

International Accounting Standards  
Board  
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United Kingdom

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## **Supplement to Exposure Draft ED/2009/12: Amortised cost and impairment**

Far, the Institute for the Accountancy Profession in Sweden is responding to your invitation to comment on the supplement to the exposure draft *ED/2009/12: Amortised cost and impairment*.

Far welcomes the efforts of the IASB to develop a more operationally feasible model for impairment and expected losses for open portfolios.

Far agrees that providing for all expected loss for loans in a bad book and using the time proportional method for the good book will in most circumstances lead to useful information for the investors as that will reflect management's view on the economics of the lending activities. Far agrees with the proposed model but notes that, based on the relatively high level it is described in by the supplemental document, a final standard will require that some of the main concepts are appropriately defined to ensure consistency in practise.

Far believes, however, that the proposed floor of the credit losses expected to occur within the foreseeable future has no conceptual basis and will distort the reporting of the economic substance of lending transactions. Furthermore, Far believes that when the floor triggers the recognition of a day-one-loss it is in conflict with the definition of a loss in the conceptual framework. Far therefore believes that the minimum floor allowance should be removed in the final standard. Far does not believe that convergence of the accounting with the US for impairment justifies a conceptually flawed standard.

In appendix 1 Far sets out its responses to the questions the IASB has raised.

Far



Göran Arnell  
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## Appendix 1

### Question 1

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

Yes, Far believes that the proposed approach for recognition of impairment as described in the supplementary document will most likely make the recognition of credit losses earlier than the current impairment model under IAS 39.

Far has noted that the supplementary document uses several concepts that are not defined. This will increase the risk of inconsistent application and outcomes that will not be comparable. It is for instance unclear whether “expected loss” apart from the loss of the capital amount, also includes;

- losses of interest rates,
- direct costs (such as costs for obtaining and selling collateral),
- cash-flows from financial guarantees or credit derivatives,
- allocated overhead costs etc.

Far believes that the boards should develop a qualitative description of what a loss is in the context of impairment allowances.

### Question 2

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

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

Far believes that the proposed approach is equally operational for closed portfolios as for open portfolios.

Far believes that it is important that the measurement approach should be the same for all portfolios of financial assets measured at amortised cost under IFRS 9. Thus it is important that the logics and mechanics of the amortised cost model are the same also for impairment measurement purposes for both the “good” and “bad book”.

Far also believes that a simplified approach may be appropriate where a strict application of the guidance would not be practicable. Such a simplification should result in a reasonable approximation of the original measurement approach and should not introduce new concepts. Different approaches for measurement will in fact introduce sub-categories under the amortised cost method, which in turn will create complexity for both prepares and users.

Far therefore believes that discounting is an essential part of the amortised cost model and conceptually discounting would also be a core component for impairment measurement purposes. The final standard should thus clarify that both the “good book” and “bad book” assessment of impairment should consider the time value of money. This can be done either by including the effect of discounting implicitly in the loss measures, which should then not be discounted, or on nominal loss measures that would require explicit discounting so that the concept of the time value of money is considered or approximated.

As mentioned in the comment letter to ED/2009/12 Far does not believe that the use of “probability-weighted possible outcomes” is a relevant measurement basis for single assets. Far believes that the use of statistical measures for individual assets will lead to recognition of amounts of losses that never will occur in reality. In situations when the entity holds a number of assets that is too small to result in a sufficiently significant statistical measure of the probability to default in payments, the amount of amortised cost should not consider these statistical measures until they become realistic measures of cash-flow of the instrument. Otherwise the amount of amortised cost will be a number that will never be the amount that actually will eventually be collected since the amortised cost will then either be too small (if there is no default) or too high (if there actually is a default).

### **Question 3**

*Do you agree that for financial assets in the ‘good book’ it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?*

In Far’s view it is appropriate to recognise impairment allowances in the “good book” using the time proportional method. The time proportional method has sufficient conceptual merits in its approximation of amortised cost and is at the same time operational. The time proportional method results in deferral and matching of revenue (interest) and expense/loss (credit losses) in a manner that should portray the economic result of the lending activities in a fair manner not overstating earnings during times where credit losses accrue but that are not realised until later.

Far does not think, however, that introducing a floor of the credit losses expected to occur within the foreseeable future is appropriate. This floor not only lacks conceptual merits, it is even in conflict with the definition of a loss in the conceptual framework. The Framework defines a loss as “decreases in economic benefits”. The floor will in many situations result in “day-one-losses” that do not represent decreases in economic benefits.

### **Question 4**

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

Far supports the efforts of the IASB to develop an operational and simplified approach to the expected cash flow model. Whether or not it is operational for entities will depend on the ability to extract the information with regard to, for instance, the weighted average age and weighted average life of a portfolio. There will be entities that will need to amend systems and processes to be able to operate the model. Far also believes that there remain operational challenges to assess the total expected credit losses over the remaining life for companies that have chosen not to use more advanced models for capital adequacy purposes.

**Question 5**

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

Far believes that basing the impairment allowance on a time proportional expected credit loss method is useful for decision-making. This impairment allowance will reduce the net income from the lending activities to reflect the expectation that some of the interest rate margin is a charge for expected losses. It is more useful to recognise the interest rate revenue on a gross basis and not mix this revenue with a reduction for the originally expected credit losses as was made in the previous proposals. This deferral of income made as an impairment allowance portrays fairly well the performance of a bank.

Far does not think that a floor of credit losses that are expected to occur within the foreseeable future (when this allowance is higher than the time proportional) provides for information that is useful for decision-making. When using this floor, new loans will many times generate “day-one-losses” which is an irrelevant measure of performance and equity will constantly be understated using this method when the floor is higher than the time proportional allowance.

Far believes that the IASB approach could be modified so that adequate provisions are made also for portfolios with front- or end-loaded loss emergence patterns. However, Far believes that a floor is not the best way to deal with this issue. Far believes that another way to solve this issue is to have a principle where

- a time-apportioned method of recognising future credit losses should be applied,
- an assumption of a straight-line pattern for expected future losses is an allowed practical expedient, but
- there is clear evidence of a significant different pattern for loss-emergence, this other pattern should be used.

**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?*

Far believes that the requirement to differentiate between the “good book” and the “bad book” is described clearly enough for loans that under the current IAS 39 are assessed for impairment on an individual basis. Far believes that an approach based on the two groups is appropriate, since it allows entities to reflect the internal management model in accounting for impairment of their loan portfolios. However, for loans that are assessed for impairment on a collective basis under the current IAS 39 it is not clear how the requirement should be applied for smaller loan balances where there is no active individual assessment of the credit risk.

**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?*

Far believes that once an entity has chosen the criteria (or criteria for different portfolios) of what is a “bad book”, it should be possible to audit that the entity has consistently and correctly adhered to this criteria when differentiating loans for impairment allowance purposes.

**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?*

The proposed requirement is fairly consistent with the current requirements in IAS 39 to recognise losses on an individual basis when losses have been identified individually and a supplemental collective allowance is made for losses in groups of loans that are not individually impaired. Far finds this current concept to be a sound concept and therefore supports the general idea of this differentiation.

**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.*

**Far’s responses**

- (a) No, Far does not agree with the minimum allowance floor. There is no conceptual basis for this allowance in cases where the floor creates a “day-one-loss”. Far finds this result to be incompatible with the conceptual framework. The “day-one-losses” will also give a distorted presentation of the performance and position of the entity since there is no economic basis for recognising a loss simply because a new loan has been granted. Far does not believe that a floor is the correct way to deal with the risk

of inadequate provision balances for portfolios that clearly do not have straight-line loss emergence patterns in cases when this has a significant impact.

- (b) No, Far does not think the minimum allowance floor is an acceptable measure of impairment in circumstances in which there is evidence of an early loss pattern. If the boards believe that there should be a different calculation of the impairment allowance when there is a loss pattern that is clearly not linear, this should in that case be resolved within the requirements of the time proportional credit losses.
- (c) See answers to questions (a)-(b) above.
- (d) See answers to questions (a)-(b) above.
- (e) See answers to questions (a)-(b) above.
- (f) See answers to questions (a)-(b) 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.*

Far does not have data to determine whether the floor typically will be equal to or higher than the amount calculated with paragraph 2(a)(i) but is positive that this will sometimes be the case (such as when the entity has a growing business).

**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) Far believes that conceptually the time value of money should be considered in a model for impairment for amortised cost. This can conceptually and in practise either be done implicitly in the estimation process of future losses, or if future losses are established based on undiscounted amounts, explicitly through discounting. The way to calculate the impact of time value of money should approximate the outcome of the effective interest rate method. Apart from being inconsistent with the amortised cost method, the proposals will also make comparison of financial statements more difficult. A practical problem with discounting expected losses is the inherent uncertainty in when the losses will occur. In many cases entities have underlying data to support the amount of the expected losses but not necessarily of the timing of the expected losses. Entities should in these situations be allowed to use as a practical expedient the assumption that expected losses are evenly distributed over time, unless there is clear evidence of a different loss pattern than straight-line (see also answer to question 5 above).

- (b) The choice of the discount rate should for conceptual reasons follow or approximate the original effective interest rate. Allowing another choice than the original effective interest rate (or an approximation of this rate) would introduce a new measurement basis which in turn would make accounting for financial instruments more complex to understand rather than simpler. Furthermore, the option for preparers to use different discount rates leads to lack of comparability. Far therefore believes that the final standard should include a principle that states that the measure of expected loss should approximate a measure of cash flows consistent with the amortised model.

If an entity chooses to not to discount its estimates of future losses that includes capital amounts as well as interest (and potentially also other amounts such as direct and indirect costs) and does not discount these amounts, the provisions will be larger than for another entity that chooses to discount its estimates of losses that implicitly already are discounted in the estimates of future losses and only includes capital amounts. This may give rise to significant differences in provisions for portfolios where the average life is long and the weighted average age is short. These differences in deriving the provisions for impairment are not desirable, and the final standard should ensure sufficiently consistent application of the same principles taking into consideration of materiality and thus explicitly allowing for practical expedients that approximates the outcome of a more literally compliant application of the principles.

#### **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?*

Far supports the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in the supplementary document for reasons explained in the answers above. However, as stated in the reply to questions 5 and 9(a), in cases where there is clear evidence of a significantly different pattern for loss-emergence than a straight line pattern, then amortisation should be made using this other pattern.

#### **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?*

Far does not prefer the FASB approach for assets within the scope of this document due to the fact that it would lead to information that is both irrelevant and misleading to users and is based on a loss concept that is not in compliance with the definition of a loss in the Conceptual Framework. Far does not prefer the general concept of this FASB approach for the same reasons.

**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 LASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?*

Yes, Far agrees that the determination of the effective interest rate should be separate from the consideration of credit losses. Far believes that accounting for interest rate revenue and credit losses should be made in separation. Apart from the operational challenges of the original proposal, Far believes that conceptually interest rate is earned to cover different expenses including (credit) losses regardless of whether these losses are expected or unexpected. This gross presentation of income and expense is more in line with the general requirements of IAS 1 not to offset income and expenses than the previous ED and also provides more clear information to users.

**Question 15Z**

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

Yes, Far thinks that, from a conceptual point of view, loan commitments that are not accounted for at fair value through profit or loss and financial guarantees should also be subject to the impairment requirements and the time proportional allowance. Also, loan commitments and financial guarantee contracts are contracts that expose the issuer to credit risk and credit losses, and the matching of income and expense should be made in the same manner for these contracts as for loan contracts.

**Question 16Z**

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

Far believes the model would be operational for loan commitments and financial guarantee contracts for most banks since these instruments contain credit risk similar to the credit risk of loans. Far believes however that there may be operational challenges for insurance companies to use the concepts for the forthcoming amendments to IFRS 4 insurance contracts for some of its contracts, and IFRS 9 impairment concepts for credit insurance contracts.

**Question 17Z**

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

Yes, Far agrees with the idea to de-couple the accounting for interest rate revenue from the accounting of expected credit losses and how these items of income and revenue are matched over time.

**Question 18Z**

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

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

(a) Far agrees in general with the proposed disclosure requirements. Far presumes that all disclosure requirements for financial instruments (ie disclosure requirements currently in IFRS 7 and those disclosures required by this draft IFRS) are eventually presented together in IFRS 7.

(b) Far acknowledges that vintage information in some circumstances may be valuable, but in addition Far sees several other disclosures that may be even more valuable to understand the credit risk of the portfolio (e.g. information about collateral, loan-to-value information). Other additional disclosures should be

- that information about the sensitivity of the most important assumptions underlying the calculations should be made,
- whether discounting or not has been applied (in the event that the final standard allows a choice of whether discounting is applied or not) and
- what interest rate that has been used for discounting (in the event that the final standard allows a choice of discount rate).

**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?*

Far does not agree that there is any value in this information to users of financial statements and it would create additional administrative burdens to keep track of an allocated collective allowance to be able distribute it to individual loans. The analysis of the allowance account for bad loans would, as is common practise today for loans that are individually assessed for impairment, include an amount representing the allowance for credit losses that have been individually indentified as impaired during the reporting period. Far cannot see any value in the information of comparing this amount to the amount transferred out of the “good book” since these amounts will generally, for obvious reasons, not match and the information of the mismatch would be irrelevant to users.