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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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Email: commentletters@iasb.org

30 June 2010

Dear Sir David,

Re: Exposure Draft 2009/12 Financial Instruments: Amortised Cost and Impairment

Deloitte Touche Tohmatsu is pleased to respond to the Exposure Draft, ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (the 'ED').

We agree with the Board's objective in this phase of the IASB project to replace IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) to address weaknesses of the incurred loss model in IAS 39 that were highlighted during the global financial crisis. An impairment loss model that focuses on an assessment of recoverable cash flows reflecting all current information about the borrower's ability to repay would be an improvement on the current approach in IAS 39 which relies on identification of trigger events and often leads to a delay in loss recognition. However, we have concerns about the specific requirements proposed by the IASB, in particular those to determine, and allocate, the initial estimate of expected credit losses on a financial asset and to use a probability-weighted outcome approach. We believe that this approach will in many cases be unnecessarily complex. Further, the incorporation of potential future economic environments in estimating recoverable cash flows would be extremely complex, costly and burdensome to apply by preparers. The requirement in the ED to forecast future economic environments and events without providing sufficient guidance with respect to the level of objectivity, verifiability, or support for the underpinnings of these inputs presents significant challenges to internal auditors, external auditors, and regulators. Overall, we believe that the measurement principle would not be operational if the Board were to adopt the ED in its current form.

Finally, we note that the impairment approach that the IASB has proposed in the ED differs in many significant aspects from the impairment approach that the FASB has proposed in Proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB ED). Because the financial instruments project is one of the key convergence projects on the IASB's and FASB's joint agenda, we strongly encourage the two boards to achieve convergence in all the phases of the project, including the impairment phase.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884 or Andrew Spooner in London at +44 (0) 207 007 0204.

Sincerely,

Veronica Poole
Global IFRS Leader - Technical

Appendix

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 find the description of the objective of amortised cost measurement to be clear.

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?

We agree with the objective set out in the ED that amortised cost should provide information about the effective return on a financial instrument by allocating interest revenue or expense over the expected life of the instrument. However, we disagree with the proposal in the ED of how an entity would determine that effective return and thus what amount as part of interest revenue would be allocated over the expected life of a financial asset. The ED would require an entity to determine the effective return of a financial asset on the basis of its initial expectations about future cash flows over the expected life of the asset incorporating expectations about future credit losses and the asset's initial carrying amount. The consideration of future credit losses in the determination of the effective return is one of the key differences between the objective described in the ED and that in the existing IAS 39.

An incurred loss model provides different information to users of financial statements than an expected loss model. An incurred loss model recognises losses *in the period* in which it is determined that, as a result of one or more events, a borrower does not have the ability to repay amounts due in accordance with the contractual terms. The expected loss model proposed by the IASB assumes *at initial recognition and beyond* that the borrower does not have the ability to repay amounts due in accordance with the contractual terms. Furthermore, in practice, an incurred loss model generally assesses recoverable cash flows on the basis of the cash flows that are most likely to be recovered (a single 'best estimate' approach), whereas the IASB's expected loss model is much more complex in that it requires a probability-weighted outcome approach in determining the expected losses at initial recognition and continuously thereafter. We recognise that the IASB is endeavouring to overcome flaws identified with the incurred loss model, yet as we note in our response to Question 4, we also have concerns about the verifiability of unsupported forward looking predictions made by an entity's management that underpin the expected loss model proposed by the IASB.

Broadly, the expected loss model proposed by the IASB has more in common with a fair value-based measurement than a cost-based measurement, because it relies heavily on assessing probability-weighted outcomes of potential future events. The IASB's expected loss model attempts to convert a contractual interest return into a credit-risk free interest return and remeasure the relative opportunity cost or benefit of fixing the compensation for credit risk at the contractual credit margin. This approach introduces considerable complexity and subjectivity in the determination of interest income and credit losses due to its reliance on the development of expectations about potential future events and their impact on future cash flows.

The incurred loss model as applied today has been criticised for exaggerating interest revenue in the early years of the lives of assets that are regarded as having inherently poor credit quality and the resulting large impairment losses in future periods following identification of a 'trigger event' (this is often referred to as the 'cliff-effect'). We accept that an over-emphasis on the identification of trigger events (leading to recognition of impairment in a given period) can be a distraction from the overall objective of impairment measurement, which should be the identification of cash flows that are not recoverable (or conversely, the cash flows that are recoverable). An impairment loss model that focuses more on an assessment of recoverable cash flows reflecting all current available information about the borrower's ability to repay would be an improvement to the approach currently applied in IAS 39, which focuses on 'objective evidence' of impairment and therefore runs the risk in its application of being driven more by the identification of trigger events, less by whether an entity expects to recover the contractual cash flows under the asset.

Further concerns with the expected loss model as described in the ED are detailed in our response to Question 4, as well as including our thoughts to overcome these concerns.

Question 3

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

We agree that the standard should state the measurement principles upfront and that these principles should lay the foundation for application guidance of the amortised cost model. We agree with the inclusion of application guidance that provides the reader with a more detailed understanding of the concepts. However, the lack of implementation guidance or illustrative examples is a concern. At its most basic level, examples of the application of the amortised cost model to financial assets or liabilities in scenarios that incorporate transaction costs and changes in the estimated timing and amount of cash flows (for example due to prepayments) have been very useful when the Board included them in the implementation guidance in IAS 39. At an increasing level of complexity, examples that demonstrate the mechanics of applying the IASB's expected loss model (albeit to a simple loan) are needed. It is less the theory included in the ED that is complex, rather its application, and therefore illustrative examples are of genuine value. This is particularly the case if the IASB finalises the proposals in their current form because the impairment model will be new to all current IFRS reporters and will likely be a new model compared with local GAAP for first time adopters of IFRSs.

The IASB has helpfully provided additional information on its website, specifically, examples of the application of its expected loss model in spreadsheet form, to aid constituents' understanding of the ED. Should the IASB proceed with the ED as published it would be beneficial to retain such resources, and other resources the IASB may wish to develop, as educational guidance.

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?

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

We agree that the measurement principle for amortised cost should be the present value of the expected cash flows over the remaining life of the financial instrument discounted at the effective interest rate (EIR). However, we believe that the measurement principle would not be operational if the Board were to adopt the ED in its current form.

Concern #1: Probability-weighted expected cash flows

The measurement principle of amortised cost as described in the ED would require that an entity use a probability-weighted outcome technique to estimate the amounts and timing of the cash flows that it would expect to collect over the life of the financial instrument. Practically, assessing probability-weighted cash flows to reflect different scenarios of amounts and timing of future cash flows will in most cases introduce considerable, and in some cases, unnecessary complexity. When estimating future cash flows for impairment measurement in IAS 39, a probability-weighted approach is not required and therefore many entities estimate the amounts and timing of cash flows that are most likely, or apply some other minimum probability threshold. We would not wish to discourage entities from applying advanced techniques in measuring recoverable cash flows on a portfolio assessment should they have the ability to do so, but we do not believe it should be the minimum mandatory requirement. Further, an entity should be required to disclose the approach it uses in estimating the amounts and timing of future cash flows as different entities may apply different levels of sophistication.

Concern #2: Recognition threshold

The expected loss model in the ED does not have a minimum threshold for recognition of impairment losses. This will result in a continuous re-estimation of probabilities of default on all assets, even though the assets may have a relatively low probability of default, for example certain debt securities, short-term receivables due from highly credit rated entities, intergroup debt guaranteed by a highly credit rated parent. An introduction of a recognition threshold for impairment would reduce the burden and limit the recognition of impairment to cases where a minimum threshold is breached. This threshold could limit an impairment loss to cases when it is more likely than not that the entity will not collect all contractual cash flows when due. We acknowledge that a recognition threshold would be more relevant for the assessment of impairment of financial assets on an individual basis because the threshold will likely be met at the portfolio level, however, for the reasons stated above, we believe the introduction of a threshold has merit.

Concern #3: Forward looking information

We note that the ED does not limit the forward looking information that an entity might, or would have to, consider in developing its expectations of the amounts and timing of the recoverable cash flows over the life of the financial instrument. This will be challenging for preparers, auditors and regulators. We would support the use of information that is currently available and is objectively verifiable. For example, internally generated information on credit quality derived from the entity's experience of actual credit history may be used to support the entity's assessment of recoverable cash flows for financial assets at the reporting period end. Interest rate yield curves that are derived from market prices of debt instruments can provide the entity with information as to the future expectations of interest rates. We believe that restricting the use of forward looking information with the introduction of a verifiability parameter would foster discipline and consistency in the implementation of the new impairment model and in doing so strike the right balance of making best use of information that is available to the entity without requiring the entity to make unsupportable predictions of the future economic environment.

Concern #4: Individual vs. portfolio impairment assessment

The ED does not specifically distinguish between assessing recoverable cash flows on an individual or portfolio basis. We presume the intention of the Board was that the expected loss model in the ED could be equally applied to both. However, as has been highlighted by the work of the IASB's Expert Advisory Panel the application of the ED for portfolios of items would be incredibly challenging.

We consider an individual assessment should be required where the asset is individually significant, with a further portfolio assessment required where the individual assessment does not result in impairment recognition. Financial assets that are not individually significant should at a minimum be subject to a portfolio assessment if the items in the portfolio are similar. Further, should the IASB differentiate between individual and portfolio assessment we would encourage the IASB to consider how the model would apply when an entity does not have portfolios of similar items, specifically, whether an entity should include financial assets held in hypothetical portfolios of similar items (that is does not hold) to ensure that the assessment of recoverable cash flows factors any risks arising at the portfolio level not at the individual level. This is particularly important when lending businesses are in their infancy or there are insufficient numbers of similar items to warrant a portfolio assessment.

Concern #5: Allocation of initial credit losses as part of EIR determination

The expected loss model included in the ED requires an entity to determine a credit risk-adjusted EIR. We understand the conceptual argument for determining an EIR that is lower than the contractual interest rate because of the compensation demanded from the borrower for the risk of non-payment. However, as noted by the IASB's Expert Advisory Panel, the challenge for many entities in applying an expected loss model would be to integrate credit risk data with, or link it to, their accounting systems. Traditionally, the credit department, and not the accounting function, is the department that performs credit risk assessment for impairment measurement. We can see the advantage of maintaining this separation if it results in the same, or approximately the same, accounting outcome. (We note that the separation of information in the accounting systems vs. in the risk systems has been referred to as 'decoupling'.) Credit risk professionals focus on the cash flows that they expect the borrower will not pay and currently these expectations drive the impairment measurement, as opposed to the additional complexity in the ED of translating expectations of credit losses at initial recognition into effectively a 'negative yield' adjustment to the contractual EIR. As illustrated in the spreadsheets the IASB has included on its website, determining this for a single floating rate loan is particularly challenging and complex as it requires the use of iteration to determine the part of the fixed spread in excess of the floating rate that represents the initial expectations of credit losses. We understand the Expert Advisory Panel has discussed a number of approaches to attempt to translate expected loss amounts over the life of a loan into periodic amounts for recognition in profit or loss. We recommend that the Board pursue these decoupling approaches if the expected loss model in the ED is pursued because the credit risk-adjusted EIR will in practice be overly burdensome.

We note that the ED does not explicitly prohibit the use of an open portfolio, i.e. a portfolio to which an entity adds new loans when it originates or acquires them. However, we believe that the proposals are more aligned with the application for a closed portfolio, i.e. a portfolio to which an entity does not add any newly originated or newly acquired loans after it has defined the population of the portfolio. The proposed requirement to estimate, for each loan, the expected cash flows in determining a credit risk-adjusted EIR at initial recognition would make it difficult to ascertain, from an aggregated perspective, whether a change in the estimate of the expected cash flows should be attributed to any new loans that were added to the portfolio (with the result that the initial credit losses would be spread) or to the existing loans (in which case the change in estimated credit loss would be immediately recognised), or a combination of the two. Irrespective of which impairment model the IASB eventually pursues, we consider that the model must be able to accommodate the design of open portfolios as in practice many lenders assess credit risk, and manage their business, in this way. We note that the FASB ED permits an approach that determines impairment losses on the basis of historical loss rates adjusted for current conditions (the so determined loss percentage in essence reflects the single best estimate of the collectability of the portfolio). This approach has the advantage of being capable of being applied to the gross value of a dynamic portfolio. In light of the difficulty of applying the impairment model in the IASB's ED to open portfolios, we would welcome such a practical expedient.

Financial liabilities

We generally agree with the measurement principles of amortised cost as applied to the measurement of financial liabilities. This is broadly similar to the approach already required in IAS 39. However, consistent with our observation above that a probability-weighted approach in estimating the timing and amount of contractual cash flows of financial assets will in many cases be unnecessarily burdensome, we consider the same to be true when estimating the timing and amount of contractual cash flows of financial liabilities. Where the timing and amount of cash flows can vary, a minimum threshold, for example, more likely than not, as opposed to a more sophisticated probability-weighted approach, should be acceptable.

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?

(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 objective would you propose and why?

Yes, the objective of presentation and disclosure is clear and appropriate.

Question 6

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

Our preference is that the EIR is the contractual EIR adjusted for any premium or discount and capitalised transaction fees or costs but not for future credit losses. The recognition of impairment losses should be in profit or loss as an impairment loss as it arises, not as an adjustment to the EIR.

Should the IASB proceed with the model as proposed in the ED we agree that interest revenue and interest expense should be disclosed separately from changes in estimates and those items listed in paragraph B19 of the ED.

Question 7

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

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

We agree with the proposed disclosure requirements but have two substantive comments.

Paragraph 17(b) requires disclosure if changing one or more of the inputs to reasonably possible alternative assumptions would change credit losses expectations at initial recognition or subsequently. The ED requires an entity to disclose the impact of flexing those assumptions. We would expect in nearly all cases this disclosure to be required in the case of an expected loss model as by virtue of the entity being required to estimate future events and their impact on recoverable cash flows at initial recognition and over the life of an asset. As has been evident in complying with a similar requirement for Level 3 fair value measurement disclosures, different entities flex different assumptions by differing degrees with differing levels of aggregation. Also, there will be differing levels of sophistication as some entities flex inputs independent of other inputs, whereas others flex multiple assumptions, say interest rates and prepayment speeds, because they are correlated. Achieving comparability across entities will be very difficult, if not impossible, and therefore at a minimum we believe the final standard should make clear that the approach chosen to flexing inputs and assumptions should be consistently applied from period to period, with any changes in the approach disclosed and justified.

Paragraph 21(a) requires an entity to disclose for each class of financial assets a reconciliation of changes in non-performing financial assets during the period. Appendix A defines 'non-performing' as 'the status of a financial asset that is more than 90 days past due or is considered uncollectible.' We do not find the Board's basis for a bright line past due criterion as articulated in paragraph BC 61 convincing. In practice, different entities may have different approaches to determining as to which point in time a financial asset is considered to be non-performing. Thus, rather than a bright line past due criterion, we would prefer to align the definition of a non-performing asset in the impairment standard with how entities define non-performing assets in their credit risk policies.

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?

If the IASB finalised the ED in its current form, we would expect the implementation of systems changes to be very significant, particularly for lending institutions. We consider that the preparers that are most affected by these proposals are best placed to answer the question of what is a sufficient lead-time needed to implement the proposals.

Question 9

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

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

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

If the IASB were to pursue the expected loss approach, we would agree that the proposed transition requirements would strike a good balance between useful and comparable information that would result from a fully retrospective application and the operational challenges and opportunity for use of hindsight that would come with that type of application. We would also agree with the proposal to restate comparative information but would refer to the comments by preparers on the impact of that proposal on the lead time for implementing the impairment approach.

If the IASB were to pursue an approach different from that in the ED we would encourage them to seek the views of preparers so as to ensure that the transition guidance for any new requirements is capable of being implemented and at the same time the information produced on transition and beyond is relevant.

If the IASB were to incorporate our preferences as described in Question 4 we would prefer a simpler transition approach, which would be similar to the approach mentioned in the summary of transition requirements and described in more detail in BC71(b) of the ED, but that would treat any change resulting from the transition as a change in estimate to be recognised in profit or loss. So on transition an entity would determine the amortised cost of financial instruments that it initially recognised before adoption of the new model as follows:

- use as the discount rate the EIR that the entity previously determined for these instruments in accordance with IAS 39, and
- use the cash flow estimates in accordance with the new model.

The entity would recognise the difference between the carrying amount of these financial instruments as determined on adoption in accordance with the new model and the instruments' 'old' carrying amount in profit or loss.

Question 10

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

We agree with the proposed disclosure requirements in relation to 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?

In light of the complexity of the expected loss model proposed by the IASB and the resulting operational challenges, we support the inclusion of practical expedients. For example, not including the effect of time value of money for short-term trade receivables and payables is reasonable and is already common practice when applying IAS 39. We note that the example of applying the practical expedient to short-term receivables that is included in a spreadsheet on the IASB's website would be worthy of inclusion in any implementation guidance.

However, we are concerned with the wording in paragraph BC15, which states that '[a]n entity may use practical expedients in calculating amortised cost *if their overall effect is immaterial*' (emphasis added). This wording would seem to imply that an entity would have to apply the expected loss model to determine whether the effect of using a practical expedient is immaterial, which would defeat the purpose of providing for a practical expedient. Accordingly, we would suggest changing the wording in paragraph BC15 to: 'An entity may use practical expedients in calculating amortised cost if their overall effect is *expected to be* immaterial' (suggested edits emphasised).

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?

Subject to our response to question 11, we believe that the principles in paragraph B15(a)-(c) of the ED with which practical expedients must be consistent are clear. Accordingly, we do not believe that additional guidance on practical expedients is necessary. However, we would suggest adding an example of a practical expedient similar to that provided in the FASB ED for financial assets that an entity individually identifies as being impaired and that are collateral dependent. Moreover, on this question we would advise the Board to consider the feedback from preparers, especially from smaller banks and also from non-banks.

Other comments

While not specifically referred to in the ED, we believe the measurement of loan commitments that are not measured at FVTPL, which is currently governed by IAS 37, should be included in the scope of IFRS 9 and thereby governed by the new impairment model. A writer of a loan commitment that is not measured at FVTPL should provide for credit losses in a consistent manner with the loan that will be originated when the loan commitment is drawn down by the borrower. Without such an amendment to scope there is a potential for inconsistency between the measurement approach for losses under loan commitments and the losses that would be measured at origination of the loan when it is drawn down under the commitment (with a potential gain or loss in profit or loss at initial recognition of the loan for the difference in the measurement basis). Consistency in measuring losses for off-balance sheet loan commitments and on-balance sheet loans will avoid this problem and will align with the practice whereby generally credit risk assessment of loans to be originated and loans that are already originated is performed together.