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Dear Sir David

# Re.: Supplement to Exposure Draft 2009/12 "Financial Instruments: Impairment"

We appreciate the opportunity to comment on the supplement to the exposure draft mentioned above and would like to submit our comments as follows:

# **General Remarks**

As mentioned in our comment letter on the IASB exposure draft *Financial Instruments: Amortised Cost and Impairment*, dated 16 March 2010, we welcome the introduction of the expected loss model as an appropriate alternative to the incurred loss model. Nevertheless, we acknowledge the operational challenges of the original exposure draft, especially in the context of open portfolios. Therefore, we support the objective of the proposals which is to approximate the outcomes of the exposure draft while allowing certain operational concessions.

One major source of operational complexity likely to ensue from the original exposure draft was the allocation mechanism for credit losses, i.e. the integrated effective interest rate, which incorporated initially expected credit losses. These challenges result from entities' operating separate accounting and credit risk systems. The integrated effective interest rate has now been replaced by a non-integrated effective interest rate, thereby "decoupling" the computation of the ef-



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fective interest rate from the consideration of credit losses. The IDW acknowledges that the boards have now addressed the widespread concerns in this area.

The supplementary document aligns internal credit risk management with the impairment requirements to a greater extent. One example is the proposal as to how to determine whether a financial asset would be included in the "good book" or in the "bad book", thereby determining the timing of recognition of expected losses according to the characteristics of the financial assets in a manner consistent with many credit risk management systems. This alignment will make it easier for financial institutions and other preparers to apply the proposals in practice.

Before reaching a common solution to the accounting for impairment of financial assets, the IASB and the FASB were pursuing different objectives for their impairment proposals, which caused them to favour different proposals for the recognition of expected credit losses and, as a result, different allowance amounts. While the IASB intended to maintain a link between the pricing of financial assets and expected credit losses and, hence, to allocate expected losses over the lifetime of financial assets, the FASB intended to ensure that the allowance balance is sufficient to cover all estimated credit losses regardless of the timing of those losses. Given these different objectives, it is not surprising that the common solution contains conceptual weaknesses and undue complexity. In particular, we do not see any persuasive reason for introducing a "higher of - approach" in the "good book". The minimum allowance amount (floor) in the "good book" adds operational complexity to the proposals and could cause inappropriate "day one losses". Furthermore, the foreseeable future period is not specified and the application of this criterion may be subjective, thereby decreasing comparability and facilitating earnings management (see our answer to question 9 regarding our concerns about the floor mechanism).

Consequently, we do not agree with the proposed common impairment model, nor do we support the FASB approach; our concerns are explained in the answer to question 13. In fact, we prefer the IASB approach. However, further simplification is necessary to make the approach more operational: The amount of expected credit losses (in the "good book") that are not yet recognised should be allocated straight-line over the weighted average remaining life of the portfolio (without any catch-up, see our answer to question 4).

We would like to comment on the specific proposals as follows:



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#### Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (i.e. delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

In our view, the proposed approach for recognition of impairment remedies the identified weakness of delayed recognition of expected credit losses.

However, we would like to mention that the change from an "incurred loss model" to an "expected loss model" was driven, in part, by the alleged "procyclicality" of the "incurred loss model" results especially from the so called "cliff effect": It is not permissible to recognise expected credit losses until a trigger (loss) event has occurred. Once the recognition threshold has been crossed, an impairment loss is recognised that reflects the credit losses expected (but not recognised) from the outset. We believe that the approach for recognition of impairment described in this supplementary document might still be procyclical. While the recognition of time-proportional expected credit losses (in the "good book") avoids a "cliff effect", both the recognition of credit losses expected to occur within the foreseeable future (in the "good book") and the recognition of the entire amount of expected credit losses (in the "bad book") have procyclical aspects. This can have a wide-ranging and significant impact in case of a revised general economic outlook. On balance, all impairment models are procyclical in some way.

Finally, we would like to point out that the recognition of the entire amount of expected credit losses in the "bad book" is very similar to an "incurred loss model", because both depend on trigger events.

## **Question 2**

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.



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In our opinion, the impairment model proposed in the supplementary document can also be applied to closed portfolios and other instruments.

It is important to have one impairment approach for single assets, groups of assets, closed portfolios and open portfolios. A combination of different impairment approaches would increase complexity and introduce an opportunity for earnings management. Moreover, transparency and comparability would be reduced.

If the proposed floor concept were applied to closed portfolios and single assets, it would inevitably create "day one losses", which are inconsistent with the initial measurement of financial assets at fair value. Regarding our lack of support for the floor mechanism, we refer to our answer to question 9.

In this context, we would also like to comment on the scope of the supplementary document: The proposals are limited to open portfolios of financial assets that are measured at amortised cost, excluding short-term trade receivables, pending the proposals in the revenue exposure draft being redeliberated. While we acknowledge that the starting point for amortised cost measurement for short-term trade receivables should be aligned with and follow on from the measurement of the related revenue, we believe that it is essential that the impairment model for short-term trade receivables be consistent with the general impairment approach.

#### Question 3

Do you agree that for financial assets in the "good book" it is appropriate to recognise the impairment allowance using the [proposed] approach? Why or why not?

The IDW agrees with the principles-based differentiation between a "good book" and a "bad book", based on the internal credit risk management of financial institutions and other entities.

However, we do not support the "higher of - approach" and recommend further simplification. In this context, we refer to our answers to questions 4 and 9.

## **Question 4**

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?



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We support the IASB allowing entities to choose between a straight-line approach (using either a discounted or undiscounted estimate) and an annuity approach (using a discounted estimate) to allocate expected credit losses over the life of a portfolio, since different entities have different systems and levels of sophistication. Besides, a mandatory annuity approach could lead to significant costs and operational changes for many preparers, particularly banks with large portfolios of financial assets.

However, even if the IASB's proposal were contained in the final standard, we doubt whether the degree of simplification would be sufficient. Therefore, we propose that the amount of expected credit losses (in the "good book") that are not yet recognised should be allocated over the weighted average remaining life of the portfolio (without any catch-up). This would make the impairment model more operational.

#### **Question 5**

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

In general, we acknowledge that the proposed approach provides information that is useful for decision-making and will be easier to apply than the previous proposals made by the boards. However, the proposals grant several explicit and implicit options and accounting policy choices. It could be argued that options and accounting policy choices are detrimental to comparability and will lead to diversity in practice, thereby reducing decision-usefulness. Nevertheless, we believe that options and accounting policy choices are necessary to make the concept operational. Moreover, disclosures about the judgements that management has made can be used to ensure the necessary transparency.

# **Question 6**

Is the requirement to differentiate between the two groups (i.e. "good book" and "bad book") for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

In general, we believe that the differentiation between the two groups is clearly described. However, the basis for conclusions of the final standard should explicitly state that banks can use Basel II default criteria to differentiate between



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"good book" and "bad book". This allows such entities to reduce costs and to align risk management and financial reporting.

## Question 7

Is the requirement to differentiate between the two groups (i.e. "good book" and "bad book") for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

We believe that the requirement to differentiate between the "good book" and the "bad book" for the purpose of determining the impairment allowance is operational and auditable.

## **Question 8**

Do you agree with the proposed requirement to differentiate between the two groups (i.e. "good book" and "bad book") for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

As mentioned above, we agree with the proposed requirement to differentiate between a "good book" and a "bad book" for the purpose of determining the impairment allowance. Both the proposed time-proportional approach and our preferred approach (we refer to our answer to question 4) treat initially expected credit losses and subsequent changes in loss estimates in the same way, thereby requiring a complementary approach that results in the immediate recognition of expected credit losses for those financial assets for which it is no longer appropriate to allocate expected credit losses over a time period.

The proposal aligns the internal credit risk management and the impairment requirements, since financial assets would be included in the "good book" and the "bad book" in accordance with an entity's internal risk management. We agree with this alignment because it allows for ease of application by financial institutions and other preparers. Moreover, using criteria on the basis of internal credit risk management is consistent with other phases of the project to replace IAS 39.

According to paragraph B4 of the supplementary document, entities that do not manage credit risk using an approach that differentiates the management of financial assets depending on the uncertainty about their collectibility in a way similar to the principle in paragraph 3 must still differentiate their financial assets



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into two groups for the purpose of determining the impairment allowance in accordance with paragraph 2. We believe that some specific criteria (rather than examples) are needed to determine when to transfer assets between the "good book" and the "bad book".

The final document should explicitly state that there is strong evidence for a transfer of financial assets to the "bad book" if the contractual terms are renegotiated due to financial difficulties experienced by the entity.

## **Question 9**

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

- (a) Do you agree with the proposal to require a floor for the impairment allowance related to the "good book"? Why or why not?
- (b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the "good book" only in circumstances in which there is evidence of an early loss pattern?
- (c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?
- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
- (f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the "floor" requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.



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(a)-(f): The boards wanted the minimum allowance amount to be equal to the expected credit losses over a period of time to ensure that the allowance balance is always at least equal to those credit losses when they are expected to occur (paragraph BC63). However, we do not see any persuasive reason for introducing the minimum allowance amount (floor) in addition to the differentiation between "good book" and "bad book".

The floor compromises the time-proportional approach and adds operational complexity, due to the obligation to calculate two sets of expected losses at each reporting date and to compare them in order to determine the required impairment allowance. Moreover, the mechanism could cause an immediate charge to earnings, i.e. a "day one loss", even for lending activities undertaken on market terms. Such "day one losses" are inconsistent with the initial measurement of financial assets at fair value. Furthermore, the term "foreseeable future" is vague and subjective, which will reduce the comparability of financial statements and allow earnings management. We also note that this term is even used within the IFRSs in different contexts and with different meanings (e.g. Framework F23, IAS 21.15, IAS 32.BC9 and IAS 39.50D), which exacerbates the problem.

We acknowledge that for financial assets for which expected credit losses are recognised over time in an early loss pattern scenario, the time-proportional approach may not create an allowance balance sufficient to cover the expected credit losses before they occur. However, we believe that recognising a time-proportional amount of the lifetime expected credit losses is appropriate even in an early loss pattern scenario because the allocation of expected credit losses according to the time-proportional model reflects the economics of the lending transactions in this case, too, and the risk management objective has not changed from receiving the regular payments until maturity.

(b): If the boards decide to implement a minimum allowance amount for the "good book", an entity should not be required to invoke a floor only in those circumstances in which there is evidence of an early loss pattern. This model would require specific and detailed criteria to define an "early loss pattern". We do not see any convincing argument for introducing such requirements.

(c): If the boards decide to implement a minimum allowance amount for the "good book", they should state that the foreseeable future is generally a period of twelve months. Under the proposed definition of foreseeable future, different entities will have different views on the length of time for which they can make specific projections. Entities with highly sophisticated risk management will be able to make specific projections over longer periods than will entities with less



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sophisticated risk management. This will lead to situations in which entities with more advanced credit risk management systems will carry larger allowances for expected losses than will other entities. Stating that the foreseeable future is generally a period of twelve months would enhance comparability and would allow the use of data already collected for regulatory purposes. Furthermore, such a simple fixed-time period would reduce complexity because, in this case, it would neither be necessary to differentiate the foreseeable future period for different asset classes nor to review decisions at each measurement date.

Besides, it is unclear at which point in time credit losses would be regarded as "occurring". If the boards adhere to their proposal, they should clarify whether the loss for a financial asset would be included in the loss estimate for the foreseeable future by reference to the time when it first became problematic or when the actual loss is expected to be realised. One potential solution to this issue may be to align the definition of when losses are expected to occur with the timing of transfer of assets from the "good book" to the "bad book".

(d): If the boards decide to implement a minimum allowance amount for the "good book", the period considered in developing the expected loss estimate for the foreseeable future should not change on the basis of changes in economic conditions. As mentioned above, in our opinion, the foreseeable future should always be a period of twelve months.

The supplement assumes that the foreseeable future for a particular portfolio would be fairly constant and would not be expected to change significantly from period to period. However, during times of economic crisis, it might be argued that the ability to make specific projections of events and conditions and to make reasonable estimates based on specific projections is reduced considerably. Deteriorating economic conditions and recessions are often associated with increased uncertainty. This could lead to the counter-intuitive result that, as economic conditions worsen, the foreseeable future might be considered shorter, thus possibly reducing the minimum allowance amount (floor) for the "good book". This may occur despite the fact that the amount of losses expected in the foreseeable future and over the total life of the assets may both increase.

(e): We refer to our answer to question 9(c).

(f): The "foreseeable future" is a subjective term. In our view, the introduction of a "ceiling" would be a rules-based attempt to objectify fundamental uncertainties, thus creating an expectation gap.



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#### **Question 10**

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

Whether the floor will be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i) often depends on the period of the foreseeable future. In this context, we refer to our answer to question 9.

We believe that in the case of short-term financial assets (e.g. credit card deposits) the floor will often be the higher amount.

#### Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

- (a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?
- (b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?
- (a): We agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a). This allows for different levels of sophistication and considers the fact that measurement of impairment has yet to be deliberated by the boards (paragraph BC41).
- (b): The IDW does not agree with permitting the proposed flexibility in the selection of a discount rate. Even small changes in discount rates could have a significant impact on the amounts recognised. The proposal would allow earnings management and would reduce the comparability of financial statements. In our view, requiring the (readily obtainable) risk free rate would provide operational relief and would avoid the disadvantages mentioned previously.



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#### **Question 12**

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (i.e. to recognise expected credit losses over the life of the assets)? Why or why not?

We prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document. The IASB approach would recognise a time-proportional amount of the lifetime expected credit losses for the "good book" without requiring a floor. We refer to our answer to question 9, where we explain why we do not support the minimum allowance amount (floor).

We acknowledge that for financial assets for which expected credit losses are recognised over time in an early loss pattern scenario, the IASB approach may not create an allowance balance sufficient to cover the expected losses before they occur. However, we do not believe that the foreseeable future floor in the proposed model is the only way to deal with this issue. Examples of other possible solutions are set out in paragraph BC74 of the supplement.

Admittedly, the IASB approach would involve judgement when deciding what assumptions to use, as well as when to transfer assets between the two differentiated groups (i.e. the "good book" and the "bad book"). This could raise concerns

- about the lack of comparability between entities that may have similar portfolios, but use different judgement, and
- that the approach creates a potential for earnings management.

However, these concerns apply equally to any impairment approach involving judgement, including an approach that recognises losses expected to occur in the foreseeable future.

Furthermore, there are concerns that lifetime estimates are not reliable. However, an impairment allowance derived from a time period other than the expected lifetime would provide neither a relevant nor a faithful representation of the economic activity it is meant to depict. An approach that focuses solely on losses expected over a period shorter than the life of the asset is more susceptible to earnings management. In this case the allowance is entirely dependent on management's estimate of the time period to be used, as well as the amounts of the expected losses. In contrast, if the losses are recognised on the



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basis of lifetime expected losses, because the pricing of the loan provides a reference for those estimates, there is less room for earnings management.

However, as mentioned in our answer to question 4, the IASB approach should be simplified to make it more operational. In our view, the amount of expected credit losses (in the "good book") that are not yet recognised should be allocated over the weighted average remaining life of the portfolio (without any catch-up).

## **Question 13**

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (i.e. to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

The IDW does not support the FASB approach for open portfolios of financial assets. This approach would require an entity to recognise immediately all credit losses expected to occur in the foreseeable future (without a minimum period specified). Whilst we acknowledge that the FASB approach is simple and can be applied without significant system and process changes, we do not support this proposal for the following reasons:

- The FASB concept does not maintain the link between the pricing of financial assets and expected credit losses.
- It does not distinguish between a "good book" and a "bad book", which, for the reasons explained above, we support.
- Recognition of losses expected to occur in the "foreseeable future" (rather than remaining lifetime losses) is an arbitrary and subjective cut-off that increases the potential for earnings management and leads to inconsistent application.
- In periods of economic downturn or crisis, the application of the "foreseeable future" concept might lead to inadequate impairment allowances (see our answer to question 9(d)).
- The FASB approach could result in a "day one loss" for newly originated financial assets.



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#### **Question 14Z**

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

We welcome the fact that the IASB has decided to exclude expected credit losses when determining the effective interest rate, i.e. to use a non-integrated or "decoupled" effective interest rate, thus eliminating a source of operational complexity in the original exposure draft.

## **Question 15Z**

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

In our view, the impairment requirements should be aligned for all credit exposures irrespective of their type (i.e. whether loans or loan commitments that are not accounted for at fair value through profit or loss) and be located in the final IFRS 9, since loans and loan commitments of financial sector entities have the same risk exposures and are generally managed using the same business model, risk management and accounting systems.

## **Question 16Z**

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

We believe that the proposed requirements would be operational if applied to loan commitments and financial guarantee contracts.

In this context, we welcome the IASB's tentative decision to retain the existing approach in IFRSs that:

 permits an issuer of a financial guarantee contract to account for the contract as an insurance contract if the issuer had previously asserted that it regards the contract as an insurance contract; and



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requires an issuer to account for an a financial guarantee contract in accordance with the financial instruments standards in all other cases (IASB Update, March 2011, page 3).

#### **Question 17Z**

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

We agree with the proposed presentation requirements, which result from the simplified approach that does not differentiate between initial estimates of credit losses and changes in those estimates, making it no longer possible to present separately the effect of allocating the initial credit loss estimates and changes in those estimates.

#### Question 18Z

- (a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?
- (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

The supplementary document proposes very detailed disclosures. However, as the proposed model for recognition of impairment would allow substantial flexibility and significant judgement in implementation, most of the proposed disclosures aim to provide sufficient information to enable users to understand how that flexibility and judgement have been exercised.

Nevertheless, paragraph Z8 requires certain information on financial assets for which the impairment allowance is determined in accordance with paragraph 2(a) for the current annual period and the previous four annual periods. In our view, such disclosures are too extensive and should not be required.

Apart from that, should the IASB accept our proposals to eliminate the floor mechanism, the disclosure requirements will necessarily be limited.



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#### **Question 19Z**

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

We agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups. However, we recommend that the IASB clarify in the final standard that the amount transferred between the two groups is the impairment allowance included in the last (interim) financial statements before the transfer.

#### Other Remarks

The supplement is silent on income recognition in the "bad book". When a financial asset is transferred to the "bad book", the credit risk management objective has changed from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset. Consequently, we believe that interest income recognition should cease when the transfer occurs. The final document should address this issue.

The methods for measuring credit losses are yet to be redeliberated by the boards (paragraph IN20(b)). For example, the measurement could be based either on discounted or on undiscounted cash flows. Any decision in this area is likely to have an impact on the issue of whether estimated credit losses include both interest and principal or principal only. We suggest the boards clarify the practical implications of this issue before publishing the final document.

Furthermore, this supplement fails to address important questions in respect of transition. The proposals could result in significant consequences for the equity of entities if applied retrospectively. From a practical standpoint the proposed model can only be applied prospectively to existing portfolios due to the degree of estimation and judgement involved. Retrospective application would involve hindsight, which is not appropriate.



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Finally, the supplement often refers to "profitability" (for example in paragraph IN5(a) and paragraph BC53). We believe that the profitability of contracts is an economic issue that should not be mistaken for accounting requirements. Therefore, the final document should avoid the term.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

Norbert Breker Technical Director Accounting and Auditing Uwe Fieseler Director International Accounting