

30 September 2010

Technical Director
File Reference No. 1810-100
Financial Accounting Standards Board
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Dear Sir/Madam

SAICA SUBMISSION ON THE EXPOSURE DRAFT ON ACCOUNTING FOR FINANCIAL INSTRUMENTS AND REVISIONS TO THE ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

In response to your request for comments on the FASB's exposure draft on *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

This comment letter includes comments received from members of the South African banking industry, academia and audit practitioners.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

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GENERAL COMMENTS

We support the Financial Accounting Standards Board (FASB)'s stated objective for issuing the exposure draft on *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, to "provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments".

We are, however, of the opinion that this exposure draft introduces numerous rule-based applications that normally increase the complexity of the application of a standard and as a result does not always provide decision useful and relevant information to the users of the financial statements. We are therefore of the opinion that the stated objective may not have been met in all instances.

You will note that we did not provide comments on all of the questions raised in the exposure draft. We selected questions to be addressed based broadly on the following two criteria:

1. The question addresses an issue that is not consistent with the proposal or principle as issued by the International Accounting Standards Board (IASB) as part of their project to replace IAS 39 – *Financial Instruments: Recognition and Measurement* ("IAS 39"); and
2. The question does not require an in-depth knowledge of the economic, legal and accounting environments that currently exist in the US.

Additionally, comments relating to (i) credit impairment; (ii) interest income; and (iii) hedge accounting were provided on a general basis and with no specific reference to the questions asked in the exposure draft.

SPECIFIC COMMENTS

Scope

Question 2

The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

The scope paragraphs of IAS 39 currently exclude loan commitments that (i) has not been designated as financial liabilities measured at fair value through profit or loss (the "fair value option"); (ii) are not derivatives in substance; and (iii) are not commitments to provide loans at a below-market interest rate. These loan commitments are accounted for in terms of IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*.

Apart from the Fair Value Option, the IAS 39 scope exemption is based on the characteristics of a loan commitment agreement that alters the substance and hence

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warrants different accounting treatment. We are unsure why the FASB exposure draft excludes this specific type of loan commitment (loan commitments related to a revolving line of credit issued under a credit card arrangement), and why the distinction is made based on the type of instrument rather than on the substance of the instrument. We would suggest that, if the FASB preference is to include a scope exemption for loan commitments, such an exemption be based on the substance of the contract, rather than a rules-based exemption and incorporate similar principles to those issued by the IASB.

Initial Measurement

Question 8

Do you agree with the initial measurement principles for financial instruments? If not, why?

The IASB (in both IAS 39 and IFRS 9 – *Financial Instruments*) currently requires a single measurement principle for all financial instruments at initial recognition, i.e. all financial instruments should initially be measured at fair value. This exposure draft introduces a mixed measurement approach at initial recognition, which could either be fair value or transaction price depending on the subsequent measurement model applied.

The IASB standards provide, similar to this exposure draft, different accounting principles for transaction costs incurred depending on the subsequent measurement model applied to the specific financial instrument. IAS 39 also provides guidance on how to account for differences between the transaction price of a financial instrument and its fair value. Whilst we acknowledge that one could end up with a similar initial measurement amount for certain financial instruments at initial recognition by applying IFRS 9 and IAS 39 to those under this exposure draft, we believe that having one consistent initial measurement principle for all financial assets and liabilities would significantly reduce complexity and inconsistency in the application of the initial measurement principle.

Furthermore, we recommend that the FASB define “transaction price” within the exposure draft.

Question 9

For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

We agree that where the difference between the transaction price and the fair value on the transaction date relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact, this should by default be recognised in net income. However, it should also be evaluated whether the difference qualifies for recognition as some other asset or liability under another applicable accounting standard, such as a business combination where the entire fair value is recognised on the date of the business combination. This treatment will be consistent with the initial measurement principle as proposed in question 8.

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We are, however, unsure if this guidance will extend to financial instruments measured at fair value with all subsequent changes in fair value recognised in net income. From our reading of the exposure draft, it appears that this guidance only applies to financial instruments for which qualifying changes in fair value are recognised in other comprehensive income. We suggest that the guidance above be extended to include financial instruments measured at fair value with all subsequent changes in fair value recognised in net income.

Question 10

Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

Further to our response to Question 8 above, we do believe that a single initial measurement principle, regardless of subsequent measurement, should be applied.

We believe the most appropriate measure at initial recognition is fair value with added guidance to be provided on (i) how to account for differences between transaction price and fair value for all financial instruments; and (ii) how the term transaction costs is defined.

Subsequent Measurement

Question 13

The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

In the spirit of the stated objective of reducing complexity, the four different measurement models proposed (fair value through net income, fair value through OCI, amortised cost and cost, which provide the preparer with certain choices of application) appear to be too complex. We suggest that the FASB consider a similar approach to the IFRS 9 model as adopted by the IASB for the classification and measurement of financial assets that provide two measurement models based on an entity's business model and the underlying characteristics of the contract. The criteria for application of a specific measurement model are therefore based on a set of principles rather than a strict rule-based interpretation and application.

The principle on which financial instruments are subsequently measured should determine the presentation on the face of the financial statements. As such, we believe that a principle that is linked to an entity's business model and the characteristics of the instrument's cash flows is appropriate as it would provide relevant and decision-useful information to the

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users regarding the results and the risks associated with the business of the entity. We believe that providing various measurement figures on the face of financial statements, some of which may not relate to an entity's business model, would add complexity by making it more difficult for users to understand which number provides the best evidence of the entity's financial position given its type of business model

Additionally, we are uncertain why the FASB includes an exception rule for specialised industries. We believe that if an entity applies its business model as a core principle to determine its subsequent measurement model, less rule-based exception rules would be required.

We do note that the subsequent measurement exemption to measure short-term receivables and payables at amortised cost is not available to "*short-term lending arrangements such as credit card receivables*". We are again uncertain why the specific distinction is made for this type of short-term receivable as, in substance, we cannot see a difference in its characteristics compared to other short-term receivables. In the event that the FASB decides to retain this prohibition, we would suggest that "short-term lending arrangements" be defined in the glossary.

Question 15

Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why?

We believe that the principles for determining the correct subsequent measurement model for both financial assets and liabilities should be the same.

This does not imply that the measurement model for a financial asset and a financial liability that arises from the same contract will necessarily be the same across entities (i.e. holder and issuer accounting may not mirror itself). For example, a government institution might issue long-term debt instruments for long-term funding purposes in which it pays a funding cost for those funds over its contractual life, whereas a financial institution might acquire those long-term debt instruments with the purpose for short-term profit making. The core principle of the entity's business model should be applied consistently to both entities. This might result in the government entity subsequently measuring the financial liability at amortised cost whereas the financial institution will measure the financial asset arising from the same contract at fair value. Thus, if one applies the business model principle correctly, one would obtain the correct subsequent measurement result.

Question 16

The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

As stated in our responses to Questions 13 and 15, we would suggest that the principle to determine the subsequent measurement model be based on an entity's business model. As

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the determining factor is principle-based, we believe that if an entity's business model changes, reclassifications of the subsequent measurement model should also be permitted.

In the event that the FASB retains the suggested rules-based guidance to determine the subsequent measurement model to be applied, a rules-based prohibition on reclassification would appear to be more appropriate. Since this principle may result in entities selling and then repurchasing the same instruments to achieve a change in classification and measurement of an instrument, it may again be preferable to permit reclassification of financial instruments together with sufficient disclosure requirements.

Question 17

The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost- to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

We believe that the proposed measurement principle for core deposits increases, as opposed to reducing, the complexity in reporting financial instruments, which is contrary to the FASB's stated objective. We acknowledge that the theoretical principle in the proposed measurement approach is to reflect the benefit that the entity enjoys through obtaining funding at a cheaper rate than what it would have had if alternative sources of funding had been used. We do, however, believe that the practical ability to obtain the rates to perform the computation would outweigh any benefits that are derived. We suggest that the current measurement exemption contained in IAS 39, which requires "on-demand" liabilities to be measured at the amount payable on demand, be applied to core deposits. Additional disclosure regarding the terms and conditions of the funding agreement would provide the same level of useful information to the users of the financial statements when compared to the suggested measurement model.

Based on our understanding of the definition of "core deposits", it could include inter-company loan accounts in the individual financial statements of a subsidiary where the loan from its holding company is its only stable source of funds and the loan agreement has no contractual maturity. We acknowledge the fact that the basis for conclusions refers specifically to financial institutions, and as such suggest that the wording for the definition of core deposit liabilities in the glossary be reconsidered.

Question 19

Do you believe that the correct financial instruments are captured by the criteria in the proposed guidance to qualify for measurement at the redemption amount for certain investments that can be redeemed only for a specified amount (such as an investment in the stock of the Federal Home Loan Bank or an investment in the Federal Reserve Bank)? If not, are there any financial instruments that should qualify but do not meet the criteria? Why?

We would suggest a consistent, principle-based approach for measurement. Exceptions to the rule or the principle may add complexity which is contrary to the FASB's stated objective.

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We propose that a principle-based exemption from measuring an instrument at its redemption amount may be applicable in situations where an entity cannot determine a fair value reliably. We further propose that the FASB propose, in a similar way to that of the IASB, that all equity investments (with the exception of those scoped out of the standard) should be required to be measured at fair value and to provide indicators where cost might not be representative of fair value.

Question 22

Do you believe that the recognition of qualifying changes in fair value in other comprehensive income (measuring the effects of subsequent changes in interest rates on fair value as well as reflecting differences between management's and the market's expectations about credit impairments) will provide decision-useful information for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows? If yes, how will the information provided influence your analysis of an entity? If not, why?

We support the measurement distinction (through comprehensive and other comprehensive income) based on the intention for which the entity holds a particular financial instrument, as this supports the principle of using an entity's business model to determine its subsequent measurement model. As discussed previously, we believe that financial instruments should be measured in the financial statements on the basis on which the entity manages the financial instruments, and therefore believe that it may not be appropriate to measure all financial instruments at fair value. We would, however, suggest that a pure amortised cost subsequent measurement model would reflect the business model of the entity more accurately for instruments that an entity intends to hold for collection or payment(s) of contractual cash flows and therefore provide relevant and decision-useful information to the users of the financial statements.

In the event that the FASB intends to retain the mixed subsequent measurement model, in terms of where changes in fair value are recognised, we would support that the qualifying changes in fair value should be recognised in other comprehensive income for those instruments that an entity intends to hold for collection or payment of contractual cash flows.

Question 24

The proposed guidance would provide amortized cost and fair value information on the face of the financial statements. The Board believes that this would increase the likelihood that both measures are available to users of public entity financial statements on a timely basis and that both measures are given equal attention by preparers and auditors. Do you believe that this approach will provide decision-useful information? If yes, how will the information provided be used in the analysis of an entity? If not, would you recommend another approach (for example, supplemental fair value financial statements in the notes to the financial statements or dual financial statements)?

As stated in our response to Question 13 above, the face of the financial statements should reflect the business model applied to the financial instruments by the entity. The provision of various measurement figures on the face of financial statements (some that do not relate to an entity's business model) would potentially add complexity by making it more difficult

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for a user to understand which number provides the best evidence of the entity's financial position given its business model.

We also believe that it is inappropriate to argue that information should be moved from the footnotes and disclosures to the face of the financial statements on the assumption that users do not study an entire set of financial statements. One would expect a reasonable investor to apply the necessary level of diligence to obtain enough information to make an informed decision. If the investor believed that such information was important, relevant and material in understanding the financial position, then that user would refer to the appropriate areas of the financial statements for that information. We do not support a qualitative characteristic in the preparation of financial information that caters for users that do not apply the necessary level of diligence.

Question 25

For hybrid financial instruments that currently would require bifurcation and separate accounting under Subtopic 815-15, do you agree that recognizing the entire change in fair value in net income results in more decision useful information than requiring the embedded derivative to be bifurcated and accounted for separately from the host contract? If yes, how will the information provided be used in the analysis of an entity? If not, for which types of hybrid financial instruments do you believe that it is more decision useful to account for the embedded derivative separately from the host contract? Why?

We acknowledge that the exposure draft does provide a simpler approach to deal with hybrid financial instruments. We do, however, believe that the approach contradicts the business model as the principle to determine the appropriate subsequent measurement of financial instruments. We would therefore suggest that where an entity manages a hybrid contract as a single contract (i.e. does not manage the various risk components created by the contract separately), the entire contract should be measured at fair value with changes in fair value recognised in net income. In the event that an entity manages the risk components of a hybrid contract separately, the embedded derivatives should be separated. The embedded derivatives should then be measured at fair value with changes in fair value recognised in net income (consistent with all other derivatives) and the host contract should be measured based on the measurement model that reflects the entity's business model applicable to the host contract. For example, if the host contract is held to obtain the interest and capital payments, it should be measured at amortised cost.

We believe that applying the business model would provide more decision useful information to the users of the financial statements, and it would clearly reflect the manner in which the instrument and the associated risks of the instrument are managed.

Question 26

IFRS 9 requires hybrid financial assets to be classified in their entirety on the basis of the overall classification approach for financial assets with specific guidance for applying the classification approach to investments in contractually linked instruments that create concentrations of credit risk. Also, for hybrid financial liabilities, the IASB, in order to address the effects of changes in the credit risk of a liability, tentatively has decided to retain existing guidance that requires embedded derivatives to be bifurcated and accounted for separately from a host liability contract if particular conditions are met. Do you believe that the proposed guidance for hybrid financial instruments or the IASB's model for

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accounting for financial hybrid contracts will provide more decision-useful information? Why?

As indicated in our response to Question 25 above, we would support a model that is based on the business model of the entity to establish whether a hybrid financial instrument should be bifurcated and accounted for separately.

In terms of IFRS 9, in the event that application guidance for the separation of embedded derivatives is retained for financial liabilities, we would suggest that the requirements for the separation of embedded derivatives in financial assets and financial liabilities be treated consistently. As such, the application guidance for the separation of embedded derivatives should be retained for financial assets as well. This will ensure that the principle is applied consistently to both assets and liabilities and will contribute to reducing the complexity of the rule-based application.

Presentation

Question 32

For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

We support the application of different presentation approaches for the recognition of changes in fair value due to changes in own credit risk for financial liabilities that are designated to be measured at fair value through profit or loss and financial liabilities that are held for trading.

For financial liabilities that are held for trading, consistent with the requirements in the exposure draft as well as the IASB's tentative decisions, we agree that all changes in fair value (including changes in price of credit) should be included in net income.

In the event that an entity designates a financial liability to be measured at fair value, as a result of an accounting mismatch, with changes in fair value recognised in net income, we would support the IASB's proposal to recognise the changes in fair value relating to changes in the price of credit in other comprehensive income.

We would suggest that if an entity chooses to measure a financial liability that meets the criteria in paragraph 28 at fair value with changes in fair value recognised in net income, that changes in fair value relating to changes in the price of credit (credit risk) should be required to be recognised in other comprehensive income. We believe that the recognition of changes in the credit risk of financial liabilities not held for trading in net income creates unnecessary volatility in profit or loss and it is counterintuitive for an entity to recognise fair value gains (losses) in profit or loss on financial liabilities not held for trading when the entity's own credit rating deteriorates (improves).

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Question 35

For financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income, do you believe that the presentation of amortized cost, the allowance for credit losses (for financial assets), the amount needed to reconcile amortized cost less the allowance for credit losses to fair value, and fair value on the face of the statement of financial position will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

As stated in our responses to Questions 13 and 24 above, the face of the financial statements should reflect the business model of the entity. The provision of various measurement figures on the face of financial statements (some that do not relate to an entity's business model) would potentially add complexity by making it more difficult for a user to understand which number provides the best evidence of the entity's financial position given its business model.

Furthermore, the line item "the amount needed to reconcile amortised cost less the allowance for credit losses to fair value" presented in the reconciliation contains the key differences between amortised cost and fair value that a user might want to understand, and therefore not providing more detail regarding this number nullifies the objective of the reconciliation. We believe that the reconciliation as required in terms of the exposure draft is not granular enough to provide more useful information when compared to information provided by an amortised cost subsequent measurement model.

Credit Impairment

The credit impairment model proposed by the FASB appears to be less complex and potentially more operational than the IASB's proposed expected credit loss impairment model. We do, however, have the following concerns regarding the exposure draft's proposed credit impairment methodology:

- In terms of the exposure draft, an entity only considers information that exists at the reporting date to estimate credit impairment. It appears that the proposed credit impairment model lacks an impairment "trigger" that would compel an entity to perform an impairment test. This would result in an automatic impairment loss being recognised on day 2 for originated financial assets for which impairment is evaluated collectively (i.e. on a pool basis).

We do not support the recognition of a day 2 impairment loss as a responsible lender would have taken the expected credit losses of the counterparty into consideration when pricing each individual financial asset. We would support the recognition of an impairment loss only when objective evidence (i.e. a "trigger") indicates that the lender's initial assessment of the expected credit losses was incorrect. Day 2 impairment losses could also potentially create a barrier into a specific lending market as well as be capital punitive for those entities that are subject to capital and other regulatory requirements.

- We note that the exposure draft requires that the time value of money be included when calculating the credit impairment for individually impaired financial assets (paragraph 62), but not when calculating the credit impairment for financial assets

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that are assessed collectively (paragraph 58). We believe that the inclusion of the effect of time value of money should be applied consistently for assets assessed individually and collectively. We believe that consistent application is necessary as otherwise the migration of a loan from collective to individual impairment will result in an immediate increase in the impairment loss (due to now having to incorporate the time value of money)

Please find below an extract from our comment letter submitted to the IASB regarding their proposed expected credit loss impairment model as this contains our proposed alternative model (please refer to our detailed comments on Question 4 of the attached document (pages 4 to 11)). For completeness we have included a copy of our comment letter to the IASB as an appendix to this document.

'We believe that the IASB's objectives regarding the expected cash flow model as set out in ED/2009/12, *Financial Instruments: Amortised Cost and Impairment* (the ED) are sound in principle and support the earlier recognition of credit losses, (i.e. not only after a trigger event (impairment indicator) has occurred). However, we also believe that these proposals present several key implementation and operational challenges. Whilst the ED may address some of the flaws that the ED has identified in IAS 39's incurred loss model, for example: overstatement of interest revenue and a failure to recognise the underlying economics of the transaction, we do not believe that the ED meets all of its intended objectives. Further, we believe that the ED's proposals have the ability to enhance pro cyclical tendencies.

We further believe that there may be several unintended consequences that may arise from the application of the ED. For instance, it is highly likely that during positive economic cycles entities will not price expected losses adequately into future economic cycles and during economic downturns entities may overprice bad news into their models, the combination of which may result in significant volatility in reported profit or loss, with the reporting of such gains and losses not being aligned with the realisation of the actual losses. History points to a mispricing of risk cover over the economic cycle.

We also believe that the model proposed by the ED would be both costly and complex to implement in practice and to maintain over a period of time. Concerns regarding the availability and reliability of data were raised by several of our constituents, noting that they do not currently have sufficient historical data on certain portfolios to accurately estimate expected cash flows, while attempts to obtain comparable data in the market have failed. Difficulties associated with explaining the financial results (outcomes) of the proposals to stakeholders would also present challenges, such as why impairments have changed due to changes in future forecasted economic cycles and the interaction between the various inputs in the impairment models. Financial institutions have also pointed out that potentially they would be required to run 3 models for interest income under the ED, namely:

1. Contractual interest for client statement purposes;
2. Amortised cost under the expected loss proposals; and
3. Amortised cost using IAS 39's existing principles.

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Item 2 is required in terms of the ED and item 3 will be required to be retained to fulfil certain of the ED's disclosure requirements. The Banking industry believes that the modelling of expected cash flows in terms of the requirements of the ED will require extensive changes to their credit models. Based on their Basel II experience, this will be both expensive and time consuming to implement. It is considered highly probable that the proposed model will not be consistently applied in practice due to complexity as well as forecasting requirements. There will also be an increase in management's ability to manipulate reported results (through over conservatism in initial loss expectations and management judgement in forecasting expected cash flows). Furthermore, auditors believe that the proposed model will result in more complex and costly audits owing to the complexity of such models and the requirement to audit management forecasts of future economic cycles. Many auditors also questioned how such a model would be able to be audited in practice. Therefore, we do not believe that the benefits of the ED's proposed model will necessarily outweigh the cost of implementation.

Noting what we have said above, we have set out below an alternative proposed model.

Interest Income

We again reiterate below some of our comments contained in our comment letter to the IASB regarding their exposure draft ED/2009/12, *Financial Instruments: Amortised Cost and Impairment*.

We recommend that the calculations of interest income and impairment be separated from one another for the following reasons:

- The majority of entities maintain separate interest and impairment recording systems.
- In terms of the IASB's exposure draft, changes in the expected prepayment of loans can result in the recognition of impairment losses (or reversals) which we do not believe is appropriate. We recommend that the effects of prepayment should be removed from the calculation of expected losses for the performing book. (The concept of a 'performing book' is discussed in more detail in our attached comment letter addressed to the IASB). We do however believe that the effects of changes in the timing of cash flows should continue to be accounted for in the non-performing book (since the exposure is already impaired). This recommendation is consistent with paragraph 46(b) of the FASB's exposure draft, which states that for financial assets that are contractually payable, changes in expected prepayments will not in themselves give rise to a credit impairment. By including such an exception there will be no need for entities to explain components of impairment gains and losses (due for instance to changes in prepayment rates) as required by paragraph 18(a)(i) of the IASB's exposure draft.
- In terms of the IASB's exposure draft (and as reflected by the IASB's staff examples), impairment gains and losses may arise on floating rate financial assets merely because there are subsequent changes in the shape of the interest rate curve. We recommend that the IASB exposure draft exclude the requirement to record impairment gains and losses in such instances. This would also achieve consistency

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with paragraph 47(c) of the FASB's exposure draft, which indicates that changes in such variable rates will not in themselves give rise to credit impairment. Again, by including such recommendations in the final standard, there will be no need for entities to explain components of impairment gains and losses (due for instance to changes in variable rates) as required by paragraph 18(a)(i) of the IASB's exposure draft.

- Further to the comment above, in countries such as South Africa, the interest rate on mortgages is typically linked to an administered rate (referred to as the prime rate of interest). The requirement to forecast administered rates will pose further modelling challenges.

We also believe that the recognition of interest income and expected losses should be separated in profit and loss, i.e. disclosure of expected losses should not be required as part of net interest income.

Hedge Accounting

The IASB is currently deliberating proposed changes to hedge accounting. Therefore, at this time, we do not wish to provide detailed comments on the questions raised in the exposure draft. We do, however, include the following general comments:

- We support the overall objective of the FASB to simplify the requirements to achieve hedge accounting;
- We support the use of more qualitative (rather than quantitative) assessments of hedge effectiveness, where appropriate; and
- Our suggested key objective for hedge accounting would be that net income should reflect the economic reality of the hedging relationship as well as the manner in which the risks being hedged by an entity are managed from a risk perspective, i.e. the accounting for hedges should reflect an entity's risk management model.

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FINANCIAL INSTRUMENTS AND REVISIONS TO THE ACCOUNTING FOR
DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

APPENDIX

30 June 2010

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Email: CommentLetters@iasb.org

Dear Sir/Madam

**SAICA SUBMISSION ON EXPOSURE DRAFT ON *FINANCIAL INSTRUMENTS:
AMORTISED COST AND IMPAIRMENT***

In response to your request for comments on the IASB's exposure draft on *Financial Instruments: Amortised Cost and Impairment*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

This comment letter includes comments received from members of the South African Banking industry and audit practitioners.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

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GENERAL COMMENTS

We believe that the International Accounting Standards Board (IASB's) objectives regarding the expected cash flow model as set out in ED/2009/12, *Financial Instruments: Amortised Cost and Impairment* (the ED) are sound in principle and support the earlier recognition of credit losses, (i.e. not only after a trigger event (impairment indicator) has occurred). However, we also believe that these proposals present several key implementation and operational challenges. Whilst the ED may address some of the flaws that the ED has identified in IAS 39 – *Financial Instruments: Recognition and Measurement* (IAS 39) incurred loss model, for example: overstatement of interest revenue and a failure to recognise the underlying economics of the transaction; we do not believe that the ED meets all of its intended objectives. Further, we believe that the ED's proposals have the ability to enhance pro cyclical tendencies.

We further believe that there may be several unintended consequences that may arise from the application of the ED. For instance, it is highly likely that during positive economic cycles entities will not price expected losses adequately into future economic cycles and during economic downturns entities may overprice bad news into their models, the combination of which may result in significant volatility in reported profit or loss, with the reporting of such gains and losses not being aligned with the realisation of the actual losses. History points to a mispricing of risk cover over the economic cycle.

We also believe that the model proposed by the ED would be both costly and complex to implement in practice and to maintain over a period of time. Concerns regarding the availability and reliability of data were raised by several of our constituents, noting that they do not currently have sufficient historical data on certain portfolios to accurately estimate expected cash flows, while attempts to obtain comparable data in the market have failed. Difficulties associated with explaining the financial results (outcomes) of the proposals to stakeholders would also present challenges, such as why impairments have changed due to changes in future forecasted economic cycles and the interaction between the various inputs in the impairment models. Financial institutions have also pointed out that potentially they would be required to run 3 models for interest income under the ED, namely:

4. Contractual interest for client statement purposes;
5. Amortised cost under the expected loss proposals; and
6. Amortised cost using IAS 39's existing principles.

Item 2 is required in terms of the ED and item 3 will be required to be retained to fulfil certain of the ED's disclosure requirements. The Banking industry believes that the modelling of expected cash flows in terms of the requirements of the ED will require extensive changes to their credit models. Based on their Basel II experience, this will be both expensive and time consuming to implement. It is considered highly probable that the proposed model will not be consistently applied in practice due to complexity and forecasting requirements. There will also be an increase in management's ability to

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manipulate reported results (through over conservatism in initial loss expectations and management judgement in forecasting expected cash flows). Furthermore, auditors believe that the proposed model will result in more complex and costly audits owing to the complexity of such models and the requirement to audit management forecasts of future economic cycles. Many auditors also questioned how such a model would be able to be audited in practice. Therefore, we do not believe that the benefits of the ED's proposed model will necessarily outweigh the cost of implementation.

Noting what we have said above, we have set out below (refer to Question 4) an alternative proposed model.

We note the US Financial Accounting Standards Board's (FASB) exposure draft, *'Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities'* that was released in May 2010 and for which comments are due by 30 September 2010. We have incorporated, where necessary, references to that document that we believe complement our suggestions on simplifying the proposals and should be considered by the IASB as part of its efforts in achieving convergence with the FASB.

We also note that the IASB and the FASB affirmed June 2011 as the target date for completing the major projects in the 2006 Memorandum of Understanding, as updated in 2008. We note that the IASB and FASB intend considering all comment letters and feedback received on each board's proposals during Q4 2010 to Q1 2011. We continue to support both the IASB and FASB's efforts in convergence, especially in accounting for financial instruments. However, given the later release of the FASB's proposals, we have not had the opportunity to fully comprehend and comment on all of its proposals. Further, we believe that a better process would have been for the boards to first develop and agree on a single impairment model and to have then exposed it for comment. We recommend that the IASB re-issue an exposure draft on impairment for comment after considering the comment letters jointly with the FASB. We believe that this would be appropriate given the diversity of the two proposed models. We also recommend that the IASB publish the finalised findings and recommendations of its Expert Advisory Panel at the same time to afford constituents the opportunity of commenting on these.

Finally, we recommend that the IASB re-expose IFRS 9 – *Financial Instruments* (IFRS 9) once all phases of the IASB's replacement project have been completed.

SPECIFIC COMMENTS

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?

We do not believe that the objective of amortised cost measurement in the ED is clear for the following reasons:

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- We do not agree with the description of amortised cost for financial instruments as a cost-based measurement. The subsequent measurement of amortised cost financial instruments, as described in the ED, takes into account the initial measurement of the instrument and expectations about the expected cash flow of the instrument. IFRS requires that, on initial recognition, all financial assets to be measured at fair value plus integral transaction costs. The expected future cash flows, at the measurement date, incorporate current and future economic conditions over the life of the instrument.

Therefore, we believe that amortised cost as described in the ED is a hybrid measurement basis that includes both fair value and cost elements, and should be described as such.

- We note that paragraph 4 refers to amortised cost being a measurement basis that combines current cash flow information at each *measurement date*. Some of our constituents noted that the reference to ‘measurement date’ was not clear and recommended that this term be further defined by the ED. Measurement date is defined for the purposes of IFRS 2 – *Share-based Payment* (IFRS 2), but the IFRS 2 definition is not considered to be applicable to this ED as it refers only to the measurement of an equity instrument. Measurement for the purposes of the ED should be at the reporting date being ‘*the end of the latest period covered by financial statements or by an interim financial report.*’ This comment is of particular importance in the context of paragraph 13(d) of the ED that requires disclosure of both ‘*gains and losses resulting from changes in estimates in relation to financial assets and liabilities that are measured at amortised cost.*’ It is understood that the ED thus requires separate disclosure of both gains and losses. The frequency of assessment of changes in impairment may impact on the gross amount of gains and of losses, as illustrated below.

To illustrate – assume two entities, Entity A and B, both with identical loan books, the same expected cash flow information and the same interim (June) and final (December) financial reporting dates. Entity A considers its measurement dates as being its interim and final reporting dates and on these dates changes in cash flow expectations are determined. Assuming that a negative change in cash flow expectations (i.e. deterioration) was only observed at the final reporting date; then a loss will be reported and disclosed. Entity B however re-evaluates its cash flows on a monthly basis. It determines that its cash flow expectations worsened in July, improved in August and then worsened in December, Entity B will disclose both a gain and a loss. As the net result in the financial statements is the same for both entity A and entity B, one would expect comparable disclosures.

Accordingly, it is recommended that the term ‘measurement date’ be aligned with the definition of a ‘reporting date’.

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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?

Yes, we believe that the objective of amortised cost, as set out in the ED, is appropriate for financial instruments measured at amortised cost.

Our comments on the application of the amortised cost approach are included in our responses to the questions that follow.

Question 3

Do you agree with the way the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but does not include implementation guidance or illustrated examples? If not, why? How would you prefer the standard to be drafted instead, and why?

The majority of our constituents found it difficult to understand the application of the measurement principles contained in the ED without the detailed staff examples that were provided on the IASB's website. Those constituents believe that the measurement principles should be clarified and simplified and were in favour of the inclusion of illustrative examples in the ED.

However, a minority disagreed with the inclusion of illustrative examples and raised the following concerns regarding the inclusion of examples in the final standard:

- If examples are included in a standard, it may be difficult to use another equally appropriate method to implement the measurement principle and obtain approval from regulatory bodies and auditors; and
- The examples provided would not cater for all scenarios. This could lead to the application of examples to scenarios by analogy for which they were not intended and this may lead to the incorrect application of the standard.

The minority were rather of the opinion that the principles in the ED should be clarified by the inclusion of additional guidance to ensure that the final standard is able to articulate its principles without having to revert to explanatory examples.

Nevertheless, it was generally felt that the ED needed to be clearer in describing how the approach would work and that examples in themselves should not be relied upon to explain how the principles in the standard should be applied.

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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?

Our comments below deal separately with financial assets and financial liabilities.

Financial assets

The majority of our constituents do not agree with the measurement principles as set out in the ED. As noted in our general comments above, we believe that the method proposed by the ED is overly complex, has several operational and implementation challenges, and the costs of implementing and managing such a model are likely to exceed the benefits.

Further, we believe that the output of such a model will be difficult to understand and interpret by the users of the financial statements. The proposed model should be easy to understand and be able to be implemented at a reasonable cost by all entities, most notably small and less sophisticated corporate and banking entities.

The current definitions of amortised cost and effective interest rate (EIR) contained in IAS 39 should be retained. Specifically, the EIR calculation should not be adjusted for expected credit losses as proposed in the ED. While the ED is sound on this principle, application of the ED's proposals results in complexities, less understandability by users, and costs that are not justified by its benefits.

All of our constituents accepted that management judgement, as exists in IAS 39's current requirements for impairment, should remain in the proposed model. There was no support for an objective formula approach such as that set out in the Spanish model. We further accept that allowing management judgement will always result in a degree of subjectivity and therefore result in certain inconsistency in the application thereof. We do, however, wish to seek to reduce inconsistencies in application wherever possible in our proposals set out below. The subjectivity, comparability and an understanding of the consequences of management judgement should be addressed by means of financial reporting disclosures that should include sensitivity analyses.

Our concerns with the measurement principles and our suggested changes to the proposed model are set out below:

- Amortised cost is determined using both expected cash flows and the effective interest rate (EIR) as the discount rate. In terms of the ED, expected cash flows for financial assets include credit losses over the entire life of the asset. The combination of the EIR and expected cash flows (including credit losses) results in a number of significant operational, system and modelling challenges. We

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recommend that the calculations of interest and impairment be separated from one another for the following reasons:

- The majority of entities maintain separate interest and impairment recording systems.
- In terms of the ED, changes in the expected prepayment of loans can result in the recognition of impairment losses (or reversals) which we do not believe is appropriate. For example, assume that a 20 year loan's expected life is initially expected to be 8 years which is subsequently re-estimated to be 9 years. This change would result in an impairment loss being recognised in profit or loss (since the initial expected cash flows were expected over a 8 year period and now are only expected to be over 9 years), which is not considered to be appropriate since the loan is still expected to be repaid in full before its contractually agreed period. We recommend that the effects of prepayment should be removed from the calculation of expected losses for the performing book. (The concept of a 'performing book' is discussed later in this document). We do, however, believe that the effects of changes in the timing of cash flows should continue to be accounted for in the non-performing book (since the exposure is already impaired). This recommendation is consistent with paragraph 46(b) of the FASB's exposure draft which states that for financial assets that are contractually payable, changes in expected prepayments will not in themselves give rise to a credit impairment. By including such an exception there will be no need for entities to explain components of impairment gains and losses (due for instance to changes in prepayment rates) as required by paragraph 18(a)(i) of the ED.
- In terms of the ED (and as reflected by the staff examples), impairment gains and losses may arise on floating rate financial assets merely because there are subsequent changes in the shape of the interest rate curve. We recommend that the ED exclude the requirement to record impairment gains and losses in such instances. This would also achieve consistency with paragraph 47(c) of the FASB's exposure draft which indicates that changes in such variable rates will not in themselves give rise to a credit impairment. Again, by including such recommendations in the final standard, there will be no need for entities to explain components of impairment gains and losses (due for instance to changes in variable rates) as required by paragraph 18(a)(i) of the ED.
- Further to the comment above, in countries such as South Africa, the interest rate on mortgages is typically linked to an administered rate (referred to as the Prime Rate of interest). The requirement to forecast administered rates will pose further modelling challenges.

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Further, as articulated below, the recognition of interest income and expected losses should be separated in profit and loss, i.e. disclosure of expected losses should not be required as part of net interest income. We believe that the existing disclosure requirements are better than those contained in the ED in terms of both understandability and providing decision useful information.

- The approach proposed by the ED is best suited to a closed portfolio, i.e. the approach is calculated for each loan individually and not on a portfolio basis. It is recommended that the expected loss approach rather be based on either a portfolio basis or on a specific loan basis, consistent with the way in which the credit risk inherent in an entity's portfolios is managed. Where a portfolio approach is followed, it is accepted that all financial assets within a portfolio should be homogenous in nature.
- The ED does not distinguish between performing and non-performing assets (with the exception of disclosure requirements regarding non-performing loans). Most institutions, especially financial institutions, manage the credit risk related to these two groupings of assets differently. Further, once a financial asset is in the non-performing book, there is a greater ability to forecast the expected cash flows arising from the financial asset than is the case for those in the performing book. Accordingly, it is recommended that the ED's approach differentiate financial assets in the performing book from those in the non-performing book. This will achieve simplicity and facilitate better disclosure and understandability.

To achieve this, it is recommended that the existing requirements for objective evidence of impairment be incorporated into the ED. Objective evidence of impairment would then provide a threshold for including a financial asset in one of the two books. We recommend that the IASB consider and incorporate the FASB's reference to the factors that should be considered in determining whether a credit impairment event exists in paragraphs 43 – 44 of its ED. We recommend that the FASB's guidance be incorporated into a final standard together with IAS 39's existing requirements with respect to objective evidence of impairment as outlined in paragraph 59.

- For the non-performing book it is recommended that the existing requirements contained in IAS 39 be retained regarding the computation and accounting for impairment losses. This is regarded as a balance sheet approach whereby an allowance for impaired loans is established and maintained. Changes in loss expectations should be recognised immediately in profit or loss since the loss event has already been identified.
- We recommend that both a floor and a ceiling be established for the impairment allowance to be recognised on the performing book. We suggest that both a floor and a ceiling be incorporated into the proposals to promote greater

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comparability in reporting between entities and to restrict entities from either under or over providing for expected losses.

This may be achieved by requiring the expected loss for the performing book to be determined as the greater of the ‘through the cycle’ loss rate (not necessarily linked to the Basel parameters), apportioned over the expected life of the portfolio of the loans, and the actual losses for that portfolio recognised in that period. The built up allowance should be greater than zero (refer to the discussion of a negative provision below) and be no greater than the expected loss of the portfolio of loans. Expected loss built up using a ‘through the cycle’ loss rate should make use of historical loss information, but should be adjusted to take into account new information and to remove the effects of any conditions or events that are priced into the historical information, but are no longer present.

This recommendation is also referred to as an income statement approach whereby the timing of the loss recognition is of importance. The use of the ‘through the cycle’ loss rate provides for a loss rate that has been determined over one or more economic cycles, whilst requiring the loss provision to be at least equal to the actual losses recognised in a period through the non-performing book.

A minority of our constituents were opposed to setting a floor and ceiling in a principles-based standard.

- It is recommended that the migration of loans from the performing to non-performing book should be based on the identification of objective evidence of impairment. The incurred loss on the impaired loan will be utilised from the portion of the expected losses that have been built up through the performing book and, if necessary, any increase or decrease in the incurred loss impairment allowance recognised in profit or loss. When an actual loss is realised, the loss should be charged against the non-performing book impairment allowance.
- Loans would move from the non-performing book to the performing book when objective evidence of impairment no longer exists, with any incurred loss provision being transferred back to the performing book and, if necessary, any increase or decrease in the expected loss provision being recognised in profit or loss.
- The majority of our constituents did not agree with recognising changes in loss expectations immediately in profit or loss (paragraph B2). In addition, those constituents believe that there is a contradiction in the objective of recognising initial expected losses over the expected life of the loan portfolio whilst recognising changes in loss expectations immediately in profit or loss.

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Those constituents believe that to require immediate recognition of gains and losses in profit or loss arising from a change in expectation:

- would not be aligned with the recognition of revenue;
- would compound volatility in reported profit or loss and could compound pro cyclicalities, which we understand the IASB is seeking to reduce;
- does not reflect the actual performance of the financial assets in that period (i.e. there may not be objective evidence of impairment but relates to expectations in future reporting periods);
- could result in entities being over conservative in their initial loss expectations to avoid the need for subsequent losses;
- could result in financial statements exaggerating the effect of positive information arising just prior to the reporting date that is negated after reporting date, or vice versa, and noting that such changes in expectations may relate to future reporting periods; and
- would misalign the reported results with the occurrence of the actual loss, i.e. an immediate change in reported profit or loss despite the fact that the loss event, being the change in expectations of future cash flows, may take some time to actually arise.

In responding to the above concerns, two alternative approaches were considered:

- 1) recognise the full change in loss expectations over the remaining expected life of the portfolio; or
- 2) recognise the difference between the initial and revised loss expectations that relate to the period that has elapsed since the financial asset was first recognised in profit or loss, and the rest of the difference (relating to future periods) over the remaining expected life of the portfolio.

In circumstances where initial loss expectations are revised downwards, Approach (2) above would result in a reversal of impairment losses. Accordingly, this approach was rejected on the basis that expected loss allowances could be reduced during positive economic cycles, which is contrary to one of the objectives of the ED, being to increase expected loss allowances during such periods.

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Approach (1) is preferred since it addresses the concerns noted above, most notably the reduction in the effects of pro cyclical and the better alignment with the recognition of revenue. Some constituents did, however, have a concern that Approach (1)'s effect on profit and loss following a change in estimate may not be reflective of current economic conditions. This is because the financial impact of improvements and deteriorations in credit loss expectations are spread over the remaining lifetime of the portfolio. A deterioration in credit conditions just prior to the reporting date would thus not be reflected in impairment, which undermines the relevance of the financial statements.

- Our analyses of the ED's proposals indicated that it was possible to have a negative provision (reporting an amount that is greater than the contractual amount owing), i.e. initial loss expectations are subsequently revised downward (improvement in credit loss expectations), with an immediate catch up for the past and future periods recognised in profit or loss. We do not believe that it is appropriate to carry a negative provision in the statement of financial position. Permitting negative allowances on an overall portfolio basis does not contribute to decision useful information nor does it appropriately reflect that there are still expected losses in the portfolio - a negative provision implies that the expected cash flows are higher than the amount of the financial asset at which it was initially recognised. As noted above, we believe that the expected loss allowance should at all times be greater than zero and hence negative provisions should not be permitted.
- The ED indicates that the estimates of the cash flow inputs into the calculation of amortised cost are expected values. The ED is not specific in indicating whether those cash flows are required to be determined based on extrapolating the economic conditions existing at the measurement date into the future; or whether they should be determined taking into account expected future economic cycles. It is understood that the latter was the intention of the IASB.

We have noted that paragraph 36 of the FASB's exposure draft states that, '*An entity's expectations about collectability of cash flows shall include all available information relating to past events and existing conditions but shall not consider potential future events beyond the reporting date.*' Paragraph 42 further states that, '*In estimating cash flows expected to be collected for its financial assets at each reporting date, an entity shall assume that the economic conditions existing at that point in time would remain unchanged for the remaining life of the financial assets.*' Due to the significance and fundamental nature of this item, we recommend that the IASB consider how convergence with the FASB will be achieved in this area.

Many of our constituents agreed that the requirement to consider only the effects of existing conditions and past events in the determination of expected cash flow information would significantly reduce complexity, the costs of operating such a model and would also enhance comparability. However, whilst

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the FASB's suggestions are useful, clarity will be required as to what is meant by existing conditions, e.g., an interest rate curve may be price in expected future economic cycles. Since paragraph 46(c) of the FASB's exposure draft excludes changes in variable indices in computing impairment gains and losses (as noted above), it is understood that to be consistent, future expectations of economic cycles as implied by indices would also need to be excluded.

- The ED does not explicitly indicate whether expected loss allowances should be recognised for unrecognised financial assets such as unutilised credit facilities and other loan commitments. We recommend that loss allowances be recognised only for recognised financial assets.
- In respect of facilities that have both inflows and outflows, also known as revolving facilities, the ED is not explicit in the principles that should be applied to these facilities, i.e. whether to only assess the current balance or to also take into account future withdrawals of cash. We recommend that, consistent with our comment above, loss allowances be recognised only for recognised financial assets and not be required to take into account future withdrawals of cash.
- We noted that the FASB's ED provides guidance on the accounting for expected losses on renegotiated, or otherwise modified loans, and loans that have been acquired at a discount (due to previous impairment). We recommend that the IASB consider providing similar guidance in its final standard.
- We believe that the objectives of the ED should be based upon the recognition of expected losses on a portfolio basis. The ED does not define what a portfolio is for this purpose and hence suggest that a definition be provided. We recommend defining a portfolio as a '*set of homogenous financial assets based on the manner in which information on financial assets is provided internally to key management personnel of the entity*'. We further recommend that, since the nature of a portfolio will differ from entity to entity, an entity be required to disclose the nature of its portfolios and how those portfolios have changed, if applicable, from one reporting period to another.

Financial liabilities

In terms of the ED, amortised cost shall be calculated using the EIR. Application guidance paragraph B1 states that '*Amortised cost is the amount at which a financial asset or financial liability is measured at initial recognition adjusted over time as follows:*

- (a) *minus principal repayments;*
- (b) *plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount; and*
- (c) *plus or minus any addition or reduction resulting from the effect of revising estimates of expected cash flows (e.g regarding prepayments or uncollectability) at each measurement date.'*

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Paragraph B3 includes a statement that an entity shall estimate the expected cash flows considering credit losses over the entire term of the financial asset and that for financial liabilities, estimates of expected cash flows do not reflect the entity's non-performance risk.

Paragraph B3 thus excludes credit losses, yet paragraph B1 appears to include such items. We recommend that paragraph B1 be redrafted as follows:

'Amortised cost is the amount at which a financial asset or financial liability is measured at initial recognition adjusted over time as follows:

(a) minus principal repayments;

(b) plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount; and

*(c) plus or minus any addition or reduction resulting from the effect of revising estimates of expected cash flows (e.g regarding prepayments or, **in the case of financial assets only**, uncollectability) at each measurement date.'*

(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

As noted above, we recommend that the ED clarify whether expected losses should be recognised for unrecognised financial assets such as unutilised credit facilities, other loan commitments and revolving facilities relating to the future withdrawals of cash.

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?

We agree with the description of the objective. However, we believe that the requirements of paragraph 12 should be clarified. We believe that there are two possible interpretations of the disclosures required by paragraph 12(b):

- 1) a description of the causes of the interactions; or
- 2) an explanation of the causes of interactions.

(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 would you propose and why?

Yes, we believe that the objective is appropriate and is consistent with the requirements of IAS 1: *Presentation of Financial Statements*.

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Question 6

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

Whilst we believe that the primary principles of a revised simplified expected cash flow model should be agreed before addressing presentation and disclosure requirements, we re-iterate that we believe that the recognition of interest income and impairment losses should be separated and not be jointly presented as a single 'net interest revenue' item.

We do not believe that the recommended presentation provides decision useful information and believe that the existing requirements regarding the presentation of interest revenue and impairment losses contained in IAS 39 and IFRS 7 – *Financial Instruments: Disclosures* (IFRS 7) should be retained. Further, to present such items in terms of the ED would suggest that these items are managed together, which, as pointed out above, is rarely the case.

We note further that the wording of paragraph 13 of the ED may be interpreted in a number of different ways. While the net income statement impact should always be the same, the manner in which that number is disaggregated into gross interest revenue, spreading of initial loss estimates, other changes and impairments is not clearly defined and is open to interpretation.

Question 7

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

We believe that the primary principles of a revised simplified expected cash flow model should be agreed before addressing presentation and disclosures. Further comments on the disclosure requirements have been provided below.

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

We believe that the primary principles of a revised simplified expected cash flow model should be agreed before addressing presentation and disclosures. The alternative approach that we have proposed in this document would require a consideration of its associated disclosure requirements. We would welcome the opportunity to consider and provide comment on those disclosure requirements once the final model has been agreed upon.

Notwithstanding this view, we wish to highlight the following concerns that we have with the ED:

- We are concerned overall at the extensive volume and detail of the disclosures that are required by the ED. The prescribed disclosures are so extensive that

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they may lose their usefulness since important facts may become unintentionally hidden. One of the areas where we believe that this is the case is the requirement to disclose certain information by class of financial instrument. We are aware that IFRS 7 currently requires disclosures by class of financial instrument. However, the detail required by the ED, and the nature of its disclosures, may require entities to re-assess their classes of financial instruments and, in some cases, provide additional classes for the disclosures to make sense.

- Some constituents are not in favour of the proposal to no longer split the total provision between a specific and a portfolio provision. Whilst disclosure of the allowance account is required by class and one could provide separate disclosure for the performing and non-performing books, such an approach may appear to be in contradiction with the principles of the ED. As noted above, we believe that each of these items are separately unique and contain valuable information. Our recommendations above to continue to distinguish between a performing and non-performing book would allow such disclosures and would have no inherent inconsistencies with the principles of the suggested model.
- The ED proposes a sensitivity analysis to be disclosed when changing one or more inputs to reasonably possible alternatives could change the initial expected credit loss or subsequent changes in credit loss. Some constituents are concerned that there may be many reasonably possible alternatives and permutations for credit loss expectations. Considering the potential system effects of applying the proposed model we are concerned that the costs of providing this information would far outweigh the benefits of providing this information.
- The ED proposes the disclosure of a comparison of the cumulative loss provision to the gross write offs over time. Whilst we believe that this provides useful information in terms of the ED and our recommended approach, we have the following concerns:
 - The extent to which the disclosures will be required historically and whether it will have to be on an annual basis, as presented in the example in the ED, or whether it would be possible to group the origination dates into time buckets covering certain periods, for example 1 – 3 years, 3- 5 years, 5 -10 years etc.
 - Guidance should be provided for instruments such as revolving facilities and renegotiated loans in terms of the year of origination. For example, a home loan may have been granted 20 years ago but the most recent advance given only 2 years ago. Disclosure could either be provided based on a 20 year old loan or a 2 year old loan. If this is interpreted by entities differently, comparability will be compromised. A suggestion is to differentiate loans by way of their pricing, i.e. loans are disclosed by

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year in which they were priced and only updated for vintage where the pricing is amended.

- The ED, through paragraph B24, presents a split of the cumulative write offs between write offs as a result of delinquencies and those that relate to foreclosures. Many entities do not distinguish between delinquencies and foreclosures. Accordingly, system changes would be required to provide this information. Some constituents do not believe that providing such disclosures provides valuable information to users of financial statements and that the costs would outweigh any benefits of providing such information.
- Regarding the ED's proposal to disclose '*a quantitative analysis of the interaction between changes in non-performing financial assets and changes in the allowance account if that interaction is significant*', some constituents did not agree that there is a direct interaction. Under an expected loss approach, impairment is a function of expected loss while non performing loans are a function of arrears (90 days past due or considered uncollectible). Furthermore, not all performing loans are written off, with many being rehabilitated and others being recovered through security. Therefore, we believe that this requirement adds significant additional volume to the disclosure requirements without commensurate value, especially since, in terms of the ED, there is no longer a distinction between performing and non-performing loans for the purpose of computing expected losses.
- The majority of our constituents were concerned with the proposals to disclose stress tests. While we accept that users would place value on knowing whether or not an entity performs stress tests and the nature of those tests, until now any stress tests performed by an entity would not have been subject to audit. We question whether stress tests that are used for internal risk management purposes should be included in the financial statements and should be subject to audit. Further, we are concerned about the associated costs and complexity that would be added to the annual audit if the auditors were required to audit entities' stress tests. Further, it may not be appropriate for an entity to provide disclosure on its ability to withstand the stress scenario since this may be interpreted as being '*material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern ...*' [IAS 1, paragraph 23]. Further, it may be questioned whether the auditor is able to audit such disclosures.
- The ED requires disclosure of a vintage analysis (paragraph 22 and B29). Some constituents indicated that the vintage information that is being proposed is very different from the vintage information that is currently disclosed in annual reports. The ED requires disclosure of the maturity date of loans per origination date. Those constituents believe that showing the default rate per origination

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date is far more useful for the users of financial statements than the maturity date. Those constituents also noted that vintage information is often more useful and easy to interpret when presented in a graph than a tabular format.

Question 8

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

We are of the opinion that a mandatory effective date of five years post issuance of the IFRS would be required due to the complexity involved in implementing the expected cash flow approach and the requirement of IAS 1 to present three statements of financial position when there has been a retrospective restatement (for a 31 December reporter, a three year mandatory adoption date would require the preparation of an opening balance sheet as at 31 December 2010).

Our comment above would require further consideration should our proposals for an alternative model be accepted by the IASB.

Question 9

(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?

We believe the primary principles of a potentially revised simplified expected cash flow model should be agreed before addressing presentation and disclosures. Notwithstanding this view, we note that the delinking of interest revenue from the determination of expected losses would significantly reduce the complexities associated with transition.

(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

Please refer to our comments in (a) above.

(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 (Question 8) please describe why and to what extent.

We believe the primary principles of a revised simplified expected cash flow model should be agreed before addressing transitional requirements. Notwithstanding this view, we believe that the restatement of comparative information would be required for comparability purposes.

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Question 10

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

We believe that the primary principles of a revised simplified expected cash flow model should be agreed before addressing transitional requirements. Notwithstanding this view, we note that the delinking of interest revenue from the determination of expected losses would significantly reduce the complexities associated with transition.

Question 11

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

We believe that the primary principles of a revised simplified expected cash flow model should be agreed before addressing practical expedients.

Question 12

Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment.

We believe that the primary principles of a revised simplified model should be agreed before addressing practical expedients.