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Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street
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United Kingdom

Berlin, 29 June 2010

Dear David,

Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment

On behalf of the German Accounting Standards Board (GASB) I am writing to comment on the IASB Exposure Draft ED/2009/12 'Financial Instruments: Amortised Cost and Impairment' (herein referred to as 'ED'). We appreciate the opportunity to comment on the ED.

The GASB basically agrees with the measurement principles set out in the ED in the sense that they are putting revenue recognition for and impairment of a particular instrument on the same conceptual level. However, we have concerns as to whether transforming these principles into the proposed approach has been achieved in an adequate way.

The GASB sees major operational challenges in implementing the proposed model, i.e. it will be very costly and time consuming to change the current information systems or install new ones to provide the necessary information.

The focus of the new model lies on expected cash flows which are the estimates of the amounts and timing of cash flows over the remaining life of a financial instrument. This focus is based on an assessment of the individual financial instrument, while we believe that determining expected impairments after initial recognition should be done on a portfolio basis. We acknowledge and concur with the view that the proposed model incorporates the initially expected credit losses on the level of the individual instrument by means of inclusion in the effective interest.

Some claim that the expected loss model is superior to the incurred loss model as the incurred loss model is considered to be pro-cyclical. In our opinion the expected loss model still has a pro-cyclical effect. Major market downturns or uplifts will also lead to the so-called cliff effect in profit or loss under the expected loss model when estimates are adjusted; in comparison to the incurred loss model the only difference would be that the recognition may take place a little earlier.

The proposed model eliminates the impairment triggers required under the incurred loss model by requiring periodical re-estimation of future cash flows. Nonetheless, we expect similar difficulties to arise in practice as are experienced under the current model. In our view some sort of indicators will have to be employed to determine whether and when changes occurred that will result in adjusting the previous estimates.

As a conclusion, the GASB questions whether implementing a new impairment model as set out in the ED justifies the efforts regarding costs and time in light of the concerns pointed out.

The GASB has concerns as regards the focus of the ED which seems to be driven by a desire to amend the impairment principles for financial institutions and therefore welcomes the inclusion of practical expedients. However, we disagree with the approach taken with regard to considering materiality. Furthermore, we believe that the guidance for trade receivables – a major class of financial instruments for non-financial institutions – is not sufficient.

Please find our detailed comments on the questions raised in the ED in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix – Answers to the questions of the 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?

In GASB's opinion the description of the objective of amortised cost measurement in the ED is clear with regard to financial assets. However, the GASB is not sure how the objective should work for financial liabilities as one major component of amortised cost – expected credit losses - can only be incorporated for financial assets. Therefore, a financial instrument will not be accounted for symmetrically by the holder and the issuer, even though the objective for amortised cost measurement is the same.

> **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?

Under the proposals in the ED credit risk is the only cost component determining the pricing of a loan that is considered in the determination of interest income, i.e. netting this cost component against gross interest income. All other cost components (e.g. cost of refinancing, admin cost and loan service cost) are recorded gross as an expense and are not netted with gross interest income. There is no explanation in the basis for conclusion for such divergent treatment. A possible explanation, in GASB's view, is that the credit risk component leads to a change of future cash *inflows* while the other cost components lead to a change of future cash *outflows*. We recommend that the IASB either explains the reasoning for this divergent treatment in the final standard or reconsiders the proposed approach.

Question 3

Do you agree with the way that the exposure draft is drafted, which emphasizes 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?

The GASB does not agree with the exclusion of implementation guidance and illustrative examples. We have concerns with an external paper showing the recommendations of the expert advisory panel as well as with examples on the IASB website as both haven't undergone the same due process and thus add to the complexity of the IFRS guidance hierarchy. Implementation guidance and illustrative examples, where relevant, should be part of any final standard.

Another important issue, in our view, is to clarify the link between applying the effective interest rate method on the individual financial instrument (focus on revenue recognition) and determining expected losses (focus on impairment). In practice, the latter will often be done on a portfolio basis to arrive at meaningful results.

Finally, as the ED seems heavily focussed on financial institutions, the GASB thinks that further guidance for non-financial institutions is necessary. In this respect we refer to our answer to questions 11 and 12 below.

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?

The GASB basically agrees with the measurement principles set out in the ED as they put revenue recognition and impairment on the same conceptual level and as it is appropriate to recognise credit loss information as early as possible. However, we have concerns as to whether transforming these principles into the approach proposed in the ED has been achieved in an adequate way.

Paragraph 11 of the Basis for Conclusion in the ED specifies several points of criticism regarding the incurred loss model which would be addressed by the proposed model. The first point is that the proposed model would avoid the so-called front-loading of interest income in the periods before a loss event occurs. We agree with this point and assess the proposed model as superior in this respect.

The second point is the late recognition of credit losses that leads to the so-called cliff-effect and amplifies pro-cyclicality. While some claim that this effect will be reduced in the expected loss model, the GASB believes that the expected loss model is still pro-cyclical. Major market downturns or uplifts will also have that cliff effect in profit or loss under the expected loss model when estimates need to be adjusted; in comparison to the incurred loss model the only difference would be that the recognition may take place a little earlier. This effect would only decrease if the estimates of the expected losses focus more on worst case scenarios based on historical experience, which in our opinion is not appropriate. There are recommendations currently being discussed to adjust the expected loss model to address pro-cyclicality, e.g. to spread the effect of revising estimates of expected cash flows over the remaining maturity of the financial instrument or portfolio, which, according to the proponents of this approach, better meets the objective of Amortised Cost. We believe that it is appropriate to consider these recommendations in the future deliberations. The preceding discussion and views raise the question as to whether the objective of financial reporting is to function as counter-cyclical or not. In our view this question has not been finally concluded on. We recommend to further investigate the link between financial and regulatory reporting as well as macro-economic policies, if any, before making any decision one-way.

A further point raised is that the incurred loss model is inconsistent with how entities make lending decisions. While the GASB agrees with this point, we believe that the proposed model does not reflect lending decisions any better because the proposed model focuses too heavily on the individual financial instrument whereas the determination of risk premiums is usually done on a portfolio level.

Another important point of criticism regarding the incurred loss model represents the difficulty in determining the required impairment triggers. The proposed model eliminates these triggers by requiring a periodic re-estimation of future cash flows instead. It is our view that, in practice, some sort of indicators will still have to be employed to determine whether and when changes have occurred that will result in adjusting the previous estimates, rather than re-estimating the complete set of financial instruments at each reporting date. Thus, we expect similar difficulties to arise as are experienced under the current model and suggest that the IASB provides further guidance as to how this issue can be appropriately addressed by practice.

The proposed model is focussing on expected cash flows being the estimates of the amounts and timing of cash flows over the remaining life of a financial instrument. As a result, the implementation of such a model will cause immense operational challenges, i.e. will be very costly and time consuming to change current information systems or install new ones to provide the necessary information. The focus mentioned is based on an assessment of the individual financial instrument with regard to revenue recognition by using the effective interest rate method (which includes initially expected credit losses). Although the proposals do not include any requirements as to whether the expected cash flows have to be estimated on a collective or individual basis, we believe that this model encourages a portfolio approach in determining impairments. In this respect, we believe that separating the issues of revenue recognition (individual basis) from impairment (portfolio basis; including both initially and subsequently expected credit losses) would improve practicability – an approach known as decoupling which we are aware the expert advisory panel also recommends.

As a conclusion, the GASB questions whether implementing the new impairment model as proposed in the ED justifies the efforts regarding costs and time in light of the concerns pointed out.

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 is appropriate? If not, why? What objective would you propose and why?

The objective of presentation and disclosure in relation to financial instruments at amortised is in line with the objective of amortised cost set out in the ED. With regard to the objective of amortised cost we refer to our answer to question 2 above.

Question 6

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

The GASB agrees that the proposed presentation requirements are appropriate for financial institutions with significant revenue streams resulting from interest-bearing financial assets. However, we have doubts as to whether these requirements are still appropriate for non-financial entities whose financial assets mainly consist of trade receivables. Therefore, we do not agree with the proposed requirement to include the five line items on the face of the income statement in all cases. We prefer to retain the current requirements in IAS 1.82 and 1.85, that is, additional line items shall be presented in the statement of comprehensive income, when such presentation is relevant to an understanding of the entity's financial performance. Accordingly, an entity with significant interest revenue resulting from financial assets measured at amortised cost would present the proposed line items, even absent of new requirements.

Question 7

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirements 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?

The GASB acknowledges that the IASB is proposing more comprehensive disclosures in relation to financial instruments measured at amortised cost thereby reflecting critical feedback received. In this respect, some of the proposals are independent of the impairment model for financial instruments. Others are necessary because of the judgement and resulting subjectivity inherent in the proposed expected loss model. Having said this, we have the following comments regarding the proposed disclosures.

Paragraph 15(b) of the ED requires entities to disclose its write-off policy for each class of financial assets. As appendix A of the ED contains a definition of write-off, we question the necessity to outline a write-off policy since this will likely not be more than repeating the definition in the standard. Hence, the IASB should either eliminate the definition of write-off to make the timing of write offs an accounting policy decision, or the IASB should keep the definition and eliminate the respective disclosure requirement.

The GASB understands that defining the status of a financial asset that is 90 days past due as non-performing is a convention used in the financial industry. However, we have concerns with this definition for non-financial institutions. Whether or not a financial asset is considered non-performing depends on several factors such as the specific industry sector, the business model, geographical region and local payment habits, and cannot be determined by bright lines. In this regard, an entity-specific determination of non-performing financial assets would be more appropriate. On the other hand, a given definition would support comparability of relating disclosures. We would, therefore, suggest to keep the 90 day threshold but to replace the negative term 'non-performing' with the neutral and factual description "90 days past due". It is then up to the users of financial statements whether they assess financial assets that are 90 days past due as non-performing or not.

We support the proposed comparison of loss allowance with cumulative write-offs ('loss triangle') and agree with the reasoning in BC55 und 56 of the ED. However, we are not sure whether these objectives will be met, because, based on the definition of write-off in the ED, the time-lag between the 'actual' loss incurring and the write-off may be significant. Additionally, it is not clear for how many period(s) the write-offs would have to be accumulated and when – if at all – they can be netted off. Resulting high cumulative write-off figures would impact the transparency of the disclosures.

We anticipate difficulties in practice in circumscribing what is a stress test that leads to the proposed disclosure requirements.

Paragraphs 18(b) and 19(b) of the ED both require disclosures only when the effect is significant (also in paragraph 21(b)). The GASB wonders whether the term 'significant' has the same meaning as "material". If so, we recommend eliminating the above-mentioned references to significance since, in our opinion, the general materiality principle applies to all IFRSs and therefore does not need to be repeated in each standard. In case the term 'significant' has a notion different from materiality we suggest clarifying this aspect.

The GASB understands– particularly in the context of the financial crisis – that origination and maturity (vintage) information is important for certain financial assets (CDOs and similar structures). However, requiring that information to be disclosed for all financial assets measured at amortised cost and by all IFRS-preparers of financial statements will result in an onerous and burdensome task, for which the decision-usefulness of the information is questionable in the majority of cases. Furthermore, if that information is seen as so important, why is it then not required for financial assets measured at fair value?

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 a sufficient lead time is necessary given the expected implementation challenges. The proposed three years until a mandatory effective date consider the feedback from last year's request for information. Nonetheless, as in some cases the necessary EDP platform or structure has to be installed first before the implementation can be started, the three years appear to be the lower limit of the necessary time frame.

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.

The GASB understands and agrees with the reasoning why the IASB proposed neither fully retrospective nor fully prospective application of the new requirements of the ED. We also understand the reasons why the IASB rejected the alternative transition approach. It is our impression that in the eyes of the IASB a transition approach should meet two objectives: to recognise an adequate bad debt allowance (contractual cash flows not expected in the future) at the transition date and to ensure correct revenue recognition (interest revenue) in future periods. The GASB believes that – as this is an ED on amortised cost and impairment – the focus should be placed on the bad debt allowance. Therefore, we prefer the alternative transition approach, which will reduce implementation issues. The fact that the proposed transition approach in the ED is also an approximation affirms our view.

Regarding the restatement of comparative figures, it is our understanding that applying the proposed requirements to trade receivables might result in retrospective adjustment of revenue figures. In this context, we would like to point out that the recently published exposure draft on revenue recognition envisages retrospective application. Therefore, we strongly feel that cases in which entities have to adjust their comparative revenue figures retrospectively twice should be avoided.

Question 10

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

As mentioned above, the GASB prefers the alternative transition approach for which the proposed disclosures in relation to transition are not necessary. If the IASB were to retain the proposed transition approach, we would deem the disclosures appropriate, though.

Question 11

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

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?

The GASB appreciates the inclusion of practical expedients in this ED, which was developed with a focus on financial institutions but will nevertheless be applicable to all IFRS preparers, including those for which trade receivables make up for the majority of financial assets. However, we are troubled by the course of action the IASB has taken in this respect. As already mentioned above, it is our view that the general materiality principle applies to all IFRSs; that is, IFRS requirements do not need to be applied to immaterial items. In contrast to this, the ED prescribes what needs to be done if something is immaterial. The GASB does not agree with this approach. It does not make sense to provide requirements for the accounting for immaterial items if these requirements can be ignored under the general materiality principle.

Secondly, we do not see the relief for the preparers in this approach. To assess whether the effect is immaterial, the entity has to perform both the proposed amortised cost calculation and the practical expedient, resulting in more and not less effort.

Irrespective of this criticism the GASB welcomes the explanations in B16 of the ED regarding trade receivables. Nevertheless, we believe that there are some important issues not yet addressed. We agree that the initial expected losses on trade receivables shall be treated as a reduction from revenue as this is in line with the proposed model. Accordingly, if cash flows are received in excess of the initially expected losses, we believe that these should also be recognised as revenue. We also believe that it is appropriate that subsequent changes in the estimated expected losses on trade receivables shall be presented in a separate line item in the statement of comprehensive income, if material. However, we do not think that this line item should be presented as a component of interest revenue. Additional questions arise if the cash flows received exceed both the initially and subsequently expected losses on trade receivables, e.g. nominal amount of CU 100, initially expected cash flows CU 95, subsequently expected additional losses of 5 (resulting in amortised cost of CU 90) and cash flows finally received in the amount of CU 98. In those cases the excess amount would have to be split up between the reversal of subsequently expected losses and the initial estimate. In combination with the required use of an allowance account such cases might lead to recording difficulties or the need to use two allowance accounts.