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# Comments on ED Financial Instruments: Amortized Cost and Impairment

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30 June 2010

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

Dear Sirs:

**Exposure Draft Financial Instruments – Amortized Cost and Impairment**

I am pleased to provide, in my personal capacity, comments on the above exposure draft.

**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?*

The objective of amortised cost measurement could be made clearer with respect to how the objective of the measurement basis contributes to the overall objective of the draft (IFRS). As it stands, there appears to be a difference in emphasis between the objectives of the standard and the measurement basis. The objective of the draft (IFRS) is to establish principles for the measurement of financial assets and financial liabilities that will present useful information on the "amounts, timing and uncertainty of future cash flows". However, the objective of amortised cost measurement in paragraph 3 is to provide information about the "effective return" on a financial asset or financial liability by allocating interest revenue or interest expense over the life of the financial instrument. The requirements of amortised cost measurement are clearly directed to a complex process of allocating interest income into component parts. The information on "effective return" has an income statement emphasis while the objective of the (draft) IFRS has a balance sheet, future-oriented emphasis.

If the overall objective of the exposure draft is to provide information on the "amounts, timing and uncertainty of future cash flows", the backward-looking information on the income statement relating to initial expected loss would appear redundant. Thus, consideration should be made to better align the objective of the amortised cost measurement with the overall objective of the (draft) IFRS.

The objective of the exposure draft is inappropriate to measuring effective returns on financial assets of non-financial institutions on which little or no interest is typically levied on credit sales.

**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?*

The objective of amortised cost measurement in the (draft) IFRS of providing information on the “effective return” of a financial asset is ambitious. The information arising from the application of amortised cost measurement is relevant only in so far that the reporting entity holds a financial asset for the primary purpose of collecting contractual cash flows. In fact, the objective as presented in the exposure draft would be more achievable under fair value measurement than amortised cost measurement. The amortised cost model in the exposure draft is a hybrid model that combines historical information and probability-weighted assessments of expected loss. The “effective return” in the exposure draft arises from an asymmetric recognition of losses but not gains and that combines current cash flow information at each measurement date with a valuation of those cash flows that reflects conditions on initial recognition of the financial instrument (paragraph 3 of the exposure draft). Hence, it is unrealistic to assume that the measurement principles in the exposure draft would lead to information that allows users to assess the “effective return” on a financial asset or a financial liability. The “uncertainty of future cash flows” relates only to the downside risks measured through the use of the expected loss model proposed in the exposure draft.

The hybrid model in the (draft) IFRS provides a measure that is essentially adjusted historical returns on a financial asset or liability that is held for purposes of collecting (paying) contractual cash flows. I propose that the term “effective return” be removed and replaced with terms that more appropriately describe the financial effects of the amortised cost measurement basis, for example, “interest income or interest expense and other gains or losses arising from the holding of a financial asset or financial liability primarily for the purpose of collecting (paying) contractual cash flows”.

**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?*

(1) The use of risk-free rate or the use of undiscounted cash flows under practical expedients’ would result in either Day 1 differences or unwinding differences at maturity date. The treatment of these differences in the (draft) IFRS is unclear. Implementation guidance is required on the application of the procedures under practical expedients.

(2) Application guidance (B24) should include figures for clarity. The use of symbols is confusing and the illustrative examples do not serve their purpose of providing guidance.

(3) Illustrative examples will be useful to show the application of the complex requirements of the (draft) IFRS.

(4) There is insufficient guidance on how the exposure draft can be applied to financial assets of non-financial institutions (e.g. accounts receivables) for which interest is typically not charged on customers. The lack of guidance extends to interest-free loans or loans granted on favourable interest terms. How should the expected loss be accounted for on quasi-equity loans?

**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?*

I do not agree with the measurement principles for the following reasons:

(1) The allocation of initial expected credit losses or impairment losses on monetary assets or liabilities over the life of the asset or liability is arbitrary and artificial. It purports to match interest income with initial expected losses and achieves a smoothing of income and the building up of an allowance account. However, the resultant expense and asset allowance account do not lend themselves to a clear interpretation of their economic substance and do not conform to the definitions of assets, liabilities and income in the Conceptual Framework. Users of financial statements need information on expected losses arising from current conditions and not historical losses. The allocation of "historical" expected losses (i.e. the initial expected losses) to current income does not provide useful economic information. The allocation of initial expected loss reflects information at initial recognition and is an outdated measure of expected loss. The allocated amount is neither a current measure of credit losses nor an expectation of future losses. Users of financial statements will find it difficult to interpret this measure in itself. A more meaningful measure is the change in estimate of the allowance account. However, the change in estimate as determined under the (draft) IFRS is only a partial reflection of the current information relating to expected losses. A user will need to aggregate two measures to arrive at the current measure of expected losses:

Current expected loss
= Current allocation of initial expected loss + Gain (loss) resulting from changes in estimates

(2) The accumulation of the allowance for credit losses through allocation of the initial expected credit loss (Application Guidance Appendix B paragraph B22) is essentially reserve accounting and the resultant allowance is neither an asset nor liability as defined in the Conceptual Framework.

(3) It is counter-intuitive that the allowance for credit losses arising from the allocation of initial expected credit loss will increase as the maturity date draws near. The underlying

presumption in the building up of the allowance account is that credit risk increases systematically with time. The economic reality is that credit risk is time-invariant and if there is any relationship with time at all, credit risk should decline and not increase as the financial asset approaches maturity.

A more conceptually appealing alternative to the arbitrary allocation of the initial credit loss to the income statement and allowance account is the recognition of a Day 1 allowance for expected losses. A Day 1 allowance is the present value of expected losses that is priced into the fair value of a loan on initial recognition. It makes more economic sense to recognise the allowance on initial recognition since it is an integral element of the fair value of the loan. Subsequently, the allowance for expected credit losses is adjusted for changes in estimates. The change in estimate represents the only measure of credit loss in the Income Statement.

Current expected loss = Gain (loss) resulting from changes in estimates

(4) The effective interest rate features in paragraphs 7 and 10 but are described differently. Paragraph 7 refers to the "input relating to initial measurement which is the effective interest rate to the extent that it is not contractually reset to current conditions...." Paragraph 10 on the other hand refers to the effective interest rate that "reflects how the contract sets the interest payments for the financial instruments (i.e. what part of the contractual interest rate, if any, is reset)."

The language in these paragraphs does not lend itself to unambiguous interpretation. Greater clarity and amplification is required with respect to the two separate references of the effective interest rate in paragraphs 7 and 10 to enable preparers to better understand the components of the effective interest rate.

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

The (draft) IFRS should provide more guidance on the determination of expected cash flows to minimize the risk of earnings management and to ensure a minimum level of discipline in the estimation process. Examples of guiding principles are provided in other standards (e.g. IAS 36 Impairment of Assets) and these should likewise be featured in this standard. Guiding principles may be given on the following:

(1) Documentation of processes
    a. Assumptions used
    b. Estimation technique used
    c. Inputs used
(2) Authorization of processes
(3) Quality of inputs used
(4) Calibrating of estimation technique

(5) Discount factor
(6) Assumptions

**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?*

The objective of presentation and disclosure in the (draft) IFRS is clear but it duplicates the objective in IFRS 7 Financial Instruments: Disclosure with respect to quality of financial assets relating to credit risk. There should be a clearer demarcation of the scope of IFRS 7 and the (draft) IFRS with respect to disclosure of credit risks to avoid duplication and a fragmented approach to the disclosure of credit risks. Ideally, the disclosure requirements of credit risks should be in one IFRS.

Notwithstanding the above, there is merit in showing the presentation and disclosure requirements of the amortised cost basis in the same standard as the measurement requirements. The Board may wish to consider the featuring of all credit risk disclosures in the (draft) IFRS.

(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?*

The objective is appropriate but it is an ambitious objective that is not necessarily met by the (draft) IFRS. The draft (IFRS) provides information on the financial effect of gains and losses arising from an entity's estimate of expected credit losses. However, this in itself may not be sufficient to enable a user to evaluate the quality of financial assets, including credit risk.

**Question 6**

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

The proposed presentation requirements are appropriate. However, I question the value of the information on the allocated initial expected loss (refer to Question 4).

**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?*

I agree with the proposed disclosure requirements. However, amplification is required as to whether paragraph 17 is to be applied at the aggregate level or the transaction level. At the aggregate level, the information provided is likely to be too general. At the transaction level, the extent of detail will be overwhelming.

**Question 8 to Question 10**

I agree with the lead time provision and transititional requirements.

**Question 11 and Question 12**

The intuition of the practical expedient could be better explained. As it is, the methodology seems complex, inspite of the fact that it seeks to reduce practical complexities.

No Day 1 loss is assumed to arise from the practical expedient. This limits the recognition of a priced-in present value of expected loss that is incorporated in the fair value of the financial asset.

Yours sincerely

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