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Dear Sirs,

Exposure Draft ED/2009/12, Amortised Cost and Impairment – Comments from FSR, Denmark

The Danish Accounting Standards Committee set up by FSR has discussed the exposure draft on amortised cost and impairment in several meetings during the last months. We have also had discussions with other interested parties in Denmark in a technical seminar in April 2010 in Copenhagen and we have cooperated with standard setters in Norway and Sweden on the initial technical review of the exposure draft and on setting up a possible alternative model.

As a result of our review and discussions our comments are as follows:

We are not convinced that fundamental changes in the current amortised cost model are necessary. In our view, the incurred loss model has merits, and the real problem appears to be poor credit risk disclosures rather than the model itself. Especially, we notice that comprehensive credit quality disclosures as required by IFRS 7 would have made it clear that some banks' reporting of high profits before the credit crisis arose from having high volumes of risky loans. We find that the incurred loss model provides relevant information because high risk banks will report volatile earnings while low risk banks will report more stable earnings. We are concerned that under an expected loss model, the difference in the risk profiles will become less visible.

On the other hand, we acknowledge that there has been a strong demand from constituents etc. to develop an impairment model that recognises losses at an earlier point of time than the incurred loss model. On this basis we will not object to the development of an expected loss model, even though we find that this is a step in the wrong direction..

However, we believe the model proposed by IASB is unnecessary complex and that to some extent it fails to be in line with the classification criteria for using amortised cost in IFRS 9.

We believe the "expected cash flows" should be assessed and estimated on a portfolio level. The reason is that at inception of each individual financial asset the expectation – i.e. the most likely outcome - is that all contractual cash flows will be received. Otherwise it is unlikely that the financial asset would have been originated within a business model that qualifies for amortised cost under IFRS 9, cf. below. However, for a portfolio of assets, the assessment would likely be different since it is expected, even at inception, that some of the contractual cash flows from the portfolio would not be received. Therefore, we find it more appropriate to apply the expected loss approach on a portfolio level.

We notice that the concept of incorporating expected credit losses into the amortised cost measurement is consistent with the approach set out in ED 2010/6, Revenue from contracts with customers. However, we do not find that this should preclude discussion of appropriate alternatives under this exposure draft.

IFRS 9 sets out two models for measurement of financial assets, fair value and amortised cost. The requirement for using amortised cost is a business model based on the intention to collect the contractual cash flows from instruments containing basic loan features (basic loan features as defined in IFRS 9.4.2(b)). Once an instrument with basic loan features becomes impaired we believe the intention of holding the instrument will change. As such we believe that instruments which are individually impaired (in the meaning that it is more likely than not all contractual cash flows will be collected) should not be considered to be instruments which are held to collect contractual cash flows. Hence, we would ask IASB to reconsider whether the amortised cost measurement category should include financial assets that have become individually impaired.

We have in appendix A to this letter inserted a more detailed description of an alternative model which in our view would be more principle based since it captures only instruments held to collect contractual cash flows, and with a different approach to recognising changes to expected cash flows.

We do not agree with the proposed catch up approach for re-estimation of initial estimation of credit losses. We believe that an approach where the initial estimate is updated with the most current information and future expected losses re-allocated on this basis should be considered since the initial estimate is an uncertain estimate. Hence, a catch up in the income statement – whether positive or negative - could be an incidental amount. We draw attention to the fact that under our proposed alternative model, allocation to future periods will not create an “under-provision” issue because impaired loans will be removed from the portfolio subject to expected loss provisions.

Our responses to the questions raised by IASB are attached in Appendix B to this letter.

Please do not hesitate to contact us if you would like to discuss any specific issues addressed in our response, or related issues, further.

Kind regards,

Jan Peter Larsen Chairman of the Accounting Standards Committee	Ole Steen Jørgensen chief consultant, FSR

Appendix A: Alternative model

Appendix B: Response to the questions asked in the ED

Appendix A

Alternative Model

Background[1]

IFRS 9 contains two models for measurement of financial assets; fair value and amortised cost. Financial assets not measured at amortised cost will be measured at fair value and visa versa. In this respect it is important to develop clear and precise principles for distinguishing between these two measurement categories, hence the objective of the amortised cost model has to be assessed on this background.

What is “amortised cost“?

A method of spreading income (interest income less expected impairment) and expenses over the holding period of a financial asset or financial liability[2].

Before we elaborate further on the content of amortised cost, taking into consideration the aim of reducing complexity, the goal of internal consistency and the constraint of cost and benefits of different alternatives, we should consider:

A) When is amortised cost considered[3] more relevant than fair value?
When the financial instrument is held to receive contractual cash-flows over the expected term of the instrument,
and
B) When is amortised cost not relevant?
When the contractual cash-flow of the financial instrument represents something else than repayment of principal and interest payment on outstanding principal.
When the business model relevant for the holding of the financial instrument is something else than to hold the instrument to expected contractual maturity and to receive contractual cash-flows in the period up to and including expected contractual maturity.

Further on the scope of amortised cost

Based on the present wording of IFRS 9 it could be questioned if the business model relevant for the holding of a financial instrument is consistent with measurement at amortised cost if for that specific financial instrument the entity does not expect to receive all contractual cash-flows in the period up to and including expected contractual maturity. This assessment has to be made at each reporting date.

Judgement must be applied in determining whether a financial instrument or a portfolio of financial instruments is held as part of a business model qualifying for amortised cost.

The following are indicators that a <u>financial instrument</u> is not held as part of a business model qualifying for amortised cost:
The probability of receiving all contractual cash-flows of the financial asset up to and including expected contractual maturity is less than 50 percent.
The financial instrument is held in a separate portfolio consisting of financial instruments which due to increased risk of non-performance has been separated from the portfolio in which it was previously managed to receive a special management aimed at recouping maximal possible cash-flows as opposed to all contractual cash-flows.

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[1] In this appendix expected is defined as the probability weighed expected outcome of an uncertain future cash-flow or event.
[2] Going forward we will in this appendix focus the discussion on financial assets.
[3] In a modified IFRS 9 model as indirectly laid out in this appendix.

The entity is in process of renegotiating or marketing the financial instrument in a way that reflects a significant expectation of not receiving or paying all remaining contractual cash-flows on the instrument up to and including expected contractual maturity.
Contractual payments on the financial instrument are past-due and the entity has transferred it to a portfolio of non-performing financial instruments that are managed differently from financial instruments in which the entity expects to receive all contractual cash-flows up to and including expected contractual maturity.

The following fact patterns are in isolation not inconsistent with a business model qualifying for amortised cost:
A financial asset that is part of a portfolio of financial instruments managed together based on the assumption that all contractual cash-flows up to and including expected contractual maturity will be received, but where at a portfolio level an expectation exists that not all contractual cash-flows up to and including expected contractual maturity is to be received.
A downgrading of a financial instrument indicated that it is a increased risk that not all contractual cash-flows up to and including expected contractual maturity is to be paid or received, but the entity still managed the cash flows based on an expectation that the counterpart will meet its contractual obligations.

The following are indicators that a <u>portfolio of financial instruments</u> might not be held as part of a business model qualifying for amortised cost:
The portfolio is managed by a unit or group within the entity that focuses on managing high risk loans or loans in default.
A portfolio of financial instruments is managed based on the explicit assumption that contractual cash-flows are not to be received.
Interest rate risk management is significantly adjusted to take into consideration credit related non-performance risk.

Amortised cost model
Some of the specifics related to this model include:
Impairment is only to be recognised on recognised financial assets.
Impairments are to be recognised using an allowance account.
Financial assets measured at amortised cost are to be presented at amortised cost that is net of impairments in the statement of financial position.
Impairment of assets continuing to be measured at amortised cost is only recognised at a portfolio level.
Impairment is the incurred time fraction of the net present value of contractual cash-flows not expected to be received, that is the expected losses, up to and including expected contractual maturity.
The standard should not prescribe further how impairment is to be calculated.
The discount rate used in measuring impairment could be either the reassessed effective discount rate at the level of the individual asset or at the level of the portfolio, the contractual effective interest rates, or a risk-free interest rate.
The entity has to evaluate and document its assessments of how assets that are derecognised or reclassified from amortised cost to another category effect impairment of financial assets belonging to the relevant portfolio(s) that continues to be measured at amortised cost.

Issues relating to reclassification
The proposed model will require reclassification between amortised cost and an “impairment category” when a financial asset or financial liability no longer qualifies for amortised cost. This might be the situation when an entity assesses that on an individual instrument level it does no longer expect to receive all contractual cash inflows due to credit deterioration.

A decrease in the carrying amount resulting from a financial asset transferring from being recognised at amortised cost to being recognised as an “impaired asset” is to be presented as impairment in the statement of comprehensive income.
If an entity has classified a financial assets at fair value per IFRS 9.4.2(b) and now expects to receive or pay all remaining contractual cash-flows up to and including expected contractual maturity and thus is applying a business model reflecting this expectation the financial instrument is to be measured at amortised cost using fair value at that date as a deemed cost.

List of benefits
It is the view of the Board that the proposed model features the following important benefits:
Most institutions manage their financial assets on the basis of open portfolios. Since IASB`s ECF approach requires a closed portfolio, that is a fixed population of items, it is not in accordance with how most financial and non-financial institutions manage their business. In contrast our model will work well on both open and closed portfolios, and thus reflect the operations of businesses.
In the discussions of the Expert Advisory Panel one of the operational difficulties that has been identified with the IASB`s ECF approach is that it features an integrated EIR calculation that would require integration of the data in the accounting and credit risk systems, data that financial institutions manage separate today. In our model this operational issue is not present because the calculation of the effective interest rate is decoupled from the calculation of impairment. Respondents to the IASB`s Request for information have also raised concerns about the necessary system changes and how variable rate instruments would be treated. Since our model is built on a “decoupling” approach and based on the contractual effective interest rate, only minor system changes will be needed.
The proposed model maximises the use of data known to the reporting entity (effective interest rate based upon contractual versus expected cash flows thus also no re-estimate of estimated effective interest rates neither at instrument nor portfolio level, impairment based upon expected losses on a portfolio level versus based upon expected cash flows at instrument level). The board[s] expects that it will be easy to estimate fair value of individually impaired financial assets as the entity will already have at hand identified expected cash flows, generally the cash flows will be of short duration or in the case of traded bonds there will be market data available.
In the basis for conclusions to the ED, impairment based on fair value is rejected by the IASB on the grounds that it is considered inconsistent with a cost-based approach. Under our proposed model this basis for rejection is not valid. This is because we argue that a cost-based approach in itself is not appropriate for individual identified impaired loans under the Business model approach in IFRS 9. Our proposed model therefore contributes to an internal consistent model for financial instruments both as to when amortised cost is to be applied and in the calculation of amortised cost.
The application guidance to the ED includes in B17 a practical expedient that is given in order to facilitate a cost-effective and simplified way of determining amortised cost. Since our model is largely consistent with that method, we believe that our proposal will reduce complexity and at the same time result in an outcome that is an appropriate approximation of the outcome that would result from applying the method in the exposure draft.

Appendix B

Response to the questions asked in the ED

Objective of amortised cost measurement (paragraphs 3–5)

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?

Overall, we find the objective clear. However, we are not sure that the concept of effective return is sufficiently clear described with respect of financial liabilities because this is a notion usually not associated with financial liabilities.

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?

As described in the cover letter and in appendix A we believe that amortised cost measurement should only be used for instruments which meet the classification criteria in IFRS 9; ie that instruments are held to collect contractual cash flows. As such we believe individually impaired loans and receivables would not meet the "held to collect contractual cash flows" test and that accounting for these instruments should not be combined with the accounting for financial instruments which are not individually impaired. For a more elaborate description of our views on this we refer to appendix A.

Based on this we do not agree with the description of the objective of amortised cost measurement in the exposure draft since we believe it is not fully consistent with the basic principles in IFRS 9.

The Board believes that the methodology for the calculation of amortised cost should be made separately from the measurement of impairment charges. Therefore the Board believes that the last part of the sentence in paragraph 5 should be deleted: "as well as the initial estimate of expected credit losses on a financial asset". Instead a separate paragraph explaining the concept of provision for expected losses on a portfolio basis would be needed.

The "concept" of a portfolio needs to be further developed or elaborated upon in the exposure draft. In order to secure a consistent application it is important to clarify how a portfolio approach should be applied.

Measurement principles (paragraphs 6–10)

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?

It is important to have clear and precise measurement principles accompanied by an equally clear and precise application guidance in order to secure or facilitate a consistent approach throughout different jurisdictions and different entities applying IFRS. However we also believe it is important to include illustrative examples and implementation guidance. We acknowledge that IASB has set up an expert panel which will help out in this respect, but nevertheless we believe the application of the standard in a consistent manner is dependent upon clear guidance and good illustrative examples which consider the practical implications of applying the requirements in the exposure draft.

We would also ask the Board to consider whether paragraph 9 in the exposure draft is justified. In our view this paragraph is not necessary and could be deleted.

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?

As stated elsewhere in this response that we believe the amortised cost model should only be applied on financial instruments which are not impaired since impaired financial instruments would not pass the "held to collect contractual cash flows" criteria. We would therefore ask IASB to reconsider the accounting for impaired instruments.

There are also several aspects of the proposed model we would urge the Board to clarify and make more explicit in order to increase a common understanding on how the proposed changes should be applied. The increased use of unobservable input combined with removing the "incurred loss trigger" would automatically increase the use of management judgements in the financial statements. As a consequence of this we would like to see more elaborated principle based guidance on the application of the proposed expected loss model. We acknowledge that it is difficult to develop requirements related to assessing forward looking information which would lead to consistent application.

We do not agree with the treatment of re-assessment of initial credit losses. Estimates of future credit losses are subject to many uncertain factors which potentially could vary much from one period to the other. In our view it is difficult to assess and set the timing for expected losses on initial recognition. In many instances a more precise estimate can be made as the assets matures. We would therefore prefer a model where the initial estimate is updated at subsequent measurement dates in order to reflect the best estimate. According to IAS 8.36 that a change in accounting estimate "shall be recognised prospectively by including it in profit and loss in (a) the period of the change, if the change affects that period only, or (b) the period of the change and future periods if the change affects both." As the objective of the amortised cost measurement is to report the effective interest on the instrument, a re-assessment must be allocated to the periods it affects to ensure the correct reporting of the effective interest rate. Notice should be given to the fact that due to our proposal to reclassify impaired losses out of the portfolio subject to amortised cost measurement no risk of "under-provisioning" – i.e. the incurred losses are higher than the expected losses.

It follows from paragraph 7 in the exposure draft that "Amortised cost reflects at each measurement date current input regarding the cash flow estimates." This is further elaborated in Appendix B paragraph B8 of the exposure draft from which the following is excerpted;

"Historical data such as credit loss experience are adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical data are based (...) Estimates of changes in expected cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial asset or in the group financial assets and their magnitude.)"

This should be further clarified. Assume that the unemployment rate in a country was 5%, but expectations at that point in time were that the unemployment rate would rise to 7% over the next year. If this rate affects impairment should the assessment as of December then be based on the current observable rate or expectations about increases in the unemployment rate in future periods?

In order to clarify the principle underlying estimations of future cash flows we should therefore ask the Board to clarify whether;
The estimation of future cash flows should be based on conditions existing at the balance sheet date (for instance observable unemployment rates, observable prices etc), or
The estimation of future cash flows should be based on expectations of future changes in conditions existing at the balance sheet date.

We acknowledge that the latter approach would increase the use of management judgements in the estimates, but at the same time we also believe that information should be included in the assessment of future credit losses.

As described under a) we believe impaired financial instruments would not meet the criteria in IFRS 9 with regards to be classified in a category where amortised cost would be the measurement attribute. This is further elaborated in appendix A.

Objective of presentation and disclosure (paragraphs 11 and 12)
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?

We believe the description of the objective and disclosure in relation to financial instruments measured at amortised cost has to be more precise and more aligned with the objective of amortised cost. In this respect we also question whether the current wording gives a precise and accurate description. The "financial effect" is in our view not a very precise description. Also, we believe "the quality of financial assets" should be further clarified.

Presentation (paragraph 13)
Question 6
Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

We acknowledge that practical expedients already included in the current proposal can justify a simplified approach for t entities where the effect of discounting is immaterial. Therefore we believe that it is appropriate to have the same presentation requirements regardless if the business model is to earn interest income or if interest income is just a minor part of the income for the entity.

With respect of presenting both a gross and net interest revenue, we notice that under our proposed alternative approach, the effective return after adjustment for credit losses is not an integral part of the amortised cost calculation. Therefore, we propose that the presentation format is amended to reflect this.

Disclosure (paragraphs 14–22)

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?

a) and b)

We broadly agree with the principles underlying the proposed disclosure requirements. However, we find that it should be made clearer that the objective is to provide information about interest revenue and credit losses with the view of ensuring that the level of detail is adjusted for entities whose business model is not based on earning interest revenue and who do not manage credit risk actively due to a history of insignificant credit losses. .

We are concerned of the lack of information related to the segregation (if any) into portfolios. We believe it is important to understand and have transparency into which particular portfolios entities have grouped their financial instruments subject to amortised cost.

We believe that it is questionable as to whether disclosing stress testing information (paragraph 20) would provide decision useful information. The disclosure requirements could in some instances incentivise entities to not perform severe stress testing, but instead use internal stress testing that produces a desired outcome since the disclosure requirement is linked to internal risk management procedures. Furthermore, stress testing is normally made of an estimated future performance. There might be severe legal risks in certain jurisdictions to display such information. It is normally also part of the hearth of the business which may be damaging for the entities' competitive advantage to display such information. Also, we would like the Board to clarify what would qualify as "stress testing" for the purpose of disclosure requirements.

Effective date and transition (paragraphs 23–29)

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?

We believe a mandatory effective date of three years after issuance would allow sufficient lead-time for implementing new requirements based on our alternative approach because basically banks and other entities significantly affected by the proposal could use the current models for calculating amortised cost as a starting point. We would however ask the Board to clarify whether implementation is dependent upon adopting other phases of IFRS 9.

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 tran- sition 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.

a), b) and c)
We do not agree with the proposed transition requirements since we believe retrospective application would increase the burden on preparers on initial application and could in some instances make the required lead-time to implement the proposal to short. We believe a simplified approach could be justified in order to make the implementation period as short as possible and also in order to make as many preparers as possible able to implement the new requirements earlier than they otherwise would be able to do. As such we would favour a solution without restatement of comparative information and where expected credit losses were included in the initial estimate on application of the new requirements. Under our proposed alternative approach, initial estimates of credit losses are updated in subsequent periods. Hence, the simplified transition approach proposed would – opposite to IASB's proposal – not result in the risk that the carrying amount of assets measured at amortised cost will be significantly different than under a full retrospective approach.

Question 10
Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

We do not agree with the proposed disclosure requirements related to transition. We believe the requirement proposed in paragraph 28 is burdensome to fulfil and we do not see that this information provides decision useful information to primary users.

Practical expedients (paragraphs B15–B17)
Question 11
Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

We support the inclusion of practical expedients in the proposal and we believe the proposed guidance on practical expedients is appropriate. However, we believe further guidance is needed. See our answer below.

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?

We believe additional guidance on practical expedients should be provided. The proposals included in the exposure draft would significantly change the current accounting for financial instruments measured using amortised cost. As such we believe the proposal would represent considerable operational challenge for many entities, hence practical expedients are necessary in order to ensure a less costly and more efficient transition to a new standard than otherwise would be the outcome. The Expert Advisory Panel would probably develop further practical guidance in this respect. We would especially welcome more guidance related to non financial institutions since we are of the opinion that many of these entities would find the new requirements burdensome and would like further guidance in relation to the application of "immaterial". This should especially be considered for disclosure requirements where the practical expedients included in the proposal provides little relief for non financial institutions.

We believe it is important to conclude and finalise the objective and measurement principles related to amortised cost before further guidance is developed.