EFRAG

European Financial Reporting Advisory Group

28 June 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.

EFRAG supports the direction of the proposals in the ED. We support 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 and aims at eliminating the delay in recognition of credit losses on financial assets.

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. We think it is possible that accounting standards may be developed that satisfy the needs of both prudential supervisors and capital market participants since they do have similar interests. EFRAG acknowledges that it may not be possible to remove all differences and believes that where there are divergent needs, the needs of investors and other capital market participants must take precedence over the wide range of measures that prudential regulators may require institutions to adopt.

Conceptually, we are supportive of the measurement principles but do have significant concerns about some aspects of those principles. The reasons for this support and the nature of our concerns are detailed in our response to the questions raised in the ED. These are attached as an Appendix to this letter.

Operationally, EFRAG understands that the challenges identified in our response to the Request for Information remain a significant concern for many preparers. For the latter, the practical expedient envisaged for short-term trade receivables appears insufficient. We conducted outreach activities as part of preparing this response. Overall, most of our respondents believed that, unless there was significant simplification, the cost of implementing the proposals in the ED would likely outweigh the benefits.

We understand that the Expert Advisory Panel (EAP) and other constituents have developed approaches that seek to decrease the operational complexity of the proposals in the ED whilst providing a close approximation to the expected cash flow approach. Given the nature and timing of the EAP discussions and the alternative models proposed by constituents, EFRAG is currently not in a position to comment on these proposals. However, we consider that operational simplification is crucial to making the proposals workable and we urge the IASB to consider these developments carefully with a view to providing additional guidance and/or amendments to the ED. We also consider that it is imperative that significant amendments or additional guidance are exposed for public comment by the IASB and thus subject to proper due process, including the preparation of an impact assessment.

In summary, 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 consider that the proposals in the ED need to be simplified to address operational concerns. Additional guidance or amendments to the ED, subject to appropriate due process, must be developed to 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

Françoise Flores
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?

EFRAG's response

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

1 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.

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

3 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."

4 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?

EFRAG's response

EFRAG agrees that one objective of amortised cost should be to provide information about the effective return on a financial instrument. In the case of financial assets, EFRAG considers that the effective return is best represented by allocating interest revenue (fees, points received, transaction costs and other premiums and discounts) separately from initially expected credit losses.

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.

5 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.

6 However, the ED also provides that the effective return is reflected by allocating interest revenue or interest expense over the expected life of the financial instrument using the effective interest method. The ED further provides that, in the case of financial assets, the effective return reflects the allocation of the initial estimate of expected credit losses.

7 Estimating the timing and amount of initially expected credit losses is very difficult at the individual financial asset level and generally becomes more reliable at the portfolio level. In addition, contractual interest and credit risk are generally managed separately. We understand from constituents that these factors may make the allocation of initially expected credit losses estimated at the portfolio level, using the effective interest rate which is estimated at the individual asset (or closed portfolio) level, impractical.

8 This difficulty is reflected in the operational concerns regarding the allocation of initially expected credit losses and the EAP proposals to address these concerns (i.e. decoupling). As a result, EFRAG considers that information about the effective return on a financial asset would be better reflected by allocating interest revenue and interest expense (fees, points paid or received, transaction costs and other premiums and discounts) separately from the allocation of initially expected credit losses.

9 In addition, EFRAG believes that amortised cost is a relevant measurement basis that provides information about the instrument's capacity to generate cash flows in the future - a so called 'balance sheet view'.

10 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 <u>provides information about the entity's likely actual cash flows</u>." [emphasis added]

11 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 think the ED achieves this, but we consider it would be beneficial to incorporate the balance sheet perspective into the objective of amortised cost as set out in paragraph 3 of the ED.

12 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.

13 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, Question 7 on disclosures (paragraph 68(a)) and Question 11 on practical expedients (paragraph 90).

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?

EFRAG's response

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 should 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 paragraphs BC25, BC34, BC35 and BC36.

18 Further, we note the formation of the EAP and support its objective of addressing some of the operational challenges of an expected cash flow 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. The fact that the IASB has considered it necessary to form the EAP is evidence that the principles in the ED 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 and users may interpret the impairment information differently. This would result in a lack of comparability. 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.

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. EFRAG is concerned that the nature of the proposals in the ED will be significantly, but necessarily, impacted by the EAP's output with the result that additional guidance is issued. However, given the nature and timing of the EAP output and the fact that the IASB has not yet considered whether its output will result in additional guidance or amendments to the ED, EFRAG is not in a position to comment at this stage. Given this inability to comment at this time, we consider that it is imperative that any significant amendment or additional guidance is exposed for public comment.

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?

EFRAG's response

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 are supportive of the proposed measurement principles underlying the proposed impairment approach because it:

- **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 and their application:

- **estimating the timing and amount of expected credit losses over the entire life of the financial instrument would cause practical difficulties;**
- **changes in estimates of cash flows would have to be immediately recognised although these gains and losses relate partially to future periods. In EFRAG's view these gains and losses should only be recognised in the period of the re-estimate to the extent that the change relates to current or prior periods;**
- **the basis for recognising changes in estimates of expected credit losses in profit or loss in the period of the re-estimate is not sufficiently explained; and**
- **the treatment of revolving financial assets remains to 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

21 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 would not be consistent with a cost-based measurement principle.

22 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.

23 EFRAG recognises that the expected cash flow 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.

24 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.

25 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 BC22 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.

26 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 may 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.

27 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. Rather than being reflected in the measurement of a financial asset (which would be contrary to the needs of investors and market participants), such information may be incorporated into an entity's capital requirements that would be more appropriately dealt with through the disclosure requirements in IAS 1 *Presentation of Financial Statements.*

Impairment of financial assets – the proposed measurement principles

28 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.

29 EFRAG notes that requiring credit losses to be included when estimating expected cash flows for amortised cost purposes is a significant change from the current requirements of IAS 39 and forms the basis for the IASB's new measurement principles.

30 EFRAG welcomes the rationale for developing the amortised cost model and is supportive of the measurement principles in the following respects.

<u>Use of forward-looking information about credit losses</u>

31 EFRAG supports the fact that the proposed measurement principles result 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 cash flows, including 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 credit quality of financial assets in their reported measurement.

Recognition of credit losses is not dependent on an 'incurred loss' trigger event

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

33 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.

34 The expected cash flow approach proposed by the ED does not rely on an incurred loss 'trigger event'. A change in estimate of future cash flows, including estimates 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 initially expected credit losses is consistent with measurement at initial recognition

35 The effective interest rate is used as a means for allocating the initially estimated credit losses over the life of the financial asset. Although we have some concerns about the use of the effective interest rate as the allocation methodology (see paragraphs 7-8 above), at a high level we support the resulting delay in revenue recognition since it reflects that some of the interest revenue is paid in compensation for future expected credit losses.

36 In EFRAG's view, the proposals in the ED results in greater consistency between measurement on initial recognition (with credit risk reflected implicitly or explicitly in *an instrument's contractual interest rate) and its ongoing measurement. It also* addresses the systematic overstatement of revenue under the incurred loss model in the periods before credit losses were incurred.

37 EFRAG is aware that allocation of the initially expected credit losses using the effective interest rate can be operationally burdensome. As a result, we would be supportive of approaches that approximate the allocation profile achieved by the proposals in the ED, but which 'decouple' the effective interest rate calculation from the allocation of initially expected losses. We urge the IASB to develop these approaches.

EFRAG's concerns regarding the proposed impairment approach

38 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;

(c) Given the debate and divergent opinions about the treatment of changes in estimates of cash flows, we believe it is important that the Board should explain its reasoning behind the issue in the final standard or basis for conclusions; and

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

39 These concerns are discussed in more detail below.

Estimating expected cash flows

40 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. We understand that the EAP has looked at this issue and provided simplifications and suggestions on estimating "lifetime expected loss" i.e. the cash flows the entity does not expect to receive, as a proxy for impairment related expected future cash flows. However, the EAP is still considering what ways may best assist smaller financial institutions and non-financial institutions in calculating expected cash flows. We encourage the IASB and EAP to continue with this development. Such guidance could also include practical expedients that would provide relief to some entities.

41 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 understand the EAP has developed some guidance in this area and ask that guidance be appropriately considered by the IASB.

42 Given the complexity associated with estimating expected cash flows, we think it is important that the IASB develop an overriding principle for the 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 should be explicitly stated in the ED. 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. Discussions at the EAP have confirmed that entities should consider and use the best information, and the type of information may differ between entities and internally within an entity. The IASB should consider these findings when re-deliberating the proposals in the ED.

Use of management judgement

43 EFRAG observes that 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.

44 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.

45 In EFRAG's view any reliability concerns about the level of judgement required to estimate amortised cost are best dealt with by robust disclosure. Such disclosures would include requirements relating to the methods used, assumptions applied and narrative disclosures about the reasons for changing expectations. Please refer to our response to Question 7 of the ED for further discussion on this issue.

46 We fully agree with the EAP finding that "... there should be transparent, disciplined, systematic and consistent methodology as well as an audit trail supporting the material assumptions and estimates and conclusions to support the adequacy of the loan loss provisioning level... there should be linkage between observed changes and the loss expectations."[1] However, we are unsure how the IASB will operationalise this finding.

Profit or loss due to changes in estimates

47 The ED provides that changes in estimates of expected future cash flows are recognised in profit or loss in the period of the re-estimate. A majority of EFRAG members are of the view that a change in estimate of cash flows relating to future periods is more appropriately recognised in those future periods. In their view changes in estimates should be reflected in such a manner that the carrying amount of the financial asset represents credit losses that relate to periods up until the reporting date. Changes in expected future cash flows should be allocated over the remaining life of the financial asset to the extent that the net interest margin is sufficient to absorb that allocation. If the change in estimate allocation is not compensated by the future net interest margin (i.e. it is in effect onerous), the non-compensated portion of the gain or loss is recognised in the period of the re-

[1] Paragraph 20, *Amortised Cost and Impairment: Update on Expert Advisory Panel (EAP) discussions,* published by the IASB staff on 26 May 2010

estimate. As a result, the balance sheet represents a current assessment of future cash flows based on current and future credit conditions.

48 Given the lengthy debate and divergent opinions about the treatment of changes in estimates, we also believe it is important that the Board explains its reasoning behind this issue in the final standard or basis for conclusions.

49 In addition, it would also be possible to recognise a 'gain' without having recognised a loss in profit or loss as a result of a change in estimate in the past, as explained in BC36 of the Basis for Conclusions. EFRAG recognises that to have a neutral model, the treatment of favourable and adverse changes in expected cash flows should be symmetrical. For example, spreading the effect of favourable changes in estimates whilst recognising adverse changes in profit or loss immediately would result in a biased model, which in this example, favours conservatism. Therefore, EFRAG supports the development of a model that results in the neutral income recognition of changes in cash flow estimates. As a result, should amendments be made to the proposals in the ED, we would expect the resulting model to treat adverse and favourable changes in expectations (or gains and losses) in the same way.

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

50 As we stated in paragraph 27 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.

51 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 IASB directly. Additional guidance may be needed.

52 In addition, the IASB should consider how the proposals in the ED relate to existing provisions of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. 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. In this regard we agree with the EAP that one possible approach to address this issue would be to amortise the

expected loss from the future draw down of a loan commitment against commitment fee revenue.

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?

EFRAG's response

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.

53 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.

54 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.

55 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?

EFRAG's response

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.

56 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

57 In EFRAG's response to the Request for Information dated 8 September 2009, we raised concerns about the lack of transparency that may result from the combined presentation of interest revenue and initially 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 (whether calculated using the effective interest rate or another methodology under a de-coupled approach). We support this proposal since it reflects the separate way credit risk and contractual interest is generally managed. As indicated in our response to Question 3, separate presentation is consistent with a decoupled approach that is being developed to address operational aspects of the measurement principles in the ED.

58 Further, EFRAG supports showing the impact of 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.

59 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.

60 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.

61 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

62 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.

63 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.

64 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?

EFRAG's response

EFRAG considers that robust disclosures are the best way to accommodate concerns about the level of judgement that may be involved in measuring financial instruments at amortised cost.

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) could provide transparency into an entity's ability to accurately estimate future credit losses, but is concerned that the requirements may not be operational in the context of open portfolios.

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.

65 As we mentioned in our response to Question 4, we consider that robust disclosures are the best way to accommodate concerns about the level of judgement that may be involved in measuring financial instruments at amortised cost. As previously indicated, such disclosures should include requirements relating to the methods used, assumptions applied and narrative disclosures about the reasons for changing expectations.

66 As a result, EFRAG broadly agrees with the disclosure principles in the ED since we consider they go a long way in addressing the requirements we highlight above. In particular we support the objective 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 provides 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.

67 However, EFRAG understands that a loss triangle may be difficult, if not impossible, to apply to open portfolios. The same cost/benefit concerns relate to vintage information in open portfolios. We therefore urge the IASB to consider any developments by the EAP on disclosures in the context of open portfolios, for example back-testing and/or additional qualitative disclosures. It is important that disclosures that are compatible with the use of open portfolios are developed, so that users can obtain information about the accuracy and reliability of an entity's credit loss estimates.

68 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

69 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 information about changes in cash flow estimates. 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.

70 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).

71 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

72 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

73 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 and how vintage information is applied and reported in the context of open portfolios.

74 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?

EFRAG's response

We would expect the lead time to be commensurate to the complexity of the final standard.

We would recommend that IFRS 9 has a single mandatory effective date and that all phases should be adopted by that date.

75 Given the concerns regarding the operational aspects of the proposals in the ED and the uncertainty as to how the IASB will deal with those concerns, EFRAG considers that it is too early to estimate the lead-time needed to implement the proposed requirements. To the extent that the IASB is able to develop guidance to reduce the operational complexity of the proposals, then we would expect the lead time to be commensurate to the complexity of the final standard.

76 However, we note that if the mandatory effective date is at least 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. Therefore, we would recommend that IFRS 9 has a single mandatory effective date and that all phases should be adopted by that date.

77 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 required to adopt these phases of IFRS 9 together.

78 We also note that, if possible the effective dates for IFRS 4 *Insurance Contracts Phase II* and IFRS 9 should also be aligned.

Question 9

(a) Do you agree with the proposed transition requirem*ents? If not, why? What trans*ition 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.

EFRAG's response

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.

79 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.

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

81 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.

82 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.

83 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.

84 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.

85 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?

EFRAG's response

EFRAG supports the proposed disclosure.

86 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?

EFRAG's response

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.

87 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".

88 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.

89 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.

90 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.