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1 April 2011

Dear Sir/Madam

**RESPONSE OF THE ACCOUNTING COMMITTEE OF CHARTERED ACCOUNTANTS IRELAND**

**SUPPLEMENT TO ED/2009/12: FINANCIAL INSTRUMENTS - IMPAIRMENT**

The Accounting Committee ('AC') of Chartered Accountants Ireland welcomes the opportunity to comment on the proposals contained in the above document.

In broad terms, AC favours the approach proposed in the supplementary document in that it essentially achieves the same result as that proposed in the original exposure draft without the same degree of operational complexity. AC does, however, have concerns that there is a lack of application guidance provided in what is, to some extent, a necessarily subjective area. In particular, AC considers that further clarification around the concept of the 'foreseeable future' and how this interacts in practice with the expected losses over the remaining life of a portfolio of loans is needed when calculating the amount of loan allowance for the 'good book'. Similarly, AC would welcome further guidance to clarify:

- the accounting where the requirements with regard to the 'floor' apply, namely whether one books the absolute amount of the floor or the excess over the time proportional amount;
- whether the floor results in 'day one' provision for impairment;
- how to account for changes in expected lives or expected credit losses.

These and other observations are set out in the appendix to this letter which provides responses to the questions posed in the document.

Should you wish to contact us about any of our comments please feel free to do so.

Yours faithfully

Mark Kenny
Secretary to the Accounting Committee

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**APPENDIX**

***General***

**Question 1**

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

AC considers that the delayed recognition inherent in the incurred loss approach is dealt with in this supplementary document by virtue of recognising either (a) time-proportional credit losses expected to occur for the remaining lifetime of the loans (subject to minimum amount of credit losses expected to occur in foreseeable future) or (b) the entire amount of expected credit losses for the remaining life of the loan. AC is of the view that this approach will expedite the recognition of credit losses in the financial statements, as well as maintaining the link between the pricing of financial assets and expected credit losses. Concerns relating to the application of certain aspects of the approach are set out as appropriate in the responses below.

***Scope – Open portfolios***

**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.**

While the above approach is possible to implement for single assets or closed portfolios, AC would question the 'one-size-fits-all' approach with respect to impairment from an operational perspective and the related burden it may place on smaller entities.

***Differentiation of credit loss recognition (paragraphs 2, 3 and B2–B4)***

**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?**

AC agrees with the time-proportional aspect of the model for the good book which recognises expected credit losses for a portfolio of loans over a time period. This essentially achieves the same result as that proposed in the original exposure draft without the same degree of operational complexity. AC notes that the inclusion of a 'floor' reflecting the amount of credit losses expected to occur within the foreseeable future is a product of the joint deliberations with the FASB and would consider its inclusion to be consistent with the overall objective of

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earlier recognition of credit losses. AC believes, however, that further guidance is needed with respect to its application.

**Question 4**

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

The allocation of expected credit losses over the expected life of a portfolio is intended to approximate the original proposals in the exposure draft while reducing its operational complexity. While this approach is simpler, it is not without potential operational challenges. For example, determining the weighted average age of different portfolios may be difficult, particularly in the case of large financial institutions. Sufficient data would need to be maintained particularly around historical origination and expected maturity. Entities would also need to consider prepayment options, call options and extension options. In addition, added complexity may arise for financial assets without defined maturities such as credit card receivables and overdrafts. A sufficient lead time would be required to deal with these operational complexities.

In addition, AC feels that application guidance is required to provide greater clarity in respect of how a change in the expected losses for a portfolio of loans is to be reflected in the financial statements. It is considered that confusion could arise around how much of the change should be recognised immediately and how much should be recognised over the remaining life of the portfolio, unless some specific worked examples are provided in the supplementary document.

AC would also point out that the decoupling approach set out in the current proposal requires two different expected life calculations, for effective interest rate and expected loss. B9 states that the total expected life of a portfolio "is based on the time that the financial assets within the portfolio are expected to be outstanding from inception to maturity (for example, considering prepayment, call, extension and similar options and defaults)". The definition of effective interest method in IAS 39.9 excludes future credit losses. This can lead to a mismatch of interest income and related credit losses in cases where the expected losses occur early in the life of the loan.

AC further suggests that the Boards consider addressing the required accounting where an entity revises its judgement with regard to expected life.

**Question 5**

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

Yes, as it incorporates expected losses into the value of financial assets.

**Question 6**

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

Yes the requirement to differentiate is clearly described. See also the response to question 7.

**Question 7**

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

AC considers that the approach is operational/auditable but will, by necessity, rely on management's own internal credit risk systems and this will inevitably give rise to variations in practice. It is considered that appropriate disclosure will help to overcome this.

**Question 8**

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

AC considers that the approach reflects how many financial institutions currently manage their loan portfolios.

***Minimum impairment allowance amount (paragraph 2(a)(ii))***

**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:**

In advance of dealing with the specific questions below, AC would make the following observations. AC believes that more application guidance is required with regard to the concept of the 'foreseeable future', and how this interacts in practice with the expected losses over the remaining life of a portfolio of loans, when calculating the amount of loan allowance for the 'good book'. AC notes the illustrative examples provided, and the table in IE6 in particular. In this table, it is not clear whether the 'FFP expected credit losses' is calculated based on the expected credit losses over the remaining life of the portfolio or is an amount separately derived.

Another source of confusion arises as to what is the correct amount of cumulative impairment allowance to be recorded when the floor is invoked and the foreseeable future period exceeds 12 months. For the purposes of illustration, assume a loan portfolio with a weighted average life of 5 years and expected losses over that period of 100, apportioned on a straight line basis (i.e. 20 per year). Assume that the FFP is 2 years and the following loss pattern: Y1 – zero, Y2 – 50, Y3 – 30, Y4 – 10, Y5 –10. At the end of the first reporting period, the floor amount is 80 (i.e. 50 in year 2 and 30 in year 3). Given that the TPA at the end of year one is 20, is the cumulative impairment allowance at the end of year one:

- 80 [i.e. (50+30); the absolute amount of the losses in years 2 and 3] or
- 40 [i.e. (30+10); where 30 and 10 represent the excess of the floor amount over the expected loss in years 2 and 3 respectively].

AC also felt that there was a lack of clarity about whether the application of the floor would result in day one impairment provisions. Some further clarification on the foregoing would be helpful.

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**a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?**

AC agrees with the Board's proposal to introduce a floor for the impairment allowance to ensure that losses expected to occur in the foreseeable future are fully provided for. This mitigates the risk of delayed loss recognition for portfolios of assets in which losses occur early in a portfolio's life.

**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?**

AC is unclear as to how this represents an alternative approach, but in any case believes that the floor should be invoked regardless of loss patterns.

**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?**

AC considers that the proposed approach of determining the minimum allowance amount on the basis of losses expected to occur within the foreseeable future is reasonable. AC would note with regard to the length of the foreseeable future period that while, in the interests of comparability, it might be preferable to apply a simple fixed time period of say 12/24 months, as opposed to requiring entities to determine the length of the foreseeable future period for each open portfolio, the differing markets and economies in which entities operate would make this 'one-size-fits-all' approach inappropriate. Appropriate disclosure should help reduce any issues around comparability.

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

AC is of the view that the 'foreseeable future' period may change during times of economic crisis, but would caution against allowing a situation where an economic downturn leads to a shorter foreseeable future period, ultimately resulting in a reduced loan allowance recorded.

**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.**

AC has no specific data on the foreseeable future period for particular portfolios, but would consider twelve months to be a suitable minimum period.

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**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.**

AC agrees that a ceiling should be established, particularly given the current economic climate and the related inherent uncertainty in predicting future economic events. While the ability of entities to foresee future events will vary by industry and geography, three years is considered a reasonable time period at which to limit the 'foreseeable future'. If there are exceptional circumstances that justify a longer period, the burden of proof would rest with the reporting entity to justify any increase.

**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.**

AC has no specific data from a portfolio perspective on the comparison between the floor and the amount calculated under paragraph 2(a)(i). The interaction between the two methods is complex and AC's view is that it will depend on the balance and composition of the portfolios, the weighted average age and life of the portfolios, the length of the foreseeable future period and the sophistication of an entity's internal credit risk management system.

***Flexibility related to using discounted amounts (paragraphs B8(a) and B10)***

**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?**

While AC favours the flexibility proposed on discounting to reduce operational complexity, it is felt that some sort of discounting should be performed. In addition, AC believes that, where entities select a risk-free discount rate, the entity should ensure the probabilities are embedded in the related cash-flows. It should also be a requirement to disclose the discount rate used.

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***<u>Approaches developed by the IASB and FASB separately</u>***

**Question 12**

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

AC favours the common proposal, subject to the caveats outlined in this response, as it overcomes the complexity associated with incorporating expected losses into the effective interest rate, while still being reflective of the economic substance of lending transactions. It is considered that the additional requirements added following consultation with FASB are not overly onerous.

**Question 13**

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

See response above.

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***Questions in IASB-only appendix Z***

***Impairment of financial assets***

**Question 14Z**

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

AC agrees with the pragmatic approach taken by the Board in separating the determination of effective interest rate from the consideration of expected losses. AC believes this approach still meets the Board's overall objective of maintaining a link between the pricing of financial assets and expected credit losses, while simultaneously addressing the considerable operational complexities inherent in the original proposal. AC would, however, refer to our comments in question 4 with regard to the differing definitions of expected life.

***Scope – Loan commitments and financial guarantee contracts***

**Question 15Z**

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

AC considers that this is an area of considerable complexity and is of the view that a proposal document with extensive application guidance would need to be deliberated before making a definitive judgement on the relative merits of this proposal. There are many diverse areas of complexity which include, inter alia, credit cards, development loans, and the legal question of whether an entity can resile from a commitment or not. In addition, the necessary realignment of internal credit risk systems may in some cases take a considerable amount of time.

**Question 16Z**

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

See response to 15Z.

***Presentation***

**Question 17Z**

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

AC agrees with the proposed presentation requirements.

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***Disclosure***

**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?**

AC concurs with the Board's view that the amounts in the statement of financial position and the statement of comprehensive income, in isolation, are not sufficient to allow users of financial statements to evaluate the effects of credit risk of financial instruments on an entity's financial position and performance. The proposed disclosures are extensive but, given the high degree of judgement involved, AC is of the view that generally such detail is necessary. In particular, AC considers the disclosure of information about the impairment allowance which depends on the age of the portfolio compared to its expected life for five years, to be very useful.

**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?**

AC concurs with the proposed approach. AC notes that the 'full depletion' and 'no depletion' approaches were also considered, but would agree with the Board's view that presenting an amount related to the age of the financial asset would provide useful information in a reconciliation of allowance accounts, as well as improve comparability in the measurement of transfers between the two groups. It is also noted that all three approaches result in the same effect on profit and loss and the amount in the allowance account for the two groups.