International Accounting Standard Board
30 Cannon Street
London EC4M 6XH

16 March 2011

Dear Sir or Madam,

Financial Instruments: Amortised Cost and Impairment (Supplement to Exposure Draft ED/2009/12)

We are responding to your invitation to comment on the supplement to the exposure draft Financial Instruments: Amortised Cost and Impairment (Supplement to Exposure Draft ED/2009/12) on behalf of the IFRS Committee of the Slovak Auditing Oversight Authority (UDVA).

Following the discussion at the February and March 2011 meetings of the IFRS Committee of UDVA this response letter summarises the consensus views of the nine member committee on the Supplement to Exposure Draft ED/2009/12.

We welcome the decision to re-expose for comments the key changes in the approach to reporting impairment of financial assets. We welcome the move towards the expected loss model and also the decision to de-couple (i) recognition of gross amortised cost amount and (ii) provisions for expected impairment losses. Refer to Appendix 1 for discussion supporting the de-coupling approach and estimates of expected losses based on credit risk management systems rather than based on discounted expected cash flows (incurred loss). The Appendix 1 also illustrates that the current incurred loss model was in practice applied such that banks actually estimated and recorded expected losses and not incurred losses for loans or loan portfolios with signs of impairment (for ‘fundamental analysis models’ or ‘scoring models’ used in practice).

We disagree with the application of the ‘floor’ based on losses expected in the foreseeable future. Such a floor is inconsistent with initial recognition of financial instruments at fair value as the transaction price (fair value in an arms length transaction) already reflects the expected losses. Further, we do not see how the ‘specific projections’ which are based on cash flow analysis are not ‘incurred losses’.

The proposed time-proportional basis for recognition of expected losses is operational in practice. However, we consider that actual patterns of losses may vary in different portfolios and as such an entity may determine its specific pattern and recognise losses according to that pattern rather than on a straight line basis. We believe that the standard should allow non-straight line amortisation if that better reflects time pattern when the losses are being incurred. That would also resolve the concern we raised previously about possible insufficient provisions in the early periods if the losses are incurred early in the life of the assets. Allowing non-straight line amortisation would also make the floor redundant on a conceptual basis.

While convergence with US GAAP is important, we understand that the US model is to carry the loans on the balance sheet at fair value and overstating provisions through the proposed ‘floor’ (that is recognition ‘too much too early’) therefore only has an impact on classification between profit or loss and other comprehensive income. Under the proposed amendments to IFRSs, the overstatement of provisions due to the ‘floor’ would understate banks’ capital and also understate reported performance of banks with strong growth in the loan books.
As an alternative, we can see a model in which the 'floor' is based on incurred losses rather than losses expected in the foreseeable future. We are convinced that the 'floor' based on incurred losses would give a better information than a floor based on losses expected in the foreseeable future. In our opinion, the floor based on losses expected in the foreseeable future represents an inappropriate application of the principle of prudence.

Our comments on certain other aspects of the proposals are as follows:

(a) We consider that suggested impairment model can be applied not only to open portfolios but also to closed portfolios.

(b) Allowing both discounted and undiscounted estimates combined with a wide range of possible discount rates will create diversity in practice. However, we believe that allowing the diversity will help to make the model simple. At the same time we wonder why discounting by a rate in the range from zero percent to risk free rate is disallowed.

(c) The scope of the ED excludes trade receivables. We could not understand whether there will be changes both to the existing IAS 18 and IAS 39 paragraph 43 which require initial recognition of trade receivables at fair value. Fair value reflects expected credit losses as discussed earlier in our comment letter.

(d) We are concerned that the ED does not define what 'credit losses' are. A clear definition is important in the decoupled approach. The standard should have application guidance on accounting for default interest rates, fees for contract breaches, litigation fees rechargeable to the borrower and other similar items.

(e) We recommend disclosing the total expected loss over the whole life of the assets portfolio in the notes, including a basis of the estimate and whether the amount is discounted or not. The IASB should also stress the existing requirements in IAS 8.39 for disclosure of changes in accounting estimates.

(f) We consider the 'bad book' as a separate portfolio and agree with full impairment provision for such loans. In practice, banks terminate or have a right to terminate loan contracts for defaulted loans which converts such loans into receivables due on demand. The risk management of such loans is significantly different from the 'good book' loans. For 'bad book' specific projections of cash flows should be possible in practice.

(g) We suggest considering reporting risk margin component of contractual interest income as determined at inception as a credit over time to impairment loss expenses. This would achieve that interest income is not overstated by amounts initially not expected to be collected.

If you have any questions in relation to this letter please do not hesitate to contact us at: Úrad pre dohľad nad výkonom auditu, Slovanská 1, P.O. BOX 63, 810 05 Bratislava 15, Slovak Republic.

Yours sincerely,

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Executive Director and Member of Board
Auditing Oversight Authority
Appendix 1 – Support for the De-Coupling Approach

Our key comment on the changes proposed in the original Exposure Draft ED/2009/12, was that the impairment of financial assets carried at amortized cost is an estimate of future cash flows from these assets and discounting to present value. We expressed a concern that such estimate cannot be made with sufficient reliability for a medium or long-term receivable.

Let's assume a 5-year loan repayable in monthly instalments. It is 60 instalments payable at the end of each month. At inception of the loan, it should be valued at the discounted amount of estimated expected cash flows of the loan, not at the discounted contractual cash flows. For this purpose, under the original proposals, the entity would have to estimate when each of the 60 instalments will be repaid and whether it will be repaid at nominal value.

Banks (and other entities) commonly assess the credit quality of the individual loans using financial analysis of financial statements and other information about the borrower (fundamental analysis). This analysis includes mostly short-term indicators and has predictive value for one year only, under favourable circumstances for two years (a foreseeable horizon). This means that in our example, the entity can assess 12 instalments but cannot assess the subsequent 48 instalments.

Therefore, to determine the impairment as incurred loss, we should either require forecasts of the 12 instalments (within a predictable horizon) similarly to capital adequacy regulations in banking or the accounting standard should determine how the results of the analysis are used for the subsequent periods. Even in case this is done, the forecast beyond 12 months period is more in its substance expected value rather than incurred loss. We note that a simple linear extrapolation is not appropriate because in complex homeostatic systems, such as the socio-economic systems, the trends are constantly changing.

Another method, used mainly in banking, which can be used on a group of loans, not on individual loans, is estimating the losses from a time series data taken from a relatively homogenous statistical group (statistical models). Groups of otherwise homogeneous receivables must be divided into further subgroups based on the contractual maturities because statistical patterns of repayment will logically also differ between receivables based on length to maturity, for example a receivable due in 2 or due in 5 years.

Statistical models by their nature provide an indication of the expected losses, not of incurred losses. Already at the grant date of a loan the bank can estimate what loss it can expect during its life. The statistical system gives us information about the cash flows of the loan only indirectly.

One other system used is the "matrix" system or the rating or scoring system. This is the result of a vector of variables that have only an indirect relationship with the cash flows. The results are presented as a scale and each level is assigned an expected loss rather than incurred loss.

In practice, banks manage credit risks based on estimated expected losses, not based on incurred losses. The expected losses are in practice not estimated by discounting cash flows and we therefore support the decoupling of recognition of gross amortised cost carrying value from the recognition of impairment provisions for expected impairment losses.