IAASB
INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD
545 Fifth Avenue, 14th Floor, New York, New York 10017 USA
Tel +1 (212) 286-9344 ▪ Fax +1 (212) 856-9420 ▪ www.iaasb.org

April 1, 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear David,

Re: Comments on IASB's Supplement to ED on Financial Instruments: Impairment

The International Auditing and Assurance Standards Board (IAASB) is pleased to provide comments on the IASB's Supplementary Document (SD) to its Exposure Draft (ED) on *Financial Instruments: Impairment*.

In formulating the comment letter, we have established a Working Group to monitor the development of the IASB project on Fair Value Measurement and Financial Instruments. The focus of the Working Group is to identify significant aspects of IASB proposals which could pose difficulty in an auditing context and therefore where the IAASB members' expertise can add value to the IASB's deliberations – for example, aspects of proposals where preparers' compliance may not be able to be achieved on the basis of objective evidence or where the basis for their judgments may be difficult to substantiate. Also, we took into account the discussion at the Expert Advisory Panel in which the IAASB participated as an observer.

Through our discussion, we have identified several proposed requirements that may be problematic from a verifiability/auditability perspective. The attached Appendix includes the Working Group's views on what are likely to be the most substantive issues from an auditing perspective resulting from changes in the proposed standards from current practice. Where possible, the Working Group has offered suggestions for the IASB's consideration as to how language in the standard could be amended to address the issues noted.

The IAASB looks forward to continuing to work with the IASB as early as possible in its standard-setting processes. I hope you find the comments in the Appendix valuable and encourage you to engage us in further dialogue if necessary as you finalize these proposed standards.

Yours sincerely,

Prof. Arnold Schilder
Chairman, IAASB

Appendix

IASB SUPPLEMENTARY DOCUMENT

FINANCIAL INSTRUMENTS: IMPAIRMENT

Comments of the IAASB's Working Group

OVERALL COMMENTS

The SD proposes that at each reporting date, an entity shall recognise an impairment allowance that is the total of (a) the higher of (i) the time-proportional expected credit losses and (ii) the credit losses expected to occur within the foreseeable future (for the "good book"), and (b) the entire amount of expected credit losses (for the "bad book").

The Working Group appreciates the IASB's initiative to better reflect expected losses in the calculation of financial instruments impairments, which many believe is an appropriate response to lessons learned from the recent financial crisis. The Working Group also is aware of the desire to more closely align the proposed accounting with entities' risk management. However, there are a couple of important implications from an auditing perspective.

First, an entity's accounting will reflect the entity's own risk appetite – for example, the basis on which they determine which financial instruments are in their "good book" or "bad book". Comparable entities with portfolios with similar underlying characteristics but with different risk management policies will report different financial results. Under the proposed model, disclosures that provide information about an entity's risk management policies will be critical to interpreting their financial results. Further, in adopting this model as the preferred accounting approach, the Working Group believes that it is important that stakeholders recognise that the audit process will not bring discipline to the risk management decisions. For example, the determination of which financial instruments are transferred to an entity's "bad book" is not being determined on predefined accounting criteria that can be verified during the audit process, but rather on the entity's own risk management policies.

Second, there will be a considerable amount of judgment involved in applying the proposed requirements in practice. The Working Group believes that it is important that the standard clearly sets out what support (or evidence) an entity is required to have to be able to demonstrate the judgments that they are making and the basis for them. In our comments below, the Working Group has identified certain areas where either the conditions, or the expectations of entities to support their calculation of the impairment allowance, were not sufficiently clear.

QUESTION 3 – Impairment Allowance for "Good Book"

(1) LACK OF GUIDANCE REGARDING TIME-PROPORTIONAL APPROACH

Issue Description

Paragraphs 2 and 3 of the SD require the use of the "time-proportional approach" when estimating the expected credit losses for "good book," yet very little guidance is provided for its implementation.

For example, although it appears from proposed definition of "portfolio" in Appendix A and the table set out in IEZ18 that financial assets in an entity's "good book" should be grouped into different portfolios, it is not clear how an entity should group loans. The extant IAS 39 provides guidance[1] in this regard.

[1] Paragraph A87 of IAS39 states that "For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtor's ability to pay all

Thus, the question arises whether when and how to group such financial assets in estimating impairment allowances is meant to be left entirely to the discretion of management or whether guidance similar to that in IAS 39 will carry forward.

Without more robust guidance (or at least, a guiding principle) in this respect, it may be difficult for auditors to have a clear basis on which to challenge management's decision regarding the appropriateness of asset groupings (e.g., loans with very different risk profiles could be grouped into the same category.) Likewise, there is very little guidance regarding how to allocate expected loan losses to each period (such as use of a straight-line method or annuity method). Loss patterns may significantly differ by nature of assets (e.g., losses patterns are said to be top-heavy for auto loans). Therefore, it may be important for the standard to identify matters that management should consider in determining an acceptable allocation method.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB provide additional guidance (or a guiding principle) to aid preparers and auditors in making appropriate judgments in these areas.

(2) ALL AVAILABLE INFORMATION

Issue Description

Paragraph B5 of the SD requires that an entity develop its estimate of credit losses for the remaining lifetime or the foreseeable future, considering *all* available information. The SD provides a list of possible sources, including historical data, current economic conditions, and supportable forecast of future events and economic conditions.

The Working Group is of the view that the reference to *all* available evidence may set an onerous benchmark that will not be practicable for management to implement, nor for the auditor to audit, taking into account that it encompasses forward-looking information. Therefore, the Working Group recommends that it should be made clear that management should develop its estimate of credit losses for the remaining lifetime or the foreseeable future based on evidence that is *reasonably practicable to obtain*.

Actions that IASB May Wish to Consider in Addressing the Issue

In the event the IASB decides to proceed with the revision as suggested, the Working Group recommends revisions (marked) to paragraph B5 of the SD as follows:

> "B5 An entity shall develop its estimate of expected credit losses for the remaining lifetime or the foreseeable future as required by paragraph 2, considering all **reasonably** obtainable information. Entities should consider both internal data (i.e., entity-specific information) and external data. **Such** ~~All available~~ information includes historical data, current economic conditions, and supportable forecasts of future events and economic conditions **that are reasonably practicable to obtain**."

(3) APPROPRIATENESS OF TERMINOLOGY

Issue Description

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amounts due according to the contractual terms (for example, on the basis of credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors)."

Paragraph B7 states that “For example, for shorter-term and medium term time periods, entities may develop *projections* of expected losses on the basis of specific inputs, such as *forecast* information.”

The terms “projection” and “forecast” may be understood differently than might have been envisioned in the SD. For example, the Glossary of Terms in the IFAC Handbook has separate and distinct definitions of a “projection” and a “forecast.”, the former being based on best-estimate assumptions and the latter reflecting hypothetical assumptions. Therefore, it would be helpful if the IASB clarified the use of these terms in the context of the IFRSs.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends the IASB to consider adding clarifications to the terms “projections” or “forecast” in the final standard.

QUESTIONS 6 and 7 – Separation between the “Good Book” and the “Bad Book”

(1) CONSTRUCT OF REQUIREMENTS OF THE STANDARD

Issue Description

The SD sets out proposed requirement as follows:

“2. At each reporting date, an entity shall recognize an impairment allowance that is the total of:

(a) for assets for which it is appropriate to recognize expected credit losses over a time period, the higher of:

(i) the time-proportional expected credit losses; and

(ii) the credit losses expected to occur within the foreseeable future (which shall be no less than twelve months after an entity’s reporting date); and

(b) for all other assets, the entire amount of expected credit losses.

3. Whether it is appropriate to recognize expected credit losses over a time period depends on the degree of uncertainty about the collectibility of a financial asset. It is no longer appropriate to recognize expected credit losses over a time period if the collectibility of a financial asset, or group of financial assets, becomes so uncertain that the entity’s credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.”

The Working Group believes that the concepts in paragraphs 2 and 3 are closely linked and would be clearer if several words were moved from paragraph 3 to paragraph 2.

In addition, the Working Group believes that paragraph 2 would be more clear and robust if the criteria that differentiate the categories were incorporated into the requirement so that the wording conveys the key principles underlying the requirement. It is the criteria for determining the category of financial assets for whom the impairment allowance should include the entire amount of the credit loss that is clearly defined in the proposed standard. Therefore, we also recommend that the order be changed. That is, in our view, the entity should first identify those assets for which the entire amount of expected credit losses is to be recognized (which the proposed standard clearly defines), and then determine the approach to be taken for all other assets.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends that following changes be made to the requirements (proposed wording changes are in bold and underlined):

"2. At each reporting date, an entity shall recognize an impairment allowance ~~**that is the total**~~ **composed** of:

(a) ~~(b)~~ for assets **whose collectability has become so uncertain that the entity's credit risk management objective has been changed from receiving regular payments to recovery of all or a portion of the financial asset** ~~**all other assets**~~, the entire amount of expected credit losses**; and**~~.~~

(b) ~~(a)~~ for **all other** assets, the higher of:

(i) the time-proportional expected credit losses; and

(ii) the credit losses expected to occur within the foreseeable future (which shall be no less than twelve months after an entity's reporting date)."

(2) NEED FOR A REQUIREMENT TO DIFFERENTIATE ASSETS INTO TWO GROUPS

Issue Description

Paragraph B4 states that "entities which do not manage credit risk using an approach that differentiates the management of financial assets depending on the uncertainty about their collectability in a way similar to the principle in paragraph 3 must still differentiate their financial assets into two groups for the purpose of determining the impairment allowance in accordance with paragraph 2."

This paragraph seems to contradict paragraph 2, as it establishes criteria for differentiating categories of financial assets depending on the uncertainty about their collectability, while the requirement is based on the entity's credit risk policies. Therefore, the Working Group questions whether paragraph B4 is really guidance on the application of the requirement in paragraph 2. One way to solve the problem would be to elevate paragraph B4 to the requirements.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends that the IASB examine how the abovementioned contradiction in the ED can be rectified and suggests that the concepts in paragraph B4 be elevated to the requirements.

(3) ROLE OF THE AUDIT

Issue Description

The Working Group understands that the proposed SD relies heavily on the effective operation of internal credit risk management of entities. This will improve the consistency between financial reporting and internal risk management, but at the same time it may have a downside effect on comparability across entities. Therefore, the Working Group wonders if a trade-off exists in attaining two different objectives.

For example, the SD proposes that "good book" and "bad book" be distinguished based on the objective of the recovery of financial assets. However, the Working Group questions whether a difference between credit risk management objectives is always apparent in practice. Paragraph B3 provides examples where the objective is seen as the recovery of the financial assets including an entity's taking actions such as enforcement of security interest or debt restructuring, which are quite obvious. Yet, making contact with debtors by mail, telephone and other means is only subtly different from regular contacts, especially when the credit risk management of the entity is not robust. Therefore, the Working Group questions if there is a risk that the proposed requirement may not be applied in a consistent manner across entities.

While it may not have been the intent, the Working Group feels that the standard as drafted may result in inappropriate reliance on the auditor to evaluate whether an entity's credit risk management policies are appropriate. Although auditors are required to assess internal controls and respond to assessed risks when performing audits in accordance with International Standards of Auditing (ISAs), auditors are not responsible for evaluating the effectiveness of an entity's risk management and rectifying deficiencies of controls, which rests with managements and those charged with governance.

Actions that IASB May Wish to Consider in Addressing the Issue

As noted in our introductory comments, the Working Group believes it is important that stakeholders fully understand the limitations of audit to drive consistency, under the proposed model, in financial reporting between entities with different risk management policies. Articulating an objective that clearly explains the role of an entity's credit risk management as a driver for determining the impairment estimates may be useful in this regard.

QUESTION 9 – Minimum Impairment Allowance Amount

CLARIFICATION OF FORESEEABLE FUTURE PERIOD

Issue Description

Paragraphs B11 to B16 of the SD explain credit losses expected to occur within the "foreseeable future period" in paragraph 2. In particular, paragraph B11 states that "an entity would make its best estimate of credit losses expected to occur in the future time period for which specific projections of events and conditions are possible and the amount of credit losses can be reasonably estimated based on those specific projections." That future period is referred to as the 'foreseeable future' for the purpose of this guidance. Paragraph B14 goes on to state that "the foreseeable future period may differ for different asset classes according to the characteristics of those asset classes."

The Working Group thinks that "foreseeable future period" as currently written is very subjective and the judgments around the foreseeable future period (in other words, how the amount can be *reasonably* estimated) may be difficult to verify. For example, what is considered a reasonable estimate may depend on how robust an entity organizes its internal control to provide supporting evidence, as opposed to the risk profile of assets. Thus, decisions regarding the minimum threshold seem to be left entirely to the discretion of management. Further, the Working Group questions whether the foreseeable future period will become shorter at a time of economic downturn, since the future often become more opaque in such circumstances.

Equally importantly, the Working Group believes that there is the potential for confusion between the "foreseeable future period" used to determine the minimum threshold and the basis for estimating the time-proportionate expected loss estimate. Paragraph B5 requires that, in estimating expected credit losses for the remaining lifetime or foreseeable future, expectations of future conditions should be based on *reasonable and supportable information* to substantiate those inputs used in the time-proportionate expected loss estimate. However, paragraph B11 states that an entity would make its best estimate of credit losses expected to occur in "the future period for which specific projections of events and conditions are possible and the amount of credit losses can be *reasonably* estimated based on those specific projections" (in other words, the foreseeable future period).

The Working Group supposes that the IASB intends different time-horizons between time-proportionate expected credit losses and the credit losses expected to occur within the foreseeable future (which is at least twelve-months), but feels that the two definitions are too similar to be able to draw clear distinctions. In particular, the Working Group wonders why an entity cannot reasonably estimate credit losses beyond the foreseeable future period given that there should be reasonable and supportable information for the remaining lifetime.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group suggests that the foreseeable future be defined as a definite time-period, such as twelve months. If a definitive approach is not preferred, an alternative may be to change the word “reasonably” to “reliably” and require the use of more external factors in determining the “foreseeable future.”

In addition, the Working Group recommends that the IASB reconsider the words to be used in articulating what is intended for different time-horizons in paragraphs B5 and B11.

QUESTION 11 – Flexibility Related to Using Discounted Amounts etc.

CLARIFICATION OF REASONABLENESS

Issue Description

Paragraph B10 of the SD permits an entity to use as the discount rate any reasonable rate between (and including) the risk-free rate and the effective interest rate (as used for the *effective interest method* in IAS 39) when using a discounted expected credit loss amount.

In the Working Group’s view, the wording does not place sufficient constraints around management’s choices and as a minimum, the standard should state that choices made should be reasonable in the entity’s circumstances.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends the following changes be made to the application guidance (proposed wording changes are in bold and underlined):

> “B8 An entity shall determine the time-proportional expected credit losses in accordance with paragraph 2(a)(i)**,** **using** ~~either~~ **a method that is considered to be reasonable in the entity’s circumstances, which could be...”**

> “B10 When using a discounted expected credit loss amount, an entity may use as the discount rate **a** ~~any reasonable~~ rate between (and including) the risk-free rate and the effective interest rate **that it is considered to be reasonable in the entity’s circumstances** (as used for the *effective interest method* in IAS 39).”

OTHER MATTERS (1) – MEASUREMENT OF EXPECTED LOSSES

The Working Group is aware that the IASB tentatively decided in March 2011 to measure the expected credit losses based on the expected value (principally using the probability-weighted possible outcomes), while several alternative methods may be regarded as its proxy. Although it is outside the scope of request for comments in the SD, we would like to draw the IASB’s attention to our comment letter on the IASB’s Exposure Draft of Liabilities, which states the practical difficulties of probability-weighted approach in measuring the liabilities.

OTHER MATTERS (2) – IAASB DISCUSSION PAPER

The Working Group is aware that the IASB tentatively decided in February 2011 to not incorporate a proposed disclosure requirement related to stress testing into the standard. However, the Working Group would like to draw the IASB's attention to the IAASB Discussion Paper (DP) "*The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*" published in January 2011. In the DP, the IAASB used the proposed stress-test information as an example for stakeholders' consideration as to the extent of auditors' work effort if it is to be audited (see paragraph 65-66 of the DP).