CPA
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)**

6 July 2010

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

Dear Sirs,

**IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment***

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 Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

We recognize that the current incurred loss model has been subject to much debate as a result of the financial crisis. In particular, the incurred loss model has been criticised for delaying recognition of credit losses and leading to overstatement of revenues due to the fact that it recognizes impairment losses if there is an impairment trigger and the recoverable amount falls below the carrying amount. While welcoming the IASB's effort in reviewing the current requirements in IAS 39 in respect of impairment of financial assets, we believe that it is important to make it clear in the final standard, what are the objectives of financial reporting to be achieved with the proposed expected loss model and how the expected cash flow approach as outlined improves and achieves the pursued objectives and resolves the deficiencies of the existing model.

In general, we support the direction proposed by the IASB to include forward looking credit expectations within the impairment model. However, we have significant concerns with some conceptual and practical implementation aspects of the expected cash flow model as proposed in the exposure draft:

- The proposal of presenting impairments (including expected losses) together with effective interest on the income statement is not consistent with the business models of most banking entities. Most banks and users of their financial statements focus on the margin between the lending rates and the cost of funding – "net interest margin". If the interest return is required to be reduced by the expected credit loss, the relationship between interest income and credit risk will no longer be transparent to the readers of financial statements.

- An impairment loss under the proposed approach actually includes both the actual incurred loss and future expected credit losses. We believe that readers of financial statements will find the information more useful if it can show how much credit loss has actually been incurred as well as the amount that might be

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expected to be incurred in the future. We acknowledge the high degree of difficulty in separating the two concepts but would welcome any effort to do so. In fact, a distinction between 'good' and 'bad' books as currently being discussed by the Expert Advisory Panel (EAP) could help identify when incurred losses and expected losses are more relevant or when is it essential to distinguish between the two.

- It is highly impractical and subjective to require management to estimate future credit losses over the expected life of the relevant financial asset or portfolio of financial assets and across a whole range of possible outcomes. We believe that the projection of expected cash flows could be accomplished by leveraging existing practice with appropriate adjustments (i.e. utilize data on historical losses with appropriate adjustment for expected changes in future economic and credit conditions.)

- Under the proposed model, the amounts and timing of cash flows are proposed to be based on a probability-weighted possible outcome model. While this is conceptually easier for large homogeneous portfolios it is quite difficult to understand and implement for small portfolios and individual loans and result in numbers which are difficult to explain and verify. In those cases, a best estimate approach may provide more relevant information.

- The proposed model assumes a closed portfolio while in practice most of the portfolios are open portfolios. It is impractical to estimate amortised cost and expected losses for open portfolios as required in the ED. This is because the ED proposes that initial estimates of credit losses should be spread whilst subsequent changes should be recognized upfront. In addition, an integrated effective interest rate calculation for amortised cost would require significant systems changes as the data required for the effective interest rate calculation and the impairment calculation are typically stored in different systems. We understand the EAP has been working on solutions to 'decouple' the effective interest rate calculation to make it operational. However, we do not believe that the issue arising from spreading the initially expected losses and the catch-up adjustments has been comprehensively solved.

- The proposed impairment model is oriented to financial institutions and unlikely to be suitable for non-financial institutions. We do not agree with the ED's proposal to recognize expected losses on trade receivables upfront as a deduction against revenue as we believe that this adds little value to users of financial statements as such receivables are usually short term in nature and they are not held to generate interest revenue. We note that the IASB and FASB's Exposure Draft *Revenue Recognition*, published on 24 June 2010, proposes similar guidance, stating that when measuring revenue, "an entity shall reduce the amount of promised consideration to reflect the customer's credit risk." We will be responding to this exposure draft in due course. We believe that it is more appropriate for the measurement of revenue for entities whose main business is not lending to be considered by the revenue recognition project rather than a project dealing with impairment of financial assets.

- From a practical perspective, many banks will simply not have enough detailed and reliable historical data to estimate future credit losses. This is particularly true for smaller banks and many banks in Hong Kong and Asia, who are not currently adopting a model based approach for Basel II. A very long implementation period will be required and given the high subjectivity and low reliability of the likely results, it is unlikely that the benefits will outweigh the costs.

In summary, we believe that conceptually the expected cash flow model as proposed by the IASB in this ED will result in increased subjectivity. As a result, the expected losses which will be recognized in the profit and loss account may be more volatile and procyclical than under the current incurred loss model. In our view, the proposed model is extremely complex as it integrates revenue recognition and impairment. We are doubtful that the IASB's proposed impairment model would better meet the needs of users of their financial statements.

From a conceptual and practical perspective, we believe that an impairment model should be built around the following key principles:

- The presentation of impairment should be separate from effective interest;
- The calculation of incurred and expected losses should be disclosed separately;
- Incurred losses should be calculated largely in accordance with current IAS 39 requirements;
- Expected losses should be calculated on a portfolio basis and should be applicable for both open and closed portfolios; and
- The expected loss calculation should be based on historical loss experience but should allow management judgment to take into account expected changes in future economic and credit conditions that are either highly likely or are based upon objective evidence.

On the basis of the discussion above, we have significant reservations as to whether the expected cash flow approach as proposed by the IASB constitutes an acceptable replacement for the current incurred loss approach. In our view, rather than pursuing a new model, the IASB should consider improving the existing incurred loss model by eliminating the need for an incurred loss trigger and the portfolio impairment provision could be extended to cover expected loss by both eliminating the emergence period thus covering the entire expected life of the loan (such that the cumulative annual expected losses on a portfolio are accrued at initial recognition using historical experience) and adjusting for expected changes in future economic and credit conditions that either are highly likely or are based upon objective evidence. Further details on our proposed alternative approach are discussed in Question 4.

We note that the FASB has recently issued a proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, setting out its proposed comprehensive approach to financial instruments classification and measurement, impairment, and revisions to hedge accounting. For the purpose of evaluating the IASB's expected loss model, we have not considered the full model proposed by the FASB; rather we have only focused on their proposed concept underlying the credit impairment. We urge the IASB to consider some of the features proposed by the FASB model such as removing the existing probable threshold requirement for recognizing impairments on loans to include a broader range of credit factors which we consider an improvement of the existing incurred loss model under IAS 39 and work closely with the FASB on this project in order to ensure that a converged standard results.

We finally encourage the IASB after due consideration of comments received, EAP work results and FASB model to re-expose a refined proposal for consideration by the respective stakeholders. We also recommend that the EAP is not disbanded but continues to work with the IASB to resolve the operational issues that have been identified.

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

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/WC/jn

## Hong Kong Institute of CPAs

**Comments on the IASB Exposure Draft Financial Instruments: Amortised Cost and Impairment**

**<u>Question 1</u>**

**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 consider the overall description of amortised cost measurement is clear. However, it would be helpful to make it clear in the final standard, what are the objectives of financial reporting to be achieved with the proposed expected loss model and how the expected cash flow approach as outlined improves and achieves the pursued objectives and resolves the deficiencies of the existing model.

We note that the ED requires an entity to use current cash flow information at each measurement date to measure amortised cost. It is not clearly stated whether "current cash flow information" should include expectations of future changes in economic and market conditions beyond the reporting date. We believe the drafting of paragraph 4 could be made clear on this.

In addition, we do not agree with the IASB's proposal to incorporate impairment with the effective return. Please refer to our response to Question 2 for more details.

**<u>Question 2</u>**

**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 broadly agree with the proposed measurement principles by incorporating forward looking credit expectations within the impairment model. However, we do not support the proposal to include expected credit losses in the computation of effective returns as we consider the combined information would be less useful to users of financial statements. Currently, interest income in the financial statements represents the contractual interest received/receivable and it is generally accepted that higher credit risk will be compensated by a higher interest return. If the interest return is required to be reduced by the expected credit loss, the relationship between interest income and credit risk will no longer be transparent to the readers of financial statements. The majority of Asian banks are commercial banks, many of which are deposit-led and therefore net interest margin is considered meaningful and comparative.

In addition, as noted in the discussion of the EAP, we learnt that in practice, the expected cash flow approach would give rise to significant operational difficulties because financial institutions and others typically store contractual and accounting data (in particular effective interest rate data) and expected loss data information in separate systems. It would involve tremendous time and cost to combine the data from both of the systems for integrated effective interest rate calculation.

Moreover, we have a concern that the proposed objective seems to be focused on the needs of financial institutions, and therefore is conceptually inappropriate for non-financial institutions. Generally trade receivables are not held to generate interest revenue and the impairment costs are usually treated as operating expense. Information that is focused on "effective return" may not be that relevant to the users of non-financial institutions.

In order to reduce the complexity, we suggest that the amortised cost measurement should broadly follow the existing treatment under IAS 39 while the expected loss concept should be treated as an impairment provision to be separately reported in financial statements.

## 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 support robust principles-based accounting standards, however, given that the new impairment model is a significant change to existing requirements, we consider that some of the concepts that are explained within the Basis for Conclusions could be moved to the main text to facilitate users to better understand and implement the principles in the proposed standard. For example, paragraphs BC 34 – 36 provide more explanation on the rationale behind the recognition and reversal of an impairment loss and the possible recognition of impairment "gain" without having recognised an impairment loss in profit or loss in the past.

While we agree with the IASB in limiting the degree of prescription in the guidance, we would welcome further guidance or clarity in the following areas:

- Treatment of financial assets that will be extended or renewed – It is currently unclear as to how the expected cash flow approach should be applied to revolving facilities, such as credit cards and overdrafts which is not contractually agreed, no fixed cash flows and no fixed maturity. A constructive obligation to renew may have been created by past practice. We believe that expected losses on these commitments should be factored into the impairment model by estimating an average life of a credit card portfolio based upon historical data of consumer behaviour and forecast future cash flows for this period. We would welcome guidance in respect of such instrument to ensure consistent application.

- Committed lines of credit – We noted that, in practice, banks consider credit risk on a full facility basis and, as a result, would estimate expected losses based on the expected credit utilization at each point in time. It would be helpful if the IASB provides guidance on whether expectations of loan draw downs can be included in the impairment assessment.

  Currently, IFRS requirements use two different standards for the commitment phase (IAS 37) and the phase after draw down (IAS 39). We agree with the suggestion of the EAP that the IASB should consider aligning the accounting treatment by using one consistent approach for both on-and off-balance sheet credit exposures.

**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?**

(a) & (b)

Although in general we conceptually agree with the measurement principles in the ED in terms of incorporating more forward-looking information, we have significant concerns on some conceptual and implementation aspects of an expected cash flow approach to impairment and amortised cost measurement as proposed in the ED:

- *Subjectivity of estimates*: Determining expected losses over the expected life of an asset involves a high level of judgment to arrive at the assumptions used, for example, the timing of credit losses on long-term financial assets, estimates of the point in time in the economic cycle as well as the outlook for the economic cycle. In addition to the practical challenges for preparers of financial statements, we believe that there also will be challenges associated with auditing management's forward looking estimates of future credit losses. To reduce subjectivity, we suggest that the expected loss calculation should be based on historical loss experience but should allow management judgment to take into account expected changes in future economic and credit conditions that are either highly likely or are based upon objective evidence.

- *Availability of and reliability of data*: It is a major concern of a large number of entities. Only some of the larger banks currently collect expected loss data on their loan books. Other entities, both financial and non financial, would not have expected loss data with sufficient history and granularity. For example, data on historical loss experience by product, geography or any other segmentation that may be required to appropriately capture the expected cash flows of each portfolio and the phasing of loses over the life of an instrument. Even for traded instruments for which spreads can be viewed in the market, the spread relating to credit alone is not visible and assumptions will need to be made to estimate the credit loss.

- *Separation of initially estimated expected losses and subsequent recognition of revision of estimates* – Under the proposed impairment model, the initial expected loss should be spread over the expected life of a financial instrument while changes in subsequent estimates of expected loss should be recognized in the income statement immediately. A concern on this is that in revising expectations of losses on an open portfolio, it is hard to assess whether this change relates to the old loans that were already in the portfolio or as a result of new loans added since the previous expected loss estimate. In addition, there is concern that the separation of impairment assessment will create unnecessary income volatility which can be difficult to be understood by users of financial statements as the change in net income may partly come from changes in underlying risk factors and partly come from "rectification" of the assumptions which are difficult to justify by any objective measure.

- *Combined actual incurred loss and future expected credit losses* – An impairment loss under the proposed approach actually includes both the actual incurred loss and future expected credit losses. It is reasonable to assume that readers of financial statements will want to know how much has actually been incurred as well as the amount that is expected to be incurred in the future. We acknowledge that it can be difficult in identifying when a credit loss has been incurred, particularly for portfolio impairment provision. However, consideration should be given to refining this area rather than combining incurred and expected losses.

- *Integrating expected credit losses with effective return* - The proposal of presenting impairments (including expected losses) together with effective interest on the income statement is not consistent with the business models of most banking entities. Most of the banks and users of their financial statements focus on the margin between the lending rates and the cost of funding – "net interest margin". If the interest return is required to be reduced by the expected credit loss, the relationship between interest income and credit risk will no longer be transparent to the readers of financial statements.

- *Interaction with Basel II*: Although the proposed expected loss approach may be slightly less of a challenge for preparers who have already implemented the Basel II (IRB) approach, the Basel II expected loss model does not involve the same practical challenges as the proposed approach. This is due in part to the differences in the forecasting horizon, as Basel II uses a one-year horizon for cash flows whereas the proposed expected cash flow approach requires projections over the expected life of the loan. The longer forecasting horizon under the proposed approach would be more sensitive to assumptions. While we understand that the objective of financial reporting and regulatory reporting is not the same, the banking industry generally would like the IASB to put due consideration into addressing the interaction between the two models and potential for efficiencies.

- *Trade receivables (including receivables of longer maturity)* The proposed impairment model is oriented to financial institutions whose main business is lending. Many other types of entities, such as those with long term trade receivables, will be impacted by the proposals and the focus of these entities is on generating revenue from selling goods and services, not generating interest revenue. It was considered that the proposed model, even taking into consideration the "practical expedients" would add a layer of complexity to the preparation of financial statements that is not warranted for entities whose main business activities are not lending. It is noted that non-financial institutions mostly use aging of debtors, sales representative information, and information from credit rating agencies to estimate their losses. We encourage the IASB establishes a clearly defined principle and objective of an impairment model for trade receivables and other receivables originated by non-financial institutions in particular within the framework of the Revenue Recognition project.

On the basis of the discussion above, we have significant reservations as to whether the expected cash flow approach as proposed by the IASB constitutes an acceptable replacement for the current incurred loss approach. In our view, rather than pursuing a new model, the IASB should consider improving the existing incurred loss model. Currently, the portfolio impairment provision is determined by taking into account historical experience, management's judgment as to whether the current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than that suggested by historical experience and the emergence period, which is the estimated period between a loss occurring and the loss being identified. This portfolio impairment provision could be extended to cover expected loss by both eliminating the emergence period thus covering the entire expected life of the loan (such that the cumulative annual expected losses on a portfolio are accrued at initial recognition using historical experience) and adjusting for expected changes in future economic and credit conditions that either are highly likely or are based upon objective evidence. Similarly, for homogeneous groups of assets which are currently assessed for impairment on a portfolio bases (e.g. credit cards), the current portfolio impairment provision typically utilizes a flow rate methodology which takes into account historical trends of the probability of default and amount of consequential loss. This calculation could be adjusted to cover future expected losses by adjusting the probabilities of default and losses to take into account expected changes in future economic and credit conditions that either are highly likely or are based upon objective evidence. Such an approach should not preclude reporting entities from using weighted average probabilities of future cash flows in determining expected losses where the requisite data and expertise are available. The above approach would be applicable to a "good book" of loans but not a "bad book" since the existing methodology for calculating the "bad book" impairment reserve already fully reflects expected losses.

**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?**

(a) We considered that the objective of presentation and disclosure of the ED is generally clear.

(b) As mentioned in Question 2, we consider the presentation and disclosure objective may not be appropriate for trade receivables held by non-financial institutions.

**Question 6**

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

We disagree with the proposal to include 13 (b) "the portion of initial expected credit losses allocated to the period" as part of net interest revenue since this amount simply reflects the original expected credit losses and this information will be meaningless if there are any material changes in expected credit losses, regardless of whether it is due to changes in management assumptions or market conditions.

As mentioned in Question 2, we consider that the current presentation which separately presents interest income and impairment is appropriate.

Moreover, we are concerned that the ED does not provide relevant presentation requirements for non-financial institutions. Trade receivables generally are not held to generate interest revenue and an interest component is seldom factor into the price of goods and services sold or delivered. Entities typically do not expect credit losses at the point of delivering goods or performing services, so the "day one" loss expectation at the level of an individual sale would be zero. There is therefore little informational value in presenting the proposed requirements.

**<u>Question 7</u>**

**(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?**

(a) & (b)

We broadly agree with the disclosure principles in the ED. We believe that disclosures on information about inputs and assumptions used in determining expected credit losses are necessary to address concerns about the subjectivity of the expected loss model. However, we have the following comments on the proposed disclosure requirements:

Paragraph 19 ("trend analysis") – it is not clear to us what is the period required for comparison between the development of the credit loss allowance over time and the cumulative write-off and the meaning of "a qualitative analysis of the effect of changes in credit loss estimates on this comparison if that effect is significant".

Paragraph 20 (stress testing) – Under IFRS 7, an entity is already required to disclose information that enables users of financial statements to evaluate the nature and extent of risks (including credit risk) arising from financial instruments. We consider that it is not necessary to include the stress testing requirement under this ED.

Paragraph 22 (vintage information) – We question the benefit to the readers of financial statements of disclosing the vintage information, as such information will not necessary reflect the risk characteristics of the financial instruments or how the risk is being managed.

Finally, we would like the IASB to consider linking the proposed disclosures in the ED together with those included in IFRS 7 to allow preparers and users to have a better understanding of the principle of disclosures as a whole. Also, we do note that some of the disclosures in the ED, like IFRS 7, will require subjective judgments regarding "class" of a financial instrument and the level of detail to be disclosed. We therefore urge the IASB to provide more guidance on the level of disaggregation for disclosure purpose.

**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?**

Based on the discussion with our banking representatives in Hong Kong, significant technological and operational resources will be required in view of the operational burden involved. Also, as the IASB EAP is still discussing the implementation issues (e.g. how to compute the expected credit loss), it is difficult for the banks to assess the actual lead-time required for implementing this ED at this stage. However, they believe that the lead time required could be greater than three years.

**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.**

(a) In general, we agree with the proposed transition requirements as they are pragmatic. It is believed that the proposal should reduce the burden on preparers and will mitigate the difficulties associated with determining expected loss as on a specific date in the past. However, it would be helpful if the IASB provide an illustrative example on their application.

(b) We do not prefer the alternative transition approach because we are concerned that the requirement to discount the future expected cash flows adjusted for expected credit losses by using the effective interest rate determined under the provision of current IAS 39 that excludes any reduction for expected credit losses would increase the negative impact on equity.

(c) We agree that comparative information should be restated to reflect the proposed requirements.

**Question 10**

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

We support the proposed disclosure.

**Question 11**

**Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?**

We do not consider that the practical expedients are useful as an entity is required to prove the overall distortion is not material before the practical expedients can be used.

Also, we do not agree with the proposal that the initial estimate of credit loss should be treated as a reduction in the invoice amount in determining the revenue to which the trade receivable relates (e.g. from the sales of goods). Under IAS 18, revenue is recognized only when it is probable that the economic benefits associated with the transaction will flow to the entity, that is, revenue is not recognized when an inflow is not probable. We would like the IASB to clarify whether the meaning of "probable" in IAS 18 is different from "probability-adjusted" under the expected loss model. For example, if there is a 20% chance that the invoiced amount may not be collectable, the receivable is deemed to be 'probable' and recognized in full (as there is more than a 50% chance of recovering the amount), however, the probability–weighted number under the proposed model is 80% of the invoiced amount.

**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?**

As noted above, we do not believe that the practical expedients are useful if an entity is required to prove the overall distortion is not material. However, if the practical expedient is to be retained, we suggest it should also be extended to the presentation and disclosure principles.