Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

1 September 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Request for Information – (*"Expected Loss Model") Impairment of Financial Assets: Expected Cash Flow Approach*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned request. Our responses to the questions raised in your request are set out in the Appendix for your consideration.

We support the IASB's decision to explore alternative approaches to the current impairment model, and to obtain views early on the development of the project.

Based on our initial observation, market participants generally have concerns that the implementation of the expected cash flow approach will involve significant operational challenges. The availability of data to forecast expected cash flows is a major concern. It is expected that entities may not have data with sufficient history and granularity for the entire economic cycle for loan loss provisioning purposes for all portfolios of assets held at amortised cost. It is also a challenge for corporates in general in deriving reliable data for developing future economic expectations. We are concerned that non-financial entities could be subjected to detailed application rules that go far beyond what is necessary in their relatively simple circumstances.

Overall, we consider the Request for Information only highlights the conceptual issues of the expected cash flow model without detailed guidance on its application. If a decision is made to adopt the model, we recommend that the Board provide a clear definition of what is meant by expected cash flows for the purpose of the expected cash flow approach (for example whether the expected cash flows should be a probability weighted amount, or the single best estimate), additional guidance on how to formulate the credit loss expectations (for example whether there is a hierarchy of data inputs, with market data taking precedence over internally-generated information) and also adequate time before the effective date to allow preparers of financial statements to adapt their accounting systems for the changes.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCA, FCPA
Director, Standard Setting Department

SO/WC/ac

Hong Kong Institute of CPAs

Comments on the IASB Request for Information - *(“Expected Loss Model”) Impairment of Financial Assets: Expected Cash Flow Approach*

<u>Question 1</u>

Is the approach defined clearly? If not, what additional guidance is needed, and why?

We consider that the description of the Expected Cash Flow Approach contained in the Request for Information is at a reasonably high-level and therefore by its nature lacks some implementation details for it to be applied on a consistent basis across all entities and all financial assets. We believe that additional guidance should be provided on the following areas:

<u>Definition of the “Expected Cash Flow”</u>

The expected cash flow approach uses from the outset the best estimate of expected future cash flows. However, there is no clear explanation in the paper of what is meant by expected cash flows for the purpose of the expected cash flow approach. We recommend that the IASB clarifies which approach should be used to measure the expected cash flow such as the probability-weighted, average-weighted or the most likely approach and provide additional guidance on the implementation of expected cash flows approach.

<u>Source of information</u>

The expected loss model is a forward-looking model and therefore needs to be based on expectations about the future. The choice of data requires the use of a higher level of management judgment, in particular, about the future economic conditions, which could result in significant impact to profit and loss. In some cases, the data used for forecasting expected cash flows can be unobservable. It would be helpful for the IASB to refer to examples of data sources that may be acceptable. However, we believe that the Board should allow preparers flexibility in their approach rather than introducing a hierarchy that prioritizes the data entities use for developing expectations.

<u>Revolving credits</u>

It is not certain as to how the expected loss model should be applied to portfolios containing financial assets that are revolving regularly such as credit card receivables, over-drafts and certain committed banking facilities. Expected losses on these types of portfolios could relate to financial assets not yet on an entity’s balance sheet and be impacted by the relationship with customers.

<u>Presentation in the financial statements</u>

The main feature of the expected cash flow approach is to recognize interest revenue on the basis of expected cash flows including the expected credit loss. It is not clear from the staff papers whether the impairment loss should be presented as a net off to the interest revenue in the profit and loss statement or a separate disclosure item.

Question 2

Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

Generally, we consider that the principle of the expected loss model is conceptually operational. However, we are concerned that it may become costly to implement the required systems. The main challenge in transitioning from an incurred loss approach to an expected cash flow approach will be to obtain the expected cash flow data and make changes to processes and information systems. In many non-financial sectors, normal trade receivables constitute a major part of their financial assets and they are less subjected to cyclical influences on credit losses. There are concerns about the availability of data to calculate expected losses on trade receivables.

Question 3

What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

We believe that the magnitude of cost to be incurred greatly depends on how far an entity has developed experience in the expected loss approach. It is believed that a significant operational cost would be incurred for the first time implementation. The implementation cost includes the development of the credit loss forecasting model, an extension of the control process over the use and reporting of credit data, a firm-wide change to existing systems and an increased number of highly qualified professionals and training cost will be required. It is expected that the proposed approach will impose a great burden to financial institutions, particularly those that are relatively smaller in scale or those that are still on the standarised approach under Basel II.

Some of the constituents from the financial services sectors worried that a significant lead-time will be needed for the transition from the incurred loss model to the expected loss model in terms of data readiness, both current data and comparatives. Hence, sufficient time needs to be included in the timetable between the issuance of any new requirements and their effective date to allow preparers of financial statements to adapt their accounting systems for the changes.

Question 4

How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

We support approach A for amortising upfront costs. Use of the original effective interest rate calculated upon initial recognition of the instrument would be easier to operate and consistent with the approach applied to fixed rate instruments.

We suggest that the Board explore an alternative approach to discounting revised cash flows following an impairment, whereby the effective interest rate should be revised only for changes in the variable benchmark interest rate (in the same way as AG 7 of IAS 39), but holding the original credit spread constant such that there would be a "catch-up" adjustment recognised in profit or loss, consistent with the approach for fixed rate instruments and with AG8 in the current standard. We believe that this will be the simplest to apply (as it is consistent with the approach applied at present) and will provide decision-useful information to users.

<u>Question 5</u>

How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

(a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?

(b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?

We believe that the standard should not be prescriptive and should provide flexibility for an entity by establishing a principle that as long as satisfactory assessments of expected losses can still be made if assessments continue to be done on a collective basis, an entity should be allowed to exercise judgment on whether it removes a financial asset, for which performance has become more doubtful, from a portfolio of performing assets.

<u>Question 6</u>

What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

As mentioned in Question 2, we are concerned that the implementation of the expected loss approach may impose a great burden to the industrial and commercial sectors. We recommend that a simplified approach should be allowed for trade receivables as it is expected that a simple extrapolation of past experience data may well give as accurate and useful information as more sophisticated techniques.