ASC
ACCOUNTING STANDARDS COUNCIL

29 June 2010

International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
United Kingdom

(By online submission)

Dear Sir

RESPONSE TO EXPOSURE DRAFT ON FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT

The Singapore Accounting Standards Council (ASC) appreciates the opportunity to comment on the exposure draft on Financial Instruments: Amortised Cost and Impairment issued by the International Accounting Standards Board (Board) in November 2009.

Broadly, we are supportive of the Board's decision to introduce the expected loss impairment model as it is conceptually consistent with credit risk management principles. In contrast to the current incurred loss concept, the expected loss (EL) approach to impairment for financial assets eliminates the requirement for a "trigger event", thus enabling entities to consider a broader range of credit-related forward looking information and, where appropriate, recognise impairment losses on financial assets earlier in the cycle.

There are, however, methodological issues that are likely to make the implementation process operationally challenging, stemming primarily from observed divergences in the proposed approach when compared to actual business practices. These are mainly outlined in our responses to Question 4, but we thought certain key considerations should be highlighted upfront:

- Firstly, the Board's proposal seeks to integrate expected loss assumptions into the existing definition of amortised cost and effective interest rate (EIR). This specific issue has been widely discussed among industry participants, and feedback has been provided to the Expert Advisory Panel (EAP). The EAP has since articulated a "decoupling" concept, which allows EL to be separately assessed from interest revenue, with a view to avoid the complexities of an integrated EIR calculation. This is an encouraging development;
- Secondly, reporting entities are likely to manage performing and non-performing assets differently. This will mean that it will be difficult to apply a single approach in estimating expected loss. For performing assets, the conceptual principle in the ED of amortising the initial expected loss over the life of the financial assets would be

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appropriate. However, changes arising from subsequent reassessments should similarly be amortised over the life of the assets. In contrast, for non-performing loans, the effect of changes in the credit quality of the financial assets should be taken immediately to profit and loss, similar to the existing incurred loss basis.

- While the EAP has made references to the use of Basel II parameters in estimating expected losses, it has also made provisions for adjustments e.g. in converting the Basel II EL from a through-the-cycle to a point-in-time basis. There is a broader philosophical debate on whether it is appropriate for the regulatory and accounting balance sheet to continue to diverge, or whether, in the spirit of fostering further convergence with credit risk management practices, the Board should consider further alignment with Basel II methodologies;
- Lastly, the Board should also consider the overall relevance and appropriateness of the proposed amortised cost measurement objective from the perspective of entities that are not engaged in lending or financing activities, and whether there is scope for measurement, presentation and disclosure requirements to be further tailored according to business models.

Our views are expressed in detail in the specific questions as follows:

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?

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?

We believe that the objective of amortised cost measurement and its appropriateness for the measurement category are closely inter-related and we will provide our comments on the two questions together.

We agree with the proposed objective of amortised cost measurement. We do observe, however, that this is at variance with the overall stance of the FASB: in its 26 May 2010 release, many financial instruments, including loans, are proposed to be measured at fair value. While the FASB has similarly modified the incurred loss model to accommodate earlier loan loss recognition, it has however also introduced a fair value adjustment mechanism. The Board would need to consider the implications that this development would have on the overall convergence initiative (as elaborated further in our response to Question 12).

<u>Entities not engaged in lending or financing activities</u>

We are of the view that the objective is not relevant and appropriate for entities which are not engaged in lending or financing activities as interest income and interest expense are, conceptually, not directly applicable in depicting how their cash flows are managed. The

proposals in the ED are overly complex for these entities and would add significant burden for them to fully comply.
In the case of manufacturing or service companies, the receivables arise mainly from the sale of goods or services and the payables from procurement of materials and other services. Such receivables are not held ordinarily by these entities to generate interest income as the extended payment terms granted by the entities are part of their sales process. As such, it is questionable if the application of the approach outlined in the ED will generate decision-useful information in this context.

While the ED does provide guidance on the measurement of short-term trade receivables, we believe that the Board should consider the overall relevance and the appropriateness of the proposed amortised cost measurement objective in the light of the business model of the reporting entity. Should the Board decide to retain the current requirements, we urge the Board to consider providing further practical expedients to the current proposed presentation and disclosure requirements for these entities.

Question 3
Do you agree with the way that the exposure draft is drafted, which emphasizes measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why?

How would you prefer the standard to be drafted instead, and why?

We agree with the way that the ED is drafted, which emphasizes measurement principles accompanied by application guidance. However, as accounting for financial instruments is a complex accounting standard, we would recommend that more illustrative examples and implementation guidance be provided. These need not form part of the standard but will serve to clarify the measurement principles and the application of the impairment approach. We note that the FASB release provides a range of scenarios and worked examples.

We believe that the Board has already invested a considerable amount of research time on the project and there will be cost savings for the accounting community if they continue to share the product of their efforts by way of illustrative examples and implementation guidance. These will also be useful in fostering a consistent interpretation of the principles under the standard and improving comparability of financial information across different reporting entities.

Furthermore, we suggest that the application guidance in B24 which shows a comparison of loss allowance with cumulative write-offs should include figures for better clarity.

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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?

Conceptually, we are of the view that the "Expected Loss" principle is more robust than the current incurred loss approach and is more consistent with overall credit risk management principles. However, we have concerns on some of the methodological approaches:

(i) <u>Integration of interest rate risks and credit risks</u>

Most entities manage credit and general interest rate risks differently, using separate systems and processes. The proposal in the ED of integrating the initial expected credit losses into the EIR calculation is at variance with actual practice and thus introduces significant complexity and practical application issues. We envisage that systems for estimating expected cash flows for all loans, whether on an individual loan basis or on a portfolio of products basis, based on the proposed integrated EIR approach, would need to be developed. This will be costly for the industry. As mentioned earlier, the Board should consider the decoupling approaches developed by the EAP as these are, considering that they are better aligned to current practice, less likely to require new investments.

We also support the view of the European Banking Federation that the integration of credit losses with interest revenue will make the resultant numbers more difficult for users to understand.

(ii) <u>Application issues with open portfolio of financial assets</u>

The proposals under the ED seem to be applied to "closed portfolios" of financial instruments. As the EAP has also observed, financial institutions manage their business and credit risk on an "open portfolio" basis i.e. the population of the portfolio constantly shifts due to new originations, early redemptions, loan maturities etc. We believe that an open portfolio approach should be considered for the determination of expected loss, in order to align internal risk management practices with the proposed impairment model.

(iii) <u>Estimating cash flows based on expected value approach</u>

The ED requires the projections of the expected cash flows, including credit losses for financial assets, to be on a probability-weighted basis. This requires entities to foresee the pattern of the expected credit losses over the life of the loan or loan portfolio by preparing multiple scenarios on expected cash flows that might be generated by the financial assets (whether at initial recognition or at subsequent measurement) in order to identify a suitable range of outcomes. In practice, this will be costly and time consuming and could add a significant burden to large corporations or financial institutions if they hold many different portfolios or categories of financial assets.

Given the difficulties involved, and if the integrated EIR model is to be adhered to, the Board could give further consideration to the possibility of assuming expected losses to occur equally across the life of the loan when initially calculating the EIR as a valid basis for what would be deemed as a "best estimate". In some instances, e.g. a homogeneous portfolio of financial assets for which an entity has good historic and forecast data, it is possible that the best estimate might be arrived at using the probability-weighted expected cash flow approach proposed in the ED. However, in other cases, such as a single, long-dated loan to an emerging market counterparty, the ED's expected cash flow approach may not be an appropriate basis for a best estimate.

(iv) Accounting of changes in estimates from subsequent re-measurement

The ED proposes that changes in estimates of expected future cash flows, including those relating to expected credit losses, are recognised in profit or loss in the period of re-estimation. We support the concept of the "converged impairment model" discussed by the EAP at the April 2010 meeting and recommend that the measurement principles proposed in the ED be modified as follows:

- For performing assets, the conceptual principle in the ED of amortising the initial expected loss over the life of the financial assets would apply, while changes from subsequent reassessments will be amortised over the life of the assets; and

- For non-performing ones, the effect of changes in the credit quality of the financial assets is taken immediately as profits or losses.

Entities such as financial institutions generally manage credit risks by differentiating between a performing ("good") book and non-performing ("bad") book. Loans that had become non-performing are transferred from the "good book" to the "bad book". For the "good book", and consistent with a decoupling approach, entities should be allowed to decouple the interest revenue and credit loss calculation by separately assessing the expected credit loss of the financial assets over their entire life independent from the EIR. The expected credit loss estimated, given the anticipated difficulties with probability-weighted assumptions, should be recognised on a periodic basis by a simple allocation pattern, such as dividing the expected credit loss by the duration of the portfolio of financial assets on the "good book". Subsequent reassessment of the expected loss on the "good book" would be made periodically, with changes amortised on a prospective basis over the duration of the portfolio.

For the non-performing assets on the "bad book", impairment is measured based on the expected credit loss. The proportionate amount of the "good book" allowance that relates to the loan is transferred to the 'bad book' allowance. The remaining difference when compared to the currently assessed credit loss is recognised as an immediate additional provision. Subsequent changes in expected loss would be charged immediately as gains/losses from impairment.

While the ED does not prescribe the method for estimating credit loss, it will be useful if the Board could indicate in the final standard that entities are allowed to leverage and align, as far as possible, with existing Basel II methodologies, such as in the use of Basel II risk parameters. This would avoid any wrong perception that Basel II methodologies are disallowed under the proposed approach and would reduce significant implementation costs for banks as they do not need to develop and maintain different systems for meeting the accounting and regulatory requirements.

We would also like to highlight the following issues:

<u>Expected cash flows of a collateralised financial asset</u>

We noted paragraph B10 of the ED requires the *estimate of expected cash flows of a collateralised financial asset to reflect the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable*. The inclusion of the expected cash flows of a collateralised financial asset would result in double counting if an entity does not expect the foreclosure to be realised and hence, no credit loss is expected. We suggest that the expression "whether or not foreclosure is probable" be reworded as "if foreclosure is the probable outcome" to avoid confusion.

<u>Renegotiated or modified terms</u>

We note that paragraph B14 of the ED indicates that the *impairment for a financial instrument, which had its terms renegotiated or otherwise modified because of financial difficulties, is measured by calculating amortised cost using the effective interest rate before the modification of terms.* We understand that the Board has tentatively decided that a financial liability is derecognised when its contract is considered to be substantially modified; the derecognition accounting by the borrower and lender, if an amendment to a contract meets the substantial modification criteria, should be symmetrical. For consistency of interpretation and application, the Board should consider including the expression "only if the contract is not substantially modified" to paragraph B14.

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?

Subject to our comments under question 1 and 2 on the relevance and appropriateness of the proposed objective of amortised cost measurement for entities that are not engaged in lending or financing activities, we are of the view that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the ED is appropriate and clear. However, there is an overlap with the provisions in IFRS 7 Financial Instruments: Disclosure with respect to quality of financial assets relating to credit risk. The Board may consider aggregating all credit risk disclosures in the final IFRS 9 as there is merit in showing the presentation and disclosure requirements of the amortised cost basis in the same standard as the measurement requirements.

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

We agree with the proposed presentation requirements for entities engaged in lending and financing activities. We agree that the presentation requirements in paragraph 13 provide useful information about the contractual interest revenue, initial expected credit loss and changes in the estimates of cash flow in subsequent measurement.

Consistent with our comments under question 1 and 2, we are not convinced that the information required under paragraphs 13(a) and 13(b) is useful for entities whose principal activities are not the holding of assets for the collection of interest income. A typical non-financial institution's operations may not be focused on interest revenues. We understand that the current practice for a non-financial institution is to present any impairment of financial assets such as short-term trade receivables as an operating expense. Many of these entities use gross revenue figures to determine growth patterns in sales. There is therefore minimal information value in presenting such information on the same basis as interest income.

We reiterate that the Board should consider providing different guidance and requirements accordingly to entities that are not in lending or financing business. Should the Board decide to retain the current proposed approach, we suggest that similar practical expedients for measurement of trade receivables should be extended to the presentation and disclosures requirements under 13(a) and 13 (b) for these entities.

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?

We believe that the proposed disclosure requirements would address some of the issues around subjectivity of the expected loss approach and increase transparency and reliability of financial reporting in this area. However, we have the following concerns:

(i) Stress testing

We do not support the proposal of requiring entities preparing stress testing information to disclose such information in the financial statements. Stress testing information is prepared for internal risk management purpose, and could be prepared using different assumptions and time horizons, with limited comparability with financial numbers. . Therefore, the disclosure requirements may not be decision-useful and could potentially result in information overload for users of the financial statements.

We propose that the disclosures of the stress testing be optional instead of mandatory.

Should the Board decide to retain the current proposed requirements in the final standard, the Board should consider providing more specific guidance on the type of stress testing information required and the extent of validation required on the information disclosed. An entity may perform numerous simulation and scenarios for the purpose of internal risk management and it is not clear what would constitute "stress testing" under the ED.

(ii) <u>Credit quality of financial assets</u>

We note that paragraph 21 proposes certain disclosures for non-performing financial assets. Non-performing is defined in the ED to be *the status of a financial asset that is more than 90 days past due or is considered uncollectible.* This is consistent with the Basel Committee's definition of default. However, the Basel Committee has also recognized that, for certain products, the past due period may be substituted with a figure of up to 180 days. We propose that, instead of defining all financial assets that are more than 90 days past due are non-performing, the status of a financial asset, whether performing or non-performing, be determined by the entity in accordance with its internal risk management policies, practices and experiences with the financial assets. The definition of non-performing assets shall be disclosed in the financial statements. Accordingly, the Board could consider broadening the proposed definition.

(iii) <u>Write-offs</u>

The requirements under paragraphs 15 and 19 make reference to the write-off of non-performing assets. Write-off is *a direct reduction of the carrying amount of a financial asset measured at amortised cost resulting from uncollectibility. A financial asset is considered uncollectible if the entity has no reasonable expectations of recovery and has ceased any further enforcement activities*. We noted the guidance in paragraphs B32 –B34, including the fact that an entity shall not write off any amount without including it as an addition to and a use of the allowance account. We recommend that the requirement "shall not write off any amount without including it as an addition to and a use of the allowance account" be simplified by replacing it with "any write-off shall be reflected as a movement in the credit allowance account".

(iv) <u>Disclosure of origination and maturity information</u>

The ED's proposal for disclosure of the year of origination and maturity of financial assets, is likely to result in more extensive credit information collation. We would contend that this information on a standalone basis may be of limited use to users of financial statements, and the costs of preparing such information may outweigh the benefits. We urge the Board to consider removing the disclosure requirement of vintage information.

Should the Board decide to retain the current proposed requirements in the final standard, we are of the view that the disclosure by vintage should not be made applicable across all types of financial assets accounted at amortised cost. Instead, the Board should consider limiting the disclosure to certain asset classes where vintage may be directly correlated with credit risk profiles, such as residential mortgage loans, US subprime loans.

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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?

Whilst we support the mandatory effective date of 3 years after the date of issue of the final standard and believe that it would generally allow sufficient lead-time for implementing the proposals, we do not believe that it is optimal for preparers and users to implement IFRS 9 in phases. Therefore, we believe that IFRS 9 should be early adopted in its entirety at one point in time and that the mandatory adoption date be consistent for all aspects of IFRS 9.

Question 9
(a) Do you agree with the proposed transition requirements (ED Paragraph 24 to 29)? If not, why? What transition approach would you propose instead and why?

(b) Would you prefer the alternative transition approach (original effective interest rate determined under IAS 39)? 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) We are generally in agreement with the proposed transition approach as it is the best balance between providing information to users and limiting the operational burden on preparers. The transitional provisions will also help reduce the burden on financial statements preparers to trace historical information. However, we believe that illustrative examples would be very useful.

(b) We are not convinced that the alternative transition approach is useful and relevant. Although it is easier to implement, the use of a higher discount rate (which excludes expected credit losses) to determine the carrying amounts of financial instruments carried forward from the pre-effective date would result in a much lower than appropriate initial carrying amount. As a result, the adjusted opening balance of the financial instrument will be lower and the future return rate will be distorted.

(c) We do not agree that comparative information should be restated to reflect the proposed requirements. To construct comparative information, preparers would need to forecast cash flows with the use of hindsight and we are not convinced that the benefits of presenting the adjusted comparable information would outweigh the cost.

Should the Board decide that comparative information be restated, we suggest that the Board considers providing the same IAS 8 relief given for the Classification and Measurement Phase of IFRS 9 if IFRS 9 is applied before 1 January 2012.

We also noted that the ED states that the date of initial application is the beginning of the <u>annual</u> period in which the ED is adopted and comparatives should be restated accordingly.

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However, for entities applying IFRS 9 on or after 1 January 2011, the date of initial application may be the beginning of the first reporting period. This could be interpreted as the beginning of any reporting quarter as opposed to the beginning of the annual period. We urge the Board to clarify this in the final standard.

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

The disclosure requirement in paragraph 28 means the reporting entity has to run two systems for the entire year of initial application of this IFRS. This may involve an increment cost that outweighs the benefit of the additional information provided.

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?

Subject to our comments under question 1, 2 and 6, we agree that it is appropriate for the Board to provide guidance on practical expedients and we support the use of a provision matrix as discussed in B16 as an appropriate practical expedient. This is consistent with the issuance of practical expedients in other standards such as IAS 21, which allows an entity to use an average rate that approximates the actual rate in translating foreign currency transactions into the entity's functional currency at the date of transaction.

We note that under B15 of the ED, practical expedients are only permitted where the overall effect of applying it is immaterial. We are concerned that a reporting entity, in its effort to substantiate that the application of the standard is immaterial, may be required to calculate amortised cost according to the standard and compare the results using the practical expedient. This would defeat the purpose of allowing practical expedients in the first instance, and would suggest that the Board reconsiders the need to demonstrate immateriality.

We believe that it would be useful to give an example of how the practical expedient in B17 would be applied. We note the Board has included detailed calculation examples on its website on how the proposals in the ED should be applied to fixed rate and floating rate instruments. We believe that a similar example or guidance could also be included to illustrate the application of the proposed practical expedient.

Convergence in accounting standards

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Last but not least, we would like to reiterate our strong support for the Board to work closely with FASB to align the principles and methodologies of their respective standards on impairment of financial assets. We understand that there are significant differences between the FASB's tentative impairment approach as compared to the expected loss approach proposed by the Board. Under the FASB's tentative impairment approach, an entity would recognise credit impairment when there is information indicating that the entity will be unable to collect all of the contractually promised cash flows. Furthermore, entities would have latitude to develop measurement methods that are practical under the circumstances such as applying appropriate historical loss rates, adjusted for current macroeconomic factors, or other methods that are practical for the entity.

Whilst we appreciate that the FASB and the Board have agreed to jointly consider the comment letters on their respective proposals despite the differences in their approaches and timeline, we would urge the Board to consider aligning their approaches to impairment before issuing final guidance on accounting for financial instruments, thereby reducing application issues that often result from inconsistent principles in similar standards issued by the FASB and the Board.

Should you require any further clarification, do contact me. Thank you.

Yours faithfully

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