum disclosures are provided in a way that explains the overall effect on the entity's financial position and performance and the interaction of the items disclosed.*

EFRAG's response

EFRAG's view:

- The proposed objective should be clearly linked to the measurement objective.
- In certain instances (specifically for short-term trade receivables held by non-financial institutions) the presentation and disclosure objective may not be appropriate.

68 Paragraph 3 of the ED states that the "objective of amortised cost measurement is to <u>provide information about the effective return on a financial asset or financial liability</u> by allocating interest revenue or interest expense over the expected life of the financial instrument". In our response to Question 2, EFRAG suggests that the objective should also be to provide information about the actual cash flows that are likely to arise from a financial instrument. EFRAG believes that the objective of presentation and disclosure in paragraph 11 of the ED should support these overall objectives.

69 Furthermore, in our response to Question 2, EFRAG questions the relevance of the proposed presentation and disclosure objectives to short-term trade receivables. An objective of providing information about interest revenue assumes that an entity holds a financial asset for the purpose of earning such revenue. This may not be the case for many non-financial institutions that primarily hold financial assets in the form of short-term trade receivables. EFRAG therefore considers that the IASB should relate the objective of presentation and disclosures to providing information about the effective return where such information is relevant.

70 Based on the above comments EFRAG suggests that the proposed presentation and disclosure objective could be improved by the following drafting amendments [in bold]:

An entity shall present and disclose **relevant** information that enables users of the financial statements to evaluate **the effective return on financial instruments carried at amortised cost. This includes information on** the financial effect of interest revenue and expense, and the quality of financial assets including credit risk **where relevant**.

PRESENTATION

Question 6

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

Notes for EFRAG's constituents

71 *The ED proposes the following presentation (by line item) in the statement of comprehensive income:*

(a) gross interest revenue (calculated using the effective interest method before taking into account the allocation of the initial estimate of expected credit losses). This is the contractual interest revenue;

(b) the portion of initial expected credit losses allocated to the period, which shall be presented as a reduction of gross interest revenue (item (a) above);

(c) net interest revenue (the subtotal of items (a) and (b) above). This is the economic interest or credit cost adjusted interest;

(d) gains and losses resulting from changes in estimates in relation to financial assets and liabilities that are measured at amortised cost; and

(e) interest expense (calculated using the effective interest method).

EFRAG's response

EFRAG's view:

- EFRAG broadly agrees with the proposed presentation requirements.
- EFRAG is concerned about the proposed presentation relating to short-term trade receivables held by non-financial institutions.

72 EFRAG broadly agrees with the proposed presentation requirements as they relate to financial institutions and for those entities for which earning interest is a relevant part of their business. Such entities will generally present interest revenue separately in the income statement or statement of comprehensive income. We do however have concerns about the proposals as they relate to other entities where interest revenue is of no such relevance. We have therefore split our response to this question between these two groups of entities.

Entities for which earning interest is a relevant part of their business

73 The objective of amortised cost measurement, as stated in paragraph 3 of the ED is to provide information relating to the effective return of financial instruments carried at amortised cost. To achieve this, it is important to present interest revenue adjusted for credit losses expected at initial recognition, since the effective return should incorporate the impact of credit losses that were expected to be 'paid for' by increased contractual interest charges.

74 However, in EFRAG's response to the Request for Information dated 8 September 2009, we raised some concerns about the lack of transparency that may result from the combined presentation of interest revenue and expected credit losses. We consider that the ED addresses this concern by presenting, on the face of the

statement of comprehensive income, gross interest revenue separate from the periodic allocation of initially expected credit losses. We support this proposal since we believe this provides useful information.

75 Further, EFRAG supports showing changes in estimates of expected cash flows separately from net interest revenue. The separate presentation of gains and losses due to changes in estimates of expected cash flows provides information about the accuracy and nature of an entity's ability to estimate future cash flows. Presenting changes in estimates separately from net interest revenue is also useful as it presents net interest revenue as a cost-based measure i.e. based on factors existing at initial recognition.

76 In addition, we support the related disclosure in paragraph 18(a) of the ED that requires separate disclosure of the amounts related to changes in estimates of credit losses from those amounts attributable to changes in other factors such as prepayments, write-offs of upfront fees etc.

77 EFRAG is, however, aware of diversity in presentation practices today. This is especially true for disclosures of interest revenue and impairment charges. Although the presentation proposals will result in a change for many entities, we believe that it should lead to greater comparability of financial statements and provide relevant information.

78 Given our support for the proposals, we urge the IASB, if they have not already done so, to ensure these are consistent with the proposals being developed in its project on Financial Statement Presentation.

Entities for which earning interest is not a relevant part of their business

79 EFRAG is not convinced that information about the effective return on certain financial assets provides decision useful information if the assets are held by entities whose business is not to generate interest revenue from those assets e.g. short-term trade receivables held by non-financial entities. EFRAG understands that current practice for a non-financial institution is to present any impairment of short-term trade receivables as an operating expense. These entities also generally do not report interest as a component of revenue and such entities argue that they do not factor an interest component into the price of goods and services sold or delivered. This is, as we understand it, because such entities do not provide extended payment terms in order to earn interest revenue. There is therefore little informational value in allocating and presenting such information on the same basis as interest revenue.

80 We understand that users would also support this sentiment on the basis that revenue should be presented gross with impairment charges presented in operating expenses. We also understand from users that they use gross revenue figures to determine growth patterns in sales. According to these users, such information is relevant to create expectations of the possible future cash flows that an entity may generate.

81 EFRAG therefore considers that the ED does not go far enough to provide relevant presentation requirements for non-financial institutions that do not have financial instruments carried at amortised cost other than short-term trade receivables. We suggest that the IASB look to extend the practical expedients provided for measurement purposes to the presentation principles contained in the ED.

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?

Notes for EFRAG's constituents

82 *The proposed standard provides five categories of disclosures:*

(a) *Information about expected credit losses:*

(i) *An allowance account; and*

(ii) *Information about estimates and changes in estimates.*

(b) *The quality of financial assets carried at amortised cost:*

(i) *Stress testing information;*

(ii) *Information on the credit quality of financial assets; and*

(iii) *Origination and maturity (vintage) information.*

An entity shall group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments.

83 *The allowance account is a mandatory method to account for, and disclose information about, credit losses. The disclosures relating to the allowance account are twofold:*

(a) *A reconciliation of the opening and closing balance of the account to indicate changes in credit losses showing at a minimum:*

(i) *increases resulting from the allocation of initial expected credit losses;*

(ii) *increases resulting from changes in estimates of expected credit losses;*

(iii) *decreases resulting from changes in estimates of expected credit losses; and*

(iv) *write-offs.*

(b) *The write-off policy applied (where a write-off is defined as a direct reduction of the carrying amount of a financial asset measured at amortised cost where the entity has no reasonable expectations of recovery and has ceased any further enforcement activities).*

84 *Information about estimates and changes in estimates includes (i) the basis for the input, (ii) the effect of reasonable alternative assumptions where applicable, (iii) and explanation of changes in estimates or estimation techniques. In addition, gains and losses must be disaggregated into amounts related to changes in estimates of credit losses and those related to other factors. Where these amounts are material*

disclosure of additional qualitative and quantitative disclosures are required. Lastly, an entity shall disclose for each class of financial assets a comparison between the development of the credit loss allowance over time and cumulative write-off and a qualitative analysis of the effect of changes in credit loss estimates on this comparison if that effect is significant.

85 *Stress testing information is only required if it is produced for internal risk management purposes. The ED provides no further guidance.*

86 *Information about credit quality of financial assets is provided by disclose for each class of financial assets a reconciliation of changes in non-performing financial assets during the period and a qualitative analysis of the interaction between changes in non-performing financial assets and changes in the allowance account if that interaction is significant.*

87 *Information about the origination and maturity date of each class of financial asset must also be disclosed.*

EFRAG's response

EFRAG's view:

- EFRAG supports the majority of the disclosure requirements, but suggest that the level of disclosures required to be reported by non-financial entities is reduced where appropriate.
- EFRAG considers that the 'loss triangle' disclosures (i.e. the comparison of credit loss allowances against asset cumulative write-offs) are a key component of the proposals in the ED as they provide transparency into an entity's ability to accurately estimate future credit losses.
- EFRAG's view is that the stress testing disclosures should be omitted. The 'loss triangle', allowance account and narrative disclosures about changes in estimates provide sufficient transparency. Comparability is also a concern since the stress testing disclosures are only required for some entities.
- In respect of the definition of non-performing, EFRAG does not support bright-line rules and therefore suggests that the IASB develop a principles-based definition to identify non-performing assets.

88 EFRAG's broadly agrees with the disclosure principles in the ED. In particular we strongly support the inclusion of the proposed requirement in paragraph 19 of the ED to require the disclosure of a so-called 'loss triangle' that compares allowances for credit losses again cumulative write-offs. In our view the loss triangle is key in providing transparency on an entity's ability to accurately estimate future credit losses. It is hoped that public disclosure will minimise inaccurate estimates by:

(a) making more transparent any attempts to manage earnings; and

(b) acting as an incentive for entities to invest in data collection, systems and processes that increase the accuracy of estimating expected cash flows.

89 However, before commenting on the individual proposed disclosures, we have the following concerns relating to the disclosure package as a whole:

(a) Similar to our concerns regarding the objective of amortised cost and the presentation proposals in the ED, the disclosure requirements appear to have been drafted in the context of financial institutions. EFRAG is concerned that the nature and volume of disclosures may not provide relevant information in the case of some non-financial entities whose core business is not the provision of finance. In these cases, such disclosures may distract the attention of users from the core business of the reporting entity. We note that the practical expedients included in the application guidance do not provide relief from the presentation or disclosure requirements of the ED. The IASB should investigate reducing the disclosure requirements for short-term trade receivables where those requirements do not provide relevant information. EFRAG would recommend at a minimum retaining a simplified loss triangle.

(b) The link between the proposed disclosures and those included in IFRS 7 *Financial Instruments: Disclosures* is not clear. We think that the information is inherently linked and can only be fully understood if considered as a whole. EFRAG believes that all disclosure relating to financial instruments should be included in IFRS 7 to avoid these issues.

(c) The level of disaggregation for disclosure purposes is not clear from the current wording. We do note, however, that this is a not a new concern as paragraph 6 of IFRS 7 is equally unclear. EFRAG is aware of difficulties in practice to understand and implement paragraph 6 of IFRS 7. The users that we have spoken to have noted that this area is not very well understood and creates comparability issues. EFRAG therefore urges the IASB to provide guidance to assist preparers and users of financial statements to better understand and apply the principles of the proposed standard.

Estimates and changes in estimates

90 The disclosures proposed in paragraph 17 of the ED are primarily qualitative. EFRAG agrees that these disclosures provide the background to understand the amounts presented in the primary financial statements. We find the disclosures in sub-paragraph (a), (c) and (d) useful for this purpose. Although we understand the rationale for the proposals in sub-paragraph (b), we have the following concerns about the practical implications of such disclosures:

(a) Firstly, the measurement model is based on probability-weighted average data. From the current wording, it is not clear how much time and effort reporting entities are expected to invest in determining the possible alternatives that may significantly change credit loss information. Guidance as to how materiality should be determined (also noted in our response to question 11) is very important in this regard.

(b) Secondly, we are concerned that, in order to incorporate such analysis into the models to determine expected cash flows, it would add undue complexity.

91 The requirements proposed in paragraphs 18(a) and 19 of the ED are equally important to create transparency. In particular paragraph 18(a) that requires amounts relating to changes in estimates of credit losses and other changes in estimates to be disclosed separately, is key to understanding the accuracy of an entity's ability to estimate future cash flows (see our response to Question 6 above).

92 However, in relation to the proposals in paragraph 18(b) of the ED, it is unclear as to the nature and extent of what is meant by "further qualitative and quantitative

analysis". We note that paragraph 18(b) (ii) refers to instances where "a particular portfolio, period of origination or geographical area has significant effects on these gains". We question if this implies that all entities would have to provide additional disclosure for significant portfolios, periods of origination or geographical areas. If this is the intention of the Board, we believe that this should be clearly stated rather than implied.

Stress testing

93 As mentioned above in the general comments to this question, the disclosure requirements are comprehensive. However, we question whether the stress testing disclosures in paragraph 20 of the ED are necessary given the level of information provided by other disclosures. In EFRAG's opinion, the 'loss triangle disclosure' in paragraph 19 in conjunction with the allowance account (paragraph 15) and narrative disclosures (paragraph 17) provide sufficient transparency into the use and application of amortised cost for financial instruments. Since the stress testing disclosure should only be provided by some entities (if an entity prepares stress testing for internal risk purposes) we are also concerned about comparability. For these reasons it is EFRAG's view that the stress testing disclosures in paragraph 20 are superfluous and should be omitted in the final standard.

Other disclosures

94 EFRAG broadly supports the disclosures relating to the quality of financial assets and vintage information, although we remain concerned about the volume of disclosures required especially for non-financial institutions.

95 EFRAG does not support the 'bright-line' definition of 90-days overdue for non-performing loans. We are aware in jurisdictions across Europe that different periods would be considered overdue and repayment practices have developed accordingly. We would instead recommend that the IASB develop a principle-based definition of a non-performing loan. One suggestion could be to allow entities to define and disclose their non-performing accounting policy.

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?

Notes for EFRAG's constituents

96 *The proposals in this exposure draft constitute phase two of the comprehensive revision of IAS 39, and, along with phase three on hedge accounting, will form part of the comprehensive IFRS 9. The effective date of IFRS 9 is 1 January 2013.*

97 *The Board does not propose an effective date, but rather asks for input into its deliberations. The Board notes that the proposals in this exposure draft would require an extended implementation period and therefore proposes an effective date three years from the date of publication. Early adoption will be permitted.*

EFRAG's response

EFRAG's view:

- A mandatory effective date of at least 3 years after the date of issue of the IFRS would allow sufficient lead-time for implementing the proposals.
- The IASB should make it clear that adoption of this phase is independent of the other phases of IFRS 9.

98 EFRAG understands from constituents that a mandatory effective of at <u>least</u> three years after the date of issue of the IFRS would allow sufficient lead-time for implementing the proposals.

99 We note that if the mandatory effective date is three years from the date of issue of an IFRS, a requirement to adopt the standard is unlikely before 1 January 2014. We recognise that it is not optimal for preparers and users to implement IFRS 9 in phases. However, given the level of work that will be required to implement the proposals in the ED, a phased implementation may be inevitable. As earlier adoption is permitted, entities may still have the option to adopt IFRS 9 in its entirety at one implementation date.

100 In addition, we also suggest that the IASB make it clear that adoption of this phase of IFRS 9 is independent of a decision or requirement to adoption the classification and measurement phase of that standard. This would ensure that entities would not be <u>required</u> to adopt these phases of IFRS 9 together.

Request for information

EFRAG understands that preparers and users could benefit from a single effective date for the whole of IFRS 9 as this would involve a single transition. EFRAG would however like to hear from constituents whether they would prefer that a single effective date is required and if so, what that date should be.

Furthermore, EFRAG would like to know if constituents have any concerns regarding the comparability of data should early application be allowed.

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.

Notes for EFRAG's constituents

101 *The Board considered several approaches relating to transition noting that a trade-off between the most useful information and practical considerations (including cost/benefit) would have to be considered. The Board narrowed to options to two alternatives:*

(a) *The adjusted effective interest rate alternative; and*

(b) *The 'customised transition approach'.*

The adjusted effective interest rate alternative was proposed in the ED, while the Board included a question relating specifically to the rejected approach.

Adjusted effective interest rate alternative

102 *The objective of this approach is to approximate the effective interest rate that would have been determined in accordance with this ED if it had applied on initial recognition of the financial instrument. This is accomplished by applying an effective interest rate transition adjustment to the effective interest rate previously determined in accordance with IAS 39. This adjustment is determined based on all available historical and supplementary data and could be applied in different ways, such as:*

(a) *by using ratio analysis to infer the effective interest rate transition adjustment using information for similar financial instruments that are initially recognised near the date of initial application; or*

(b) *by using the adjustment to the effective interest rate that reflects the effect of allocating the initial expected credit losses that is determined for similar financial instruments that are initially recognised near the date of initial application. When using this approach an entity shall ensure that the resulting adjusted effective interest rate is not lower than the risk-free interest rate that applied on the date of initial recognition of the financial instrument.*

103 *The result of this approach is to adjust the effective interest rate to approximate the rate that would have been determined at inception using the new amortised cost model in the ED. In the Board's view this approach provides the best balance between useful information and operational aspects.*

The 'customised transition approach'

104 *This approach provides an exemption from prospective application where entities have access to historical information without using hindsight. On transition such entities would determine the amortised cost of carry-over instruments using the effective interest rate previously determined under IAS 39 (therefore ignoring credit loss expectations) and expected cash flows as determined under the proposed approach (therefore including expected credit losses).*

105 *The approach was rejected because of the negative effect on equity – lower cash flows (due to the inclusion of expected credit losses) are discounted at a higher discount rate (due to the exclusion of credit loss expectations) which will distort interest revenue after transition. In other words, the IAS 39 EIR would be a higher rate than the EIR under the proposed standard, while the expected future cash flows would be lower (due to the inclusion of future expected credit losses) than the cash flows on which the applied EIR is based. The effect in most instances will be that the financial asset is carried at a lower amount (lower cash flows discounted at a higher rate) possibly resulting in distorted interest revenue over the life of the financial asset.*

EFRAG's response

EFRAG view

- The effect of hindsight in applying the proposed transition approach concerns EFRAG. Therefore, an alternative pragmatic approach is suggested.
- EFRAG is strongly opposed to the alternative transition approach.
- Comparative information should be restated as proposed in the ED.

106 EFRAG generally supports retrospective application where possible, as we believe that it provides the most useful information. The restatement of comparative information is very important to ensure that the financial performance and position of an entity is comparable.

107 EFRAG would not support full prospective application that would lead to grandfathering of the incurred loss model.

108 In its response to the Request for Information EFRAG indicated that the IASB should limit the potential use of hindsight when developing the transition provisions for a new impairment model for financial assets. EFRAG is not convinced that this concern has been adequately addressed by the adjusted effective interest rate alternative proposed in the ED.

109 The effective interest rate adjustment, set out in paragraphs 25 and 26 of the ED, is based on "all available historical data". We question whether it is possible in practice to view historical data without applying hindsight. The application guidance in B30 provides little clarity other than suggesting approaches that could include hindsight.

110 EFRAG therefore proposes that the IASB follows a more pragmatic approach. One such approach could be to require entities to commit to a fixed data collection date. That date would be after the publication of the final standard. From the data collection date, entities would collect data that could be used at a later date to

calculate the expected cash flows on transition. We would expect that data collection is a significantly less onerous exercise than parallel running the new requirements, however this approach would limit the potential use of hindsight.

111 For example, the data collection date could be 1 January 2011. By 1 January 2014 when the standard would require mandatory adoption, the entity would have 3 years of real data on which an effective interest rate for an instrument could be based. The approach would apply to new and existing financial assets as follows:

(a) For financial assets recognised after the data collection date, the entity would report the requirements of the final standard on a fully retrospective basis;

(b) For financial assets recognised prior to the data collection date, the entity should adjust the effective interest rate using information as at that date. This would result in a transition adjustment, but this would be mitigated to the extent that financial assets have matured prior to the date of initial application.

Request for information

EFRAG would like to hear from constituents whether the suggested alternative is pragmatic and feasible for implementation. The suggestion is based on the assumption that an entity would not be required to keep shadow accounts. Entities would therefore only collect data that would be used once the mandatory application date arrives.

112 The alternative approach considered by the Board does not, in EFRAG's view, provide useful information because:

(a) the value of the financial instrument is too low due to the application of a higher discount rate (the IAS 39 EIR) and lower cash flows (including expected credit losses); and

(b) the interest revenue or expense will be distorted, as it will be based on an incorrect asset value and discount rate.

Question 10

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

Notes for EFRAG's constituents

113 *This ED proposes that an entity discloses the following on transition:*

(a) *the effect on profit or loss that results from the difference between the effective interest rate determined in accordance with the proposed standard (including the transition requirements) and the rate used in accordance with the entity's previous accounting policy; and*

(b) *how that effect relates to the amount of the transition adjustment to the amortised cost of financial assets.*

EFRAG's response

EFRAG view

- EFRAG supports the proposed disclosure.

114 EFRAG supports the proposed disclosure. We believe that it is important to clearly indicate the quantitative effect of the change in measurement.

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?

Notes for EFRAG's constituents

115 *The Application guidance in Appendix A to the ED provides for the use of practical expedients where their overall effect is immaterial. That is, in certain instances an entity can elect not to apply the amortised cost guidance – specifically the guidance relating to expected losses within expected cash flow estimates – to determine the amortised cost for that instrument. Such calculations must however be consistent with the following principles:*

(a) *The calculation incorporates the time value of money unless it is immaterial (such as short-term receivables);*

(b) *It includes all future cash flows until maturity; and*

(c) *It results in a present value that equals the initial measurement of the financial instrument.*

116 *Trade receivables are an example of such an instance. A provision matrix could be used to determine the provision for credit losses for such instruments. An entity would estimate, based on historical loss experience, the expected credit losses included in trade receivables and, assuming that there is no stated interest rate for such receivables, the entity would neither determine an effective interest rate nor recognise any interest revenue. The trade receivables would therefore be carried at the invoice amount less expected losses, and this would be considered their amortised cost.*

117 *In addition, entities may also use practical expedients for the allocation (over the expected life of a financial asset) of the initial estimate of expected credit losses in lieu of the effective interest method if the difference in the outcomes is immaterial. An entity might, for example, determine amortised cost using two separate present value calculations:*

(a) *One to determine the amortised cost excluding the effect of expected credit losses; and*

(b) *A second calculation to determine the present value of expected credit losses (as a separate calculation) using a discount rate that is different from the effective interest rate (e.g. a risk-free rate).*

The entity determines an amortisation profile for the present value of the initial estimate of expected credit losses and accounts for the amortisation charge for the period as a reduction of the interest revenue that arises from the first calculation. Any change in the present value of expected credit losses as a result of revising the estimate of expected credit losses is recognised in profit or loss and presented as gains and losses resulting from changes in estimates.

EFRAG's response

EFRAG's view:

- EFRAG supports the inclusion of practical expedients in the ED.
- We are concerned that the 'materiality test' required to apply the practical expedient may diminish the value of its inclusion in the final standard. We therefore suggest the role of materiality in these circumstances is clarified.
- EFRAG proposes further relief for non-financial institutions where relevant, especially concerning disclosure and presentation requirements.

118 EFRAG finds the practical expedients pragmatic and supports the basis for their inclusion in the proposals in the ED. Having said that, we do have the some concerns. In particular, paragraph B15 of the ED provides that, "an entity may use practical expedients in calculating amortised cost if their overall effect is immaterial".

119 EFRAG is unsure how materiality in this context should be determined. In particular, if materiality is to be applied in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8) we question whether these provisions provide little more than an illustrative example of how paragraph 8 of that standard would be applied. However, including the provisions on practical expedients in the ED raises the question as to whether the IASB intended a different interpretation or level of materiality to be applied to the circumstances covered by the proposals in the ED. We request that the IASB clarify this issue.

120 We also have a concern that for a reporting entity to substantiate that the application of the standard is immaterial it may be required to calculate amortised cost according to the final proposals and compare the results using the practical expedient. This would defeat the purpose of the provisions. We would encourage the IASB to provide guidance in this regard.

121 The disclosure requirements of the proposals are comprehensive, but the practical expedients provide little relief for non-financial institutions. As noted in our general comments in Question 4, financial statements should provide decision useful information that is relevant to users of financial statements. EFRAG is not convinced that the proposed disclosures will provide such information to users of non-financial institutions. These entities are not primarily engaged in financial activities and it is possible that disclosures that are not relevant relating to financial assets will cloud information that is more important. EFRAG would encourage the

Board to also consider practical expedients for disclosures and presentation based on relevance rather than materiality for disclosure and presentation purposes. As a starting point, the IASB could, using these practical expedients, scope-out the following disclosure requirements:

(a) Estimates and changes in estimates (EFRAG would suggest a simplified loss triangle disclosure requirement only);

(b) Stress testing information; and

(c) Origination and maturity (vintage) information.