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Sir David Tweedie, Chairman International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

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Dear Sir David,

#### RSM International

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Re: Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment

We are pleased to comment on the Exposure Draft Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment ("the ED"). While we support the Board's efforts to reach common ground with the Financial Accounting Standards Board (FASB), we have some significant concerns with the proposed approach primarily because we believe that it would introduce unnecessary complexity.

To demonstrate the complexity, the scope of the document is limited to open portfolios of loans and debt instruments. Under the common approach proposed in the ED, not only would separate and distinct computations of impairment allowances be required for the 'good book' and the 'bad book' portions of open portfolios, but also the determination of the impairment allowance for the 'good book' portion itself would necessitate multiple computations of expected losses for various time frames. Minimally, reporting entities would need to separately compute time-proportional expected credit losses and credit losses expected to occur within the foreseeable future for each segment within the 'good book' open portfolio. However, it appears that the Board expects more than just these two computations. Specifically, in paragraph B7 of the ED, the Board states that "As a practical matter, for pools of financial assets with longer expected lives, determining the time-proportional allowance amount would involve developing expected loss estimates for both shorter-term and medium-term time periods and for time periods that are farther into the future".

Coupled with this is the additional complexity and subjectivity of continuously establishing the estimated weighted average life for each 'good book' segment of an open portfolio, with consideration given to defaults, extensions, prepayments, renewals and any other factors that cause the actual life to differ from the contractual life.

As noted in the introductory section of the ED, the Financial Crisis Advisory Group identified the complexity of multiple impairment approaches as one of the two primary weaknesses in accounting standards and their application. We have identified several areas where the proposed common approach would increase, rather than decrease the level of complexity from the existing model in IAS 39 as well as from the model proposed by IASB in November 2009 in its original exposure draft on this subject. For these reasons, we are more supportive of the FASB preferred approach to recognise expected credit losses for the foreseeable future than we are of the proposed common approach or the preferred IASB approach. Our responses to specific questions raised in the exposure document follow.

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# **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?

Regarding the requirement to recognise the higher of time-proportional expected credit losses or credit losses expected to occur within the foreseeable future for the 'good book', we believe the requirement to estimate time-proportional expected credit losses adds unnecessary complexity as spreading the expected loss over the estimated life of a pool of assets does nothing to address the perceived issue of delayed recognition of credit losses.

With regards to the application of the proposed approach overall to 'good book' loans, we believe that whether it will address the issue of delayed recognition of credit losses will vary between reporting entities depending on how each reporting entity defines and interprets the term "foreseeable future". Without examples or guidelines as to how to define the foreseeable future, we suspect that many reporting entities may default to the use of the minimum twelve month period, which would likely result in an estimated allowance that approximates what is computed currently under existing guidance for homogeneous loan pools. This is consistent with the Board's observations from outreach activity as noted at paragraph BC82 in the ED ("The FASB learned from many constituents . . . that forecasting and recognising impairment losses for the twelve months after their reporting date may not significantly change current allowance balances"). One could construe from this that if the foreseeable future is not required to minimally be a twelve month period, the estimated allowance for homogeneous loan pools could actually decline under the proposed guidance. Others may interpret the term foreseeable future in such a manner that loss recognition would extend well beyond those losses that have been incurred at the balance sheet date. Thus, if this model is ultimately adopted, we believe that the Board should provide examples or guidelines demonstrating the principles for identifying the foreseeable future that promote the objective of timely recognition of losses that have been incurred.

With regards to loans in the 'bad book', it is hard to predict the impact without guidance as to how losses on the bad book will be determined for open pools, when it would be appropriate for an asset to be moved out of the pool and evaluated individually and if and how the allowance will be adjusted upon movement from the good book to the bad book or out of the pool to an individual evaluation. Paragraph B3 of the ED acknowledges that entities often manage "bad" assets on an individual basis. It is not uncommon for assets that are reviewed individually to appear to be fully recoverable based on a strong collateral position that if evaluated as part of a pool would likely have allocated some level of expected loss.

With regards to the application of the proposed approach to debt securities, as noted in the ED at paragraph BC24, FASB believes debt securities will more often be evaluated individually due to unique risk characteristics. We are in agreement with this viewpoint and are uncertain how this guidance would be applied to debt securities, which to date have been evaluated individually. As such, we believe that field testing would be warranted to determine if such an approach should be applied to open portfolios of debt securities and if the desired outcome would be achieved. If the decision is made that debt securities should be subject to the proposed approach, this is an area where implementation guidance would be useful in making the determination of when it would be appropriate to group certain securities and how one would estimate expected losses on a pool basis.

# **Question 2**

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

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

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On the surface, it appears that the proposed model would be at least as operational for closed portfolios and other instruments as it is for open portfolios. We would recommend that field testing occur prior to the finalisation of the standard to ascertain that any proposed method(s) is operational and achieves the desired objectives of reducing complexity and adequate upfront loss recognition.

### **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?

As stated in our introduction and our response to Question 1, we believe that the use of a time-proportional approach to establishing an allowance for impairment does not address the perceived issue of delayed recognition of losses and adds unnecessary complexities to the process of establishing the allowance for the good book given that ultimately, a floor will be invoked to ensure losses for the foreseeable future are recognised.

We believe that the FASB preferred model of recognising expected credit losses for the foreseeable future is more appropriate, assuming that guidelines and examples are provided with regards to the determination of the foreseeable future and when it may be appropriate to shorten or extend that time period. In addition to the computational complexities involved in estimating life time expected losses and recognising them time-proportionately, we do not believe that it is possible to estimate life time expected losses on long-term assets with the level of precision that would make such estimates meaningful. By definition, foreseeable future is the future time period for which reasonable and supportable information exists to support specific projections of events and conditions for that period. Therefore, the implication is that estimated expected losses beyond the foreseeable future are based on unreasonable or unsupportable information, making auditing such estimates extremely difficult and presenting opportunities for earnings manipulation. Our views appear to be consistent with observations noted throughout the ED including paragraph BC20 ("FASB believed that entities could not feasibly forecast macroeconomic factors and economic cycles through the life of financial assets with a sufficient degree of reliability") and paragraph BC27 ("Most investors...agreed that it is difficult, and some think impossible, to forecast total credit losses and the timing of those credit losses over long periods of time"). Last but not least, we are concerned that a focus on lifetime expected losses considers losses that have not been incurred and that there is no support for such a position.

# **Question 4**

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

We believe the mechanics of the calculation, as demonstrated in paragraphs IE6 and IE13 of the ED are easily understood. However, as noted in our response to Question 3, the difficulty would lie in forecasting losses throughout the life of a long-term asset with enough precision to make the estimate meaningful. We believe that any perceived benefits of time-proportional recognition do not justify the time and effort it would take to perform this separate computation for comparison to the expected credit losses for the foreseeable future in determining the impairment allowance for the 'good book'. As indicated in paragraph BC28 of the ED, information indicates that losses tend to occur early in many assets' expected lives. Lastly, introduction of a time-proportional approach for the 'good book' necessitates that a different approach be used for the 'bad book' as most agree that it is not appropriate to defer losses on the 'bad book'. One of the goals of the financial instruments project is to eliminate numerous methodologies for determining impairment.

# **Question 5**

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

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We do not believe that the proposed approach of using time-proportional recognition of credit losses would be useful for decision-making because (a) the information would not be sufficiently reliable and (b) recognising the losses on a straight-line or annuity basis would simply be an arbitrary allocation of losses over the estimated life of the assets.

### **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?

The principle is clearly described in B2: an asset is included in the 'bad book' when the uncertainty about its collectibility has taken precedence over its profitability from the interest charged. However, the guidance for applying the principle is less clear. Paragraph B3 states that an entity shall differentiate between the two groups on the basis of its internal credit risk management. For example, some banks move loans to a special assets division when the loan is classified as "watch" while others would not move a loan to the special assets division until the loan is classified as "substandard". Paragraph B4 suggests that a loan would not be moved to the 'bad book' until it was classified as doubtful. We believe that this demonstrates that the proposed model would result in a divergence of practice between reporting entities. As such, we recommend consideration be given to retaining the FASB's current definition of loan impairment for purposes of identifying the 'bad book' ("probable that the creditor will be unable to collect all the contractual interest and principal payments as scheduled in the loan agreement").

#### **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?

As noted in our response to Question 6, we believe that the differentiation will be interpreted in vastly diverging manners and that it may be preferable to clearly define impairment rather than introduce a methodology for distinguishing between the 'good book' and the 'bad book'. If the proposed distinction is maintained, guidelines and examples will help make differentiation more operational and auditable. Additionally, clearly articulated enhanced policy disclosures will facilitate auditing adherence to the policy.

# **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?

We agree with the proposed requirement to differentiate. If a loan or debt security is not performing or collection has otherwise become uncertain, it has a much higher probability of loss and therefore, it makes sense to record the full expected loss at that point.

#### **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?

We agree with the proposal in this respect. If the allowance for the 'good book' was based solely on time- proportional expected credit losses, it may be insufficient to cover expected losses in the early years, when they are most likely to occur.

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(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?

We do not believe that it would be beneficial to make this distinction and further complicate the process for arriving at the allowance for the 'good book'.

(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?

We agree that the minimum amount should be based on losses expected to occur within the foreseeable future and to provide additional guidelines and examples to promote arriving at an appropriately defined foreseeable future for each asset type. Care would need to be exercised in developing such guidelines and examples to promote adherence to the fundamentally sound loss recognition principle that a loss is recognised when incurred.

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

We agree with establishing the expectation that the foreseeable future will remain fairly constant for each asset type as is conveyed in paragraph B14 of the ED. An ability to significantly lengthen or shorten the period defined as the foreseeable future can present significant opportunities for earnings management and for lack of comparability of the allowance balance from period to period.

(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.

We believe in general the foreseeable future can extend beyond twelve months. Using the most recent economic crisis as an example, expert predictions were readily available and general consensus reached on key factors such as the expected duration of the recession, and when housing prices, delinquencies and unemployment would stabilise. While it is difficult to generalise and state that in all cases, the foreseeable future will be a minimum period of twelve months, we believe that not instituting a minimum of twelve months could have an undesired consequence of too low computed reserves on 'good book' loans as we elaborated on in our response to Question 1.

(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.

We do not believe that a ceiling should be established. Besides introducing more complexity, it would be to the detriment of the proposed model's objective.

# **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.

We believe that this question would best be answered through field testing if the decision is made to potentially move forward with the time-proportional allowance concept.

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# **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?

We believe that a single method would promote comparability between entities. However, given all the complexities in the proposed common approach and the various renditions that one would need to go through in estimating the 'good book' allowance, this may be a desirable concession to otherwise minimise complexity.

# **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?

We do not prefer the IASB's approach given that time-proportional recognition of losses would not completely address the perceived issue of delayed recognition and given the difficultly of determining remaining life expected losses on long-term assets with meaningful precision.

# **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?

We prefer the FASB's approach as it results in upfront recognition of foreseeable losses, thus addressing the issue of delayed recognition in a more operational and less complex manner.

We would be pleased to respond to any questions the Boards or their staff may have about any of the preceding comments. Please direct any questions to Robert Dohrer, Chair of the Transnational Assurance Services Executive Committee of RSM International (tel: +1 919 645 6819; email: robert.dohrer@mcgladrey.com).

Sincerely,

Jean M Stephens Chief Executive Officer RSM International

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