1 April 2011

Sir David Tweedie
International Accounting Standards Board
30 Canon Street
London EC4M 6XH
United Kingdom

Submit : Via IFRS Foundation website

Dear Sir David

Comments on Exposure Draft Financial Instruments: Impairment Supplement

Thank you for the opportunity to comment on the IASB Exposure Draft *Financial Instruments: Impairment Supplement* (the Supplement). CPA Australia, The Institute of Chartered Accountants (the Institute) and the National Institute of Accountants (NIA), (the Australian Joint Accounting Bodies) have considered the Supplement. Our comments follow.

The Joint Accounting Bodies represent over 190,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia throughout Australia and internationally.

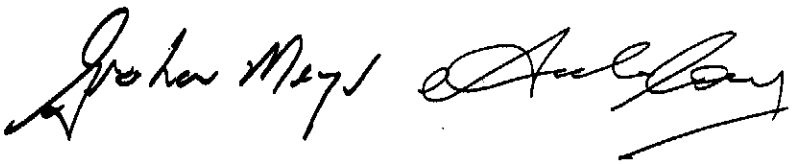
Our comment letter on the IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment* did not support the expected loss model for a number of reasons including that the proposal was inconsistent with a true amortised cost measurement model. After reading the Supplement our position is unaltered. The fact that forward-looking information is required in the measurement is inconsistent with a cost-based measurement approach as defined in the conceptual framework project. Our earlier submission also noted that Australia's experience with applying the incurred loss model was generally positive. However, we do understand each jurisdiction may interpret existing requirements differently. On rereading the Guidance on Implementing IAS 39 *Financial Instruments: Recognition and Measurement* (December 2003) we believe it is clear that the range of factors taken individually or together that constitute the objective evidence necessary for impairment under the incurred loss model is very broad. Our comment letter on the FASB Exposure Draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* stated our support for the FASB approach to impairment of financial assets when compared with the IASB incurred loss model as we viewed the FASB approach as an incurred but not reported loss model.

While welcoming the IASB's and FASB's efforts to develop a common approach, It is unfortunate the boards have not explored further how to better articulate the current IASB incurred loss model including what constitutes objective evidence of impairment. The Joint Accounting Bodies are disappointed that the agreed proposal is very likely to lead to different impairment models being applied to similar economic events. It is expected all financial assets carried at amortised cost should be measured using a consistent impairment model.

Notwithstanding our refutation of the expected loss model our response to matters on which specific comment is requested is made on the basis that the expected loss model will be implemented and is included in the attached Appendix.

If you have any questions regarding this submission, please do not hesitate to contact Mark Shying (CPA Australia) at mark.shying@cpaaustralia.com.au, Kerry Hicks (the Institute) at kerry.hicks@charteredaccountants.com.au or Tom Ravlic NIA) at tom.ravlic@nia.org.au.

Yours sincerely



Alex Malley
Chief Executive Officer
CPA Australia Ltd

Graham Meyer
Chief Executive Officer
Institute of Chartered Accountants in Australia

Andrew Conway
Chief Executive Officer
National Institute of Accountants

Appendix – Questions for specific comment

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?

We do not consider that the incurred loss model has this weakness because Australia's experience with applying the incurred loss model is generally positive but the Joint Accounting Bodies do understand that the current requirements may be interpreted differently in various jurisdictions. Notwithstanding our refutation of the expected loss model our response to this question and those that follow is on the basis that an expected loss model will be implemented. The proposed expected credit loss model should result in earlier recognition of credit losses in some jurisdictions when compared with the way in which they have applied the current incurred loss model. In other jurisdictions such as Australia we expect the timing of recognition of credit losses to be much the same under either model.

Whether or not the value of the collateral is taken into account in the calculation of the good book expected loss of a collateral dependent loan might have important implications in terms of overprovisioning upon transfer from the good book to the bad book. We believe it is important that the guidance to the Supplement resolve this measurement issue to avoid discrepancies in the interpretation of the requirements.

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?

The scope of the proposal makes it clear that the Supplement applies only to open portfolios. The Joint Accounting Bodies understand that it would be rare for non-financial institution entities to have open portfolios. Entities of this type have told the Joint Accounting Bodies they have not particularly thought about the application of the proposals to closed portfolios and other instruments. The proposed impairment model is easily applied to closed portfolios and other instruments, as it should be simpler to estimate losses of closed portfolios than open portfolios, as there are fewer variable components.

The Supplement provides definitions of open and closed portfolios. In an open portfolio, assets are added to the portfolio through its life by origination or purchase, and removed through its life by write-offs, transfer to other portfolios, sale and repayment. In a closed portfolio, assets are not added to the portfolio through its life, and are removed by write-offs, transfer to other portfolios, sales and repayment. However, there are no specific examples as to what qualifies as open and closed portfolios. It would be useful to have such specific examples provided especially if the finalised impairment model is different for closed and open portfolios. Furthermore, there should be guidance on how to group assets into the respective portfolios.

Question 3
Do you agree that for financial assets in the "good book" it is appropriate to recognize the impairment allowance using the approach described above? Why or why not?

The Joint Accounting Bodies understand the Supplement proposal is the "good book" approach requires expected credit loss to be recognized over a time period. The expected credit loss is the higher of the expected losses in the foreseeable future (a minimum of 12 months) and time-proportional expected losses over its remaining life on a straight line or annuity approach.

While the good book approach would be a 'good fit' to a homogeneous pool of loans it may not be suitable for individually-assessed loans such as mortgage loans and corporate loans. For a homogenous pool of loans, the good book expected losses (cash flow) can be estimated based on historical trends adjusted for economic factors. It would be difficult to estimate such expected losses (cash flow) in the case of individually assessed loans as the portfolio may not be reflective of the prepayment, default pattern of an individual loan (e.g., mortgage A may not be reflective of mortgage B). Further, it might be difficult to argue that those individually assessed loans were signed up with expected losses in mind, especially if they are collaterised. Impairment of such loans may be delayed to when the loan is transferred from the good to bad book.

A different approach could be to view loans in repayment mode, uncertain mode or recovery mode whereby repayment and uncertain modes would fall under good book while recovery mode falls under bad book.

Question 4
Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

Yes, the Joint Accounting Bodies believe that the time-proportional impairment approach is operational but we understand it would most likely require significantly more time, resources, data requirements, forecasting tools and collaborative efforts between accounting and risk personnel to set up the controls and processes as (1) the practice is currently based on the incurred loss model, and (2) the requirement to determine the appropriate allowance as the higher of the time-proportional amount and the amount of credit losses expected to occur within the foreseeable future period requires two computations to arrive at the impairment allowance for the good book.

The Supplement proposes that the computation of time-proportional expected loss be a choice between the straight line approach and the annuity approach. It is expected that the annuity approach will rarely be utilised given the simpler computation under the straight line approach plus non-discounted Present Value is allowed.

Question 5
Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the approach?

As the proposed approach brings more estimates into the calculation, loss estimation and data reliability may result in errors thus affecting decision usefulness of information. Disclosure of assumptions and sensitivities will be critical for decision usefulness.

Question 6
Is the requirement to differentiate between the two groups (ie. 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

It has been noted in Question 2 above that there is an absence of specific examples to enable differentiation between open and closed portfolios. The same is true of the 'good book' 'bad book' dichotomy. Further, we understand that at least some banks manage their consumer loans based on delinquency buckets that may not be consistent with the proposed approach.

Terms such as 'foreseeable future' and 'reasonable and supportable forecasts' need to be treated as defined terms otherwise a potential for varying interpretation exists. This may lead to differences in practice.

There may be a diminution of the inter-entity comparability of financial statements with a corresponding reduction in the decision usefulness of the information given the level of subjectivity and judgment that is required to be exercised. This would also lead to significantly higher levels of disclosure in relation to sensitivity analysis. Refer also to comments in Questions 14Z and 17Z.

Question 7
Is the requirement to differentiate between the two groups (ie. '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?

The Joint Accounting Bodies have discussed the 'good book' and 'bad book' approach with financial institutions. It is an approach that is operational and auditable, but is likely to require more time, resources, data requirements, forecasting tools and collaborative efforts between accounting and risk personnel to set up the controls and processes for the separate books.

Financial institutions new to this approach would need to consider the type of loan that would fall into either category and also when a loan or group of loans should shift from the good to bad book. These are also areas of operational complexity and subjectivity.

Consider the following example of classification of a loan. The expected credit loss is estimated on a portfolio basis for a loan in the good book. Should this loan go from the good book to the bad book the expected credit loss impairment is performed on an individual asset basis; some discussants have suggested that as the definition of an open portfolio requires additions to and removals from the portfolio through its life and the allowance for the good book to be calculated at the level of the portfolio, there is no particular affect on the allowance for the good book on removal of a loan to the bad book. However, some other discussants have said that when such a transfer is made, considerations should be given to how the expected loss should be carved out of the portfolio to determine the adjustment to the expected loss that should be made under the bad book, i.e. upfront recognition of the expected credit loss. It is highly recommended that a field test is conducted to assess the practicalities prior to finalising the standard.

Question 8
Do you agree with the proposed requirement to differentiate between the two groups (ie. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

Yes, the Joint Accounting Bodies believe it is conceptually sound to differentiate between good book and bad book, although note the response in Question 6 regarding the need to apply a consistent definition around this distinction. The issue on hand surrounds measurement and implementation.

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.**

a. Yes, the Joint Accounting Bodies agree with the proposal as the floor provides a minimum benchmark and prevents companies from under-provisioning.
b. See our response to (a) above.
c. Yes the Joint Accounting Bodies agree with the proposal for the reasons stated in (a) above.
d. We believe the driving factor in determining foreseeable loss would be historical information that is adjusted based on forecast information. The foreseeable period would be established by the historical trend that may be adjusted based on the forecast information. As such, the period could change based on economic conditions, although we do not believe it would be the only determining factor. Consideration might also be given to establishing a limit on the foreseeable future period similar to that established in IAS 36 Impairment of Assets that does not allow projections to exceed five years, unless a longer period can be justified.
e. As outlined in our response to Question 6 above, "foreseeable future" is not specifically defined. While we have been told that it does not make sense that a financial institution could not foresee losses beyond the tenor of the loans that they are originating (as you would need to have foresight to properly price the loan), we are not able to conclude if the foreseeable future is greater than twelve months.
f. See our comments in (d) above.

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 time-proportional expected loss will be dependent on various factors such as expected loss pattern and age of loan.

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. Conceptually, the Joint Accounting Bodies believe that there is no basis for an undiscounted estimate for assets with a life greater than 12 months. Further, multiple approaches will compromise the consistency and comparability of financial information for decision making. Therefore we do not agree with the flexibility proposed and consider that discounting should be the only approach permitted.
b. Conceptually, the Joint Accounting Bodies believe that the appropriate rate is the effective interest rate and additional guidance is necessary .

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 (ie. to recognise expected credit losses over the life of the assets)? Why or why not?

The general concept of the IASB approach is preferred on the pragmatic basis that it is a one-step approach, i.e. compute time-proportional expected loss, compared to the two-step approach under the specific IASB approach described as the common proposal in the Supplement, i.e. (i) compute 12 month foreseeable loss and (ii) compute time-proportional expected loss.

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 (ie. to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

Our comment letter on the earlier FASB Exposure Draft stated our support for the FASB approach to impairment of financial assets when compared with the IASB incurred loss model as we viewed the FASB approach as an incurred but not reported loss model.

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?

The effective interest rate determination and the expected loss estimation should be separated. If intermingled, there will be issues distinguishing interest revenue arising from the loan and interest revenue arising from the present value unwinding, if discounting is adopted under the straight line approach in determining time proportional expected loss. There should be illustrations to provide guidance on the implementation of decoupling. There should also be clear guidance on interest revenue measurement and disclosure, especially for the present value method for estimating time proportional expected credit losses.

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 response to Question 2 above, we noted it was our understanding that entities had not particularly thought about the application of the proposals to situations that were not open portfolios. Therefore, we are not in a position to comment on this question. However, as we noted in our letter, we would expect all financial assets carried at amortised cost to be measured using a consistent impairment model.

Question 16Z
Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

See our response to Question 15Z above.

Question 17Z
Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

We are supportive of the presentation of interest revenue separate to the impairment expense,

As outlined in the response to Question 14Z above, there should be illustrations to provide guidance on the implementation of decoupling and the related presentation. Additionally, we do not believe that expected credit loss expense should be presented within Net Interest Income. We have been told that the inclusion in Net Interest Income of a credit loss adjustment will lead to confusion amongst users, as it is a well understood key metric for retail banks.

Question 18Z

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) for the proposed impairment model and why?**

We note that the extent and detail of the proposed disclosures is significant and may require in some instances the disclosure of commercially sensitive information (e.g., written off assets but still subject to collection).

We consider that the detail of the disclosures should be based on the application of principles by management and that any list provided should only be indicative of applying the principles. Those disclosures thought to be excessive and confusing to users are in the areas of quantitative disclosures on back testing:

- disclosures similar (but not the same as) Basel II pillar 3 disclosures;
- watch list disclosures; and
- disclosures of assets by risk grade.

Further, given the complexity of the disclosures we request the Board to consider as part of transition requirements, to allow the build up of comparatives over a number of years instead of requiring full comparatives in the year of adoption.

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?

The Joint Accounting Bodies have no comment on this question