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Mouvement des Entreprises de France MEDEF

**A F E P**

**Association Française des Entreprises Privées**

IASB
30 Cannon Street
London EC4M 6XH
UK

Paris, 28 June 2010

Dear Sir or Madam,

*Re : Exposure Draft "Financial Instruments : Amortised Cost and Impairment"*

The IASB has issued the second phase of the comprehensive project of the replacement of IAS 39 dealing with amortised cost and impairment for financial assets and liabilities. We welcome the opportunity to respond to the Invitation to Comment on the Exposure Draft Financial Instruments: Amortised Cost and Impairment (the ED).

Detailed comments are provided in the Appendix to this letter. The following is a summary of our main concerns and comments.

1. We agree with the general principle of an approach to amortised cost and impairment based on the expected credit losses (expected loss approach) but disagree with the way it is prescribed in the ED.

   a. We do not agree with the changes in the definition of effective interest method or effective interest rate which the ED appears to be introducing;

   b. We think it is difficult to apply this approach to individual financial assets and it is best suited for application to portfolios (for which a historical statistical base can be used);

   c. We are not convinced by the practicality of the point-of-time or current estimate of expected losses, as we believe such estimates can only be made based on historical data adjusted in a potentially highly subjective way for management's assessment of how the future will differ from the past;

   d. We think the timing of expected losses is extremely difficult to forecast therefore it is more practical to assume they occur over the life of the portfolio. To apply this approach in a practical way, the average life of the existing portfolio would be used, this being calculated as the average maturity of the loans weighted by the outstanding balances.

e. We question why all changes in the estimated expected losses are recognised immediately in the income statement, as this appears contradictory with the principle of an expected loss approach in which a large part of the losses relate to future periods.

Consequently, we prefer an alternative expected-loss approach, such as that proposed by the European Banking Federation or the Autorité des Normes Comptables (ANC) in its comment letter on the ED. This approach is referred to in this comment letter as the "expected losses over the life of the portfolio" approach to distinguish it from that proposed in the ED.

2. We do not think that the proposed approach is appropriate for portfolios of listed debt securities, such as those held by insurance companies, as these rarely suffer from default and the creation of a complex method to deal with these does not seem justifiable, from the point of view of cost and perceived benefit. In addition, it should be made clear that the loss expectations for such items should not be inferred from the market expectations reflected in the quoted prices but determined by the application of judgement by the entity's management.
3. We do not agree that the ED's approach is relevant for trade receivables, which should, in our view, be scoped out rather than dealt with by "practical expedients".
4. We are not convinced that the interaction between the principles of the ED and those of the forthcoming proposed Revenue Recognition standard has been fully thought through and the principles harmonised. We think this is fundamental.

Should you wish to have any supplementary comment or explanation, please do not hesitate to contact us.

| ACTEO | AFEP | MEDEF |
|---|---|---|
| **Patrice MARTEAU**<br>Chairman | **Alexandre TESSIER**<br>Director General | **Agnès LEPINAY**<br>Director of economic and financial affairs |

**Appendix to our letter on IASB ED**
**"Financial Instruments : Amortised Cost and Impairment".**
**Answers to the specific questions raised in the invitation for comments**

## Detailed comments

## Objective of amortised cost measurement

### 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 think that the objective as described in paragraph 3 of the ED is clear.

  Having said that, we think it may be appropriate also to make it clear in this paragraph that the objective is not just to provide information about the effective return but also to provide information about future cash flows.

  Assuming we have correctly understood the meaning of the last sentence of paragraph 4, which refers to current cash flow information, we suggest that this could be made clearer by amending this to state that the cash flow information required should be for future cash flows and should be based on current or up-to-date information. Paragraphs 6 and 7 of the ED make this 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 believe that the objective described in paragraph 3 is appropriate for those financial instruments whose primary purpose is to earn a return through the charging of interest. We agree that an approach based on expected credit losses (expected loss approach) provides better information about the credit risk inherent in debt assets in this measurement category. This approach better reflects the economic basis of the premium charged as an element of the interest rate to cover the credit risk inherent in the debt instrument.

  However, we do not think that this objective is relevant to financial instruments where there is no intention to earn the primary return through the charging of interest, such as where the financial asset is a trade receivable resulting from the fulfilment of a revenue-related performance obligation. Where it is the intention to earn an interest-based return in addition to the revenue generated by the primary reason for the creation of the receivable, and the effect of this is material, the effective interest method, as currently defined in IAS 39, is relevant. Given the predominately short-term nature of such items, we do not think that the effect will be material in most cases.

  In addition, we think that the interest charged by non-financial entities for deferred payment facilities is generally not aimed at covering potential credit losses but is rather intended to compensate the entity for the financing costs incurred as a result of the deferred payment.

Inclusion of trade receivables with a “practical expedient” means that entities will have to spend a significant amount of effort wastefully on making estimates to show that these items need not be treated in the same degree of detail as those items at which the ED is really aimed. We therefore think that the measurement objective should scope out trade receivables from this measurement requirement rather than deal with them as a practical expedient. Failing this, the proposed standard should include guidance about the relevance of the objective to particular types of financial asset.

## Measurement principles

## 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 approach to the impairment model for amortised cost should be principles-based and not prescribe detailed mandatory techniques. We think that entities in different sectors and with different business models may deal with different financial assets and manage these and the related risks in significantly different ways. We think that it is necessary to allow entities to identify and apply the techniques which provide the most pertinent information about the performance of the entity in the most cost-efficient way. The accounting requirements should therefore be limited to ensuring that the objectives are clear and that entities will use techniques which are consistent with the expected losses approach. Examples of areas where we suggest entities should be given freedom to select appropriate methods include the design of the asset portfolios, the techniques used to estimate the expected losses and the method of allocation of the expected losses to accounting periods.

Although we do not agree with all the proposals in the ED, we do think that the resulting approach to impairment will represent a significant change from the current method laid out in IAS 39. In view of this, we think it will be necessary to emphasise the important features of the new model in the “measurement principles” section of the ED by bringing elements forward from the application guidance or basis for conclusions. By way of example, if the ED were to be finalised without amendment, and we reiterate that we do not think it should, examples of such elements would be:

1. It seems fundamental to this approach that the initial measurement is at fair value and that an allowance for expected credit losses is recognised over time by the effective interest rate mechanism (EIR) and expected cash flows reflecting credit losses;
2. Identified impairment losses result from subsequent changes in the estimate of the present value of the expected cash flows, whereas expected losses are reflected in interest income; and
3. Impairment gains can be recognised in the income statement even though no corresponding initial impairment loss was recognised in that statement (other than by the initial netting of the revenue against the expected loss).

While the above may be inferred from the presentation requirement laid out in paragraphs 13(a) and (b), in our view it is of sufficient importance to be clearly stated in the measurement principles section.

It may be advisable even to change the terms used to refer to this new approach, for example, by naming the new approach the "effective interest method including expected loss" model. We are concerned that if this is not done there could be considerable confusion about what is required.

We also think that the difference in measurement approach between assets, for which expected credit losses are required to be taken into account, and liabilities, for which expected losses due to the entity's own non-performance risk must not be taken into account, is important enough to be stated in the section on measurement principles (paragraphs 6 and 7) rather than relegated to a paragraph in the application guidance of Appendix B.

Finally, consistent with the above, we would expect that further non-mandatory guidance will be required to ensure that the inputs and methodology used by entities are as consistent and comparable as possible. Such guidance should be updated in line with the evolution of best practice.

## 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?***

**General**

We are concerned by the change in the meaning of terms that this ED appears to have introduced.

- It should be made clear that the effective interest method is just a method for allocating interest to periods. This method does not inherently require expected losses to be included in the relevant cash flows and indeed the inclusion of these is prohibited in the case of financial liabilities, as stated in paragraph B3.
- It should be made clear that the effective interest rate which results from the approach is one specific application of the calculation, and that an EIR calculation will not systematically include expected losses.
- We do not agree that "expected" is a synonym for "probability-weighted possible outcomes". Paragraphs 6, 8 and 9 would lead one to believe that the two are synonymous. We recognise that the proposed IAS 37 uses "expected values" to mean "probability-weighted" and in this case think that the ED should include the definition of "expected values" to make this clear.

**Specific comments on the proposed approach**

We agree with the broad principles of the impairment model based on expected losses rather than incurred losses, but, as indicated in our response to Question 2, we think it can be used only in certain circumstances.

We think that the principles of the expected losses approach as described in the ED present significant difficulties in practical application.

1. Estimation of the amounts and timing of expected cash flows (including losses) for an individual financial asset can in most cases be based only on historical data relating to experience of other, albeit similar, assets. Such a statistically based estimate is made, therefore, essentially on a portfolio basis. Furthermore, we believe that financial entities manage the risk of loss on a portfolio basis and that the risk-management systems and accounting systems are often quite separate from each other, and thus think that it is onerous to account for expected losses for an individual asset when the entity manages a large number of these. We think that the expected loss model is best suited for portfolios and should reflect the risk-management approach of the entity.

2. Following on from the above, we think that the EIR method of allocating expected credit losses is not the most cost-effecient method of allocating losses when accounting and risk-management systems are separate (also called “decoupled”). In our view, the principle should be to allocate expected losses to periods on a systematic and rational basis, without imposing the EIR approach.

3. Paragraph 8 requires estimates of amounts and timing of cash flows to be probability-weighted possible outcomes. While entities generally can estimate the amount of expected losses to an acceptable level of reliability, we think that it is much more challenging for them to estimate the timing of credit losses with any degree of reliability. We therefore think that it is reasonable to allow the use of a simplifying assumption, such as that of the loss occurring in accordance with a long-term average appropriate for the portfolio rather than to require the probability-weighted estimate of timing of losses for individual assets.

4. Banks generally use open, or “living”, portfolios in managing credit and other risks. Open portfolios group together assets of a similar nature while individual assets within the portfolio are created and extinguished on a continual basis. The use of the average life of the assets in the portfolio for the estimation of the timing of the expected losses provides, in our view, a reasonable estimate of the timing of credit losses to be used for the establishment of the amount of the credit loss allowance. We think this approach would combine simplicity of implementation with the provision of relevant information responding to the amortised cost measurement objective.

5. The current or point-of-time approach to the estimation of losses proposed in the ED seems to us to be impractical. As indicated above, in the absence of an individual indicator of impairment, such as, for example, insolvency and liquidity warnings related to individual entities, the expected loss estimates can be made only for portfolios on the basis of historical experience. Statistical data built up over the life cycle of a portfolio when coupled with observed current loss events for portfolios with characteristics close to those of the portfolio under review would provide, in our view, a more reliable estimate of expected losses than what is proposed. We think that the proposed approach will lead to highly judgemental estimates which will be almost impossible for auditors to verify or for management to justify.

We therefore prefer an alternative expected-loss approach, such as that proposed by the European Banking Federation or the Autorité des Normes Comptables (ANC) with the following principles:

1. The new impairment model should not change the current definitions of amortised cost or the effective interest rate calculation;
2. Expected losses in the new impairment model should be determined at the portfolio level;
3. The use of open portfolios should be allowed;
4. The allocation methodology should be systematic and rational and based on the expected losses over the life of the portfolio, with the effect of changes recognised on a prospective basis unless they relate to prior or current periods; and;
5. The credit loss allowance account should be utilised to cover incurred losses (write-offs) as well as to allow for expected losses.

We have the following additional concerns:

Portfolios of quoted debt securities

Where entities such as those in the insurance industry hold portfolios of debt securities with the intention of earning an interest-related return over the long term rather than for fair-value linked trading, it is consistent that these should be held at amortised cost. Debt securities are often listed and therefore have readily available market prices. We think it would be inconsistent with the expected loss model of the ED if the market expectation inherent in the quoted prices should drive the estimation of the expected losses. Market data and credit-agency ratings should be used as potential indicators of credit loss trends, but it should always be the management of the entity which arrives at an entity-specific estimate of future credit losses based upon its judgement.

Furthermore, listed debt securities rarely suffer from default. Information provided to users of financial statements should be relevant and useful while satisfying the cost/benefit challenge. This leads us to think that it is not justifiable to require a complex model to be implemented for such portfolios.

Consequently, we think that specific guidance should be included in the proposed standard to make the points above clear in the application guidance.

Trade receivables

As stated in our response to Question 2 above, we believe that the measurement principles of the ED do not provide the most relevant information for short-term receivables where a return from interest is not the primary revenue generator. In this respect, the forthcoming revenue recognition standard must provide guidance for this. Our understanding of that project is that the receivable will initially be measured at the transaction price, which is defined as the amount of consideration that a customer pays in exchange for goods or services. This will generally be the amount of the invoice adjusted as appropriate for the effect of rebates and contingent pricing.

The current guidance in the Framework and paragraph 14(d) of current IAS 18 make it clear how trade receivables should be accounted for. The following extract from paragraph 85 of the Framework summarises this.

For example, when it is probable that a receivable owed to an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognised.1

The future revenue-recognition standard appears to be consistent with this.

Credit losses tend to be customer-specific, and many entities undertake credit checks before selling to them, thereby reducing the potential scale of losses. Actual losses will become apparent relatively quickly and can be dealt with as they arise. We do not think that the effort and cost involved in setting up statistical provisioning matrices, as suggested in paragraph B16 as a practical expedient, can be justified where credit checks are carried out. For these reasons, and as a practical expedient to deal with credit losses in these cases, we would suggest that the principle should be to recognise these receivables initially at the full transaction price unless there are specific indicators that the receivable will not be recovered. On the contrary, where there is a large portfolio of homogenous receivables a reliable statistical data base could be used to set up a provision on an expected loss basis, but this should not be a requirement for all non-financial entities. We agree, however, that the expected loss approach will be relevant to sales involving significant credit terms.

We offer the following as an example of a situation where we think the ED would not result in the best information for users, but the current guidance referred to above works well. There are some types of arrangements with “risky” customers in highly competitive industries, such as the manufacture of telecommunications equipment, for which the initial expectation is that it is more likely than not that a sale will not result in a receipt of consideration. Revenue is accounted for at present (in accordance with IAS 18.14(d)) only when consideration is actually received. It is not clear to us how the revenue would be accounted for under the ED. Under one interpretation such sales would result in the recognition of a minor amount of revenue with the bulk being recognised as gains. Revenue is an important indicator for most entities and thus we do not think that this is the most relevant information for activities such as this. We believe that the existing practice (of either recognising full revenue when all the conditions in IAS 18.14 have been satisfied and thereafter recognising an expense for any non-payment that may be subsequently expected, or recognising revenue only when consideration is actually received for those cases where the condition in IAS 18.14(d) has not been met at the time of sale) is better. We therefore think that short-term trade receivables should be scoped out of this proposed standard.

In any event, we think that it is important that the ED make the interaction of IAS 18 and the ED very clear and that it is essential that the principles and requirements of the ED and those of the proposed revenue recognition standard be fully consistent.

[1] Extracted from Framework for the Preparation and Presentation of Financial Statements. © IASC Foundation.

## Objective of presentation and disclosure

## 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?*

While we agree with this objective in broad terms we have two concerns:

1. As discussed in our response to Question 1, we think a reference to the provision of information about future cash flows is missing; and
2. This section does not address the issue of the presentation of revenue other than interest income. This is relevant to trade receivables.

## Presentation

## Question 6

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

The issue of the presentation of revenue and trade receivables is not dealt with. In the case of revenue-generated trade receivables we think the existing practice of reporting gross revenue and presenting credit losses as a business expense rather than a reduction in revenue is well understood and provides more useful information. This should therefore be maintained for trade receivables as the primary purpose of the financial asset is not to generate interest revenue, but is merely a result of the revenue-earning process.

We agree with the use of an allowance account for credit losses rather than the integration of the expected losses in the asset account on grounds both of ease of accounting for preparers and clarity of presentation for users. It is our interpretation of the proposals in the ED that on initial recognition of the financial asset the allowance account will represent the initial estimation of the expected losses (presumably at a present value of zero for financial assets other than some short-term trade receivables), but that an allowance for the expected losses is built up through the allocation mechanism of the effective interest rate method. The use of a separate allowance account makes this clear. If this is the Board's intention, then we think it would be helpful to state this clearly in paragraph 15 and to articulate clearly the accounting entries that need to be made.

Similarly, we think that the most useful presentational approach for financial institutions is to allow for flexibility to allow the entity to provide the information in the way that is most helpful to the user and in conformity with the economic sector and local regulatory requirements within which they have to operate. This will mean in some instances that an interest margin will be presented separately from the credit risk effect. On the other hand, there may be cases where a gross interest revenue figure is required to be disclosed as a performance indicator and this should be allowed as well.

## Disclosure

## 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?***

Although we agree that most of the information required to be disclosed is relevant and useful in respect of the financial assets held by financial entities primarily for the purpose of earning interest, we do have concerns about the nature and quantity of some of the information required.

The objective of the ED, as laid out in paragraph 1, is to present useful information to users "for their assessment of the amounts, timing and uncertainty of future cash flows." Given the prospective nature of this objective, we do not think that the year of origination of financial assets, as required by paragraph 22 of the ED responds directly to this, but we think it represents a burden for preparers. For example, a table giving the required information for assets with a ten-year life could result in more than 50 elements. We are not sure that it provides much more relevant and useful information than the current liquidity information required by IFRS 7. In addition, if the entity's approach to estimating impairment is based on an open portfolio, as discussed in our response to Question 4, the date of origination is not at all relevant, in our view.

We disagree with the requirement to provide stress-testing information if the entity uses this technique for its own internal purposes. In the absence of a clear definition of what is meant by stress testing and clear principles about how these are performed, it is unlikely that the resultant information will be comparable between entities. We also wonder whether there is an overlap between these requirements for information about stress testing and the requirements of paragraph 17(b) of the ED, which call for sensitivity analysis disclosures. We think that the requirements of IFRS 7 are sufficient in respect of such disclosures.

However, we think that most of the required disclosure is irrelevant to financial assets generated by other revenue-earning activity (trade receivables) and represents an unnecessary burden for non-financial entities.

On a point of drafting, the word "reconciliation" in paragraph 21(a) should be replaced by "analysis". Failing that, the phrase "reconciliation between the opening and closing balances" could be used.

## Effective date and transition

### 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?***

We agree that three years after the date of publication of the IFRS would allow sufficient time for the implementation. In particular, this would allow entities to collect the information required for the transition adjustments in a contemporaneous way and thus avoid the use of hindsight.

### 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.***

In our understanding of paragraphs 26 and 27, the proposed approach to the computation of comparative data necessitates the use of available historical data and the retrospective use of data for similar financial instruments originated around the date of initial application. This appears to mandate the use of hindsight. Furthermore, given our concerns with the use of the proposed effective interest rate method for the allocation of losses, we think that this will be complex to apply.

We would therefore recommend a simplification of the transition approach through either the use of a long lead-time (of three years) or the use of the original effective interest rate and a separate expected loss allocation model.

### 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 these requirements.***

## Practical expedients

### Question 11

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

As discussed in our response to Question 4 we think that it should be clearly stated in the body of the proposed standard that short-term trade receivables will generally not fall within the scope of these requirements except in special circumstances.

## 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 indicated above, we think more guidance is required specifically allowing entities to:

1. Use portfolio approaches which are consistent with the business model or the regulatory framework;
2. Use open portfolios;
3. Use a long-term average approach to estimate credit losses , that is, based on statistical data established over the life of the portfolio or the economic cycle and adjusted for consistency with the characteristics of the portfolio; and
4. Use the average life of the assets in the open portfolio to allocate expected credit losses.