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Sir David Tweedie
Chairman of the
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30 Cannon Street
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Berlin, 8 April 2011

Dear David,

Supplement to ED/2009/12 Financial Instruments: Impairment

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

The GASB appreciates the efforts of the IASB in developing its original impairment model to make it more operational by taking into account the feedback and recommendations received from its constituents and the expert advisory panel. We also appreciate the model proposed in the SD has been jointly deliberated by the IASB and the FASB.

The GASB principally supports the proposed impairment model. It uses more forward-looking information about credit losses and thus addresses the weakness identified for the current incurred loss model by an earlier recognition of expected losses. While this was also achieved by the model included in the IASB's original exposure draft, the model proposed in the Supplement is much more operational than the model included in the IASB's original exposure draft. However, we do not agree with the proposed minimum impairment allowance (the 'floor'). We would prefer an approach - similar to the principle in IAS 38.97 - where an entity has to assess whether there are indicators based on which it is probable that the pattern of a portfolio's expected credit losses will deviate from a linear distribution, and if such a pattern can be determined reliably, recognise an impairment allowance in accordance with this pattern. Otherwise, the entity should apply the time-proportional approach for determining the impairment allowance proposed in the SD. Furthermore, we think that further clarification on the differentiation between the 'good book' and the 'bad book' is needed, e.g. for acquired portfolios of distressed debt and impaired financial assets acquired within a business combination.

We understand that the scope of this SD is limited to financial assets managed in an open portfolio as this is the area where most commentators identified major operational challenges in applying the original proposals and which in the IASB's view should be solved in the first place accordingly. As such, short-term receivables without a stated interest rate that are so short-term that the effect of discounting for the time value of money is immaterial, are out of the scope. We disagree with this scope exclusion which is in contrast to the objective of developing one single impairment model for all financial assets accounted for at amortised cost. Our general concern is that the scope exclusion for short-term receivables will result in those receivables not being adequately considered in the future deliberations, keeping in mind that trade receivables represent a major class of financial instruments for non-financial institutions – a point we already raised in our comment letter on the IASB's original exposure draft.

Finally we would like to point to the effect of the proposed impairment model in relation to transition. As the supplementary document does not address transition issues, we assume that the proposals in the original exposure draft would still apply, ie the new model should be applied retrospectively. Accordingly, an entity would determine the impairment allowance at transition date as if it had always applied the proposed model and would recognise the portion of the allowance relating to past periods against retained earnings in the first comparative period presented as an adjustment entry. We understand from our constituents that it is difficult to assess the impact this adjustment might have on retained earnings given the need for a thorough analysis and the limited time frame resulting from the two months comment period. Depending on the individual facts and circumstances the impact on retained earnings (and resulting regulatory capital) could be quite significant for some entities. Therefore, the GASB emphasises that this issue is considered carefully when transition and effective date of these requirements are decided upon.

Please find our detailed comments on the questions raised in the SD 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

> **Question 1**
>
> Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

The GASB believes that the impairment approach proposed in this supplementary document uses more forward-looking information about credit losses and thus will result in a principally earlier recognition of expected credit losses. Therefore, we think that the approach addresses the weakness identified for the current incurred loss model, in which recognition of expected credit losses is delayed until certain impairment trigger events have occurred.

> **Question 2**
>
> Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?
>
> Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all financial assets.

The GASB holds the general view, that it is important to have a single impairment approach for all financial assets of the same category, ie financial assets carried at amortised cost. It is our understanding that this supplementary document focuses on open portfolios as this is the area where most commentators identified major operational challenges in applying the proposals set out in the IASB's original exposure draft. The necessary differentiation of re-estimated credit losses relating to old or new loans in an open portfolio is no longer an issue due to the proposed ‘decoupled’ approach. An updated estimation of expected credit losses (including determination of the age and remaining life of the portfolio) will now be required at each reporting date. In this respect, an open portfolio will be treated as a closed portfolio at that point in time. Therefore, we cannot foresee any operational issues in applying the proposed approach to closed portfolios.

With regard to single assets, we believe that using the differentiation into the two groups (ie ‘good book’ and ‘bad book’) should be suitable as well. Whether single assets that are assessed as belonging to the ‘good book’ can be regarded as a portfolio depends on their number and the way an entity manages them. If those single assets are not regarded as a portfolio, we think that further guidance is necessary how to consider expected losses and to determine the impairment allowance; a possible approach would be a collective assessment similar to what is currently included in IAS 39.64.

Question 3

Do you agree that for financial assets in the ‘good book’ it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

The GASB acknowledges that the IASB has taken into account the feedback from comment letters received as well as the recommendations from its expert advisory panel with regard to the operational difficulties anticipated when applying the proposals in the original exposure draft.

One major issue in relation to the proposed expected cash flow model was the required estimation of when expected credit losses will occur, ie timing of the expected credit losses. The proposed approach allows an entity to determine the time-proportional impairment allowance for financial assets in the 'good book' by allocating the undiscounted credit losses expected to occur during the remaining life of the portfolio over the portfolio's expected life on a straight-line basis. This simplification makes the approach more operational, in particular for entities without sophisticated systems. For those entities which are able to estimate the timing of expected credit losses the proposed approach allows using either a discounted credit loss amount or applying the annuity method to better reflect their more specific estimates. However, the simplification does not resolve the issue of entities (e.g. start-ups) that have no historical experience to estimate expected credit losses.

We believe that the proposed approach for determining the time-proportional impairment allowance strikes an appropriate balance between a necessary simplification to make the proposal operational and an acceptable approximation of the outcome that would have resulted from applying the proposals in the IASB's original exposure draft.

The GASB does not support the proposed introduction of the 'floor', ie recognising the credit losses expected to occur within the foreseeable future as a minimum impairment allowance. Instead, we suggest the following approach: an entity has to assess whether there are indicators based on which it is probable that the credit losses of a portfolio will not occur evenly spread over the remaining life of this portfolio (applicable for both early loss patterns and late loss patterns). If a straight-line loss pattern is identified as probable or the loss pattern cannot be determined reliably, the entity should apply the time-proportional approach for determining the impairment allowance as set out in the SD. If a non-straight-line loss pattern is identified as probable and can be determined reliably, the entity should consider and recognise an impairment allowance in accordance with the identified loss pattern. In doing so, credit losses expected to occur in identifiable shorter time periods should be recognised on a straight-line basis over these periods (e.g. for a portfolio with 10 years remaining life and total expected losses of CU10 of which CU 4 are expected to occur in the first two years, the entity would recognise CU 2 as an impairment allowance in year 1 and year two respectively and allocate the remaining CU 6 over the remaining 8 years on a straight-line basis).

We think that our suggested approach represents a corresponding application of the principle for amortising intangible assets with finite useful lives ("The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used" (IAS 38.97)).

Question 6

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Question 7

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Question 8

Do you agree with the proposed requirements to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

The GASB generally agrees with the proposed requirements to differentiate between the two groups for the purpose of determining the impairment allowance. We fully support the approach that an entity shall differentiate the two groups on the basis of its internal credit risk management. This ensures that the accounting reflects what an entity is actually doing rather than introducing an artificial principle that might often differ from the actual systems in place.

However, we believe that in certain areas further clarification is necessary. It should be clarified whether an acquired portfolio of distressed debt (with the purchase price reflecting such distress) accounted for at amortised cost can be included in the 'good book' or not. The same issue arises where financial assets are acquired as part of a business combination and the acquired company had already recognised an impairment allowance on those financial assets. Furthermore, we heard different views whether the proposed approach can also be applied to portfolios of securities (e.g. corporate and/or government bonds) in cases where those portfolios qualify to be accounted for at amortised cost. In preferring a single impairment model we think that such types of portfolios should be covered as well.

We understand that the link to the internal credit risk management could restrict comparability between entities due to differences in the respective credit risk management. However, we believe that the proposed disclosure requirements will mitigate those concerns.

The GASB believes that in general the proposed differentiation requirements are operational and auditable. We note that a higher level of judgement will be involved the less sophisticated the internal credit risk management system is.

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Ad (a): The GASB understands that the proposed approach is the result of combining the two models developed separately by the IASB and the FASB and that the proposal to require a floor for the impairment allowance related to the 'good book' has been included to avoid insufficient allowance in certain cases. As described in our answer to questions 3 - 5 above, we disagree with the proposal of a floor for the impairment allowance related to the 'good book'.

Ad (b): The GASB prefers to consider the expected pattern of future credit losses when it is probable that this pattern will deviate from a linear distribution, which should not be limited to early loss patterns.

Ad (c): Please refer to our answer to (b) above.

Ad (d): Para. B11 of the ED defines 'foreseeable future' as 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. Following this definition, we do not concur with the IASB that the foreseeable future period will be relatively stable over time and does not significantly change each reporting period. Particularly in times of high market volatility the ability to make reliable forecasts or projections could be more limited compared to periods of low market volatility. This may result in the foreseeable future being a shorter period.

Ad (e): The foreseeable future period will depend on the individual facts and circumstances. Regarding the determination of the foreseeable future period by different entities, some argue that market discipline will prevent significant variations for similar types of portfolios. Besides, if an entity is required to report the credit losses expected to occur within the next twelve months for regulatory purposes, it is likely that this is also used for determining the floor amount.

Ad (f): In general, we believe that establishing a 'ceiling' is not consistent with the definition of 'foreseeable future' as set out in Para. B11 of the ED. Our preferred approach as set out above would use neither a 'floor' nor a 'ceiling'.

Question 10

Do you believe that the floor will typically be equal or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

Whether the floor will be equal or higher than the amount calculated in accordance with paragraph 2(a)(i) depends on the characteristics of the individual portfolio and the determination of the foreseeable future period (refer to our answer to question 9 above). We believe that the floor amount will likely be higher than the amount calculated in accordance with paragraph 2(a)(i) in cases where the instruments in the portfolio are short-term or have early loss patterns.

Question 11

The boards are seeking comment with respect to the flexibility related using discounted amounts. Specifically, on the following issues:

(a) Do you agree with the flexibility to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?

(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

The GASB understands that the proposed flexibility to use either a discounted or undiscounted estimate of the expected credit losses as one of the IASB's concessions to make the original proposals more operational. The price for this is that the outcome is a broader approximation compared to the original approach.

We do not agree with the proposed flexibility in selecting a discount rate. We have concerns that this may result in considering changes in credit risk twice – in the re-estimated expected losses and in the discount rate. Therefore, we suggest using the effective interest already calculated for recognising interest revenue (in accordance with the effective interest method in IAS 39) also for discounting the expected credit losses; for an open portfolio that would be the weighted average effective interest rate at the reporting date.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why, or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

We have described our suggested approach in our answer on questions 3 - 5 above, which would use the IASB approach only in circumstances where it is either not probable or not reliably determinable that the expected pattern of future credit losses will deviate from a linear distribution.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why, or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

We have described our suggested approach in our answer on questions 3 - 5 above and, accordingly, do not prefer the FASB approach.

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

In our comment letter on the IASB's original exposure draft we pointed out that the proposed integrated approach - besides the operational challenges already mentioned - 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 to arrive at meaningful results. Therefore, we fully agree with the proposal in the supplementary document that the determination of the effective interest rate should be separate from the consideration of expected losses.

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

The GASB agrees to apply the same impairment model to both loans and loan commitments, as those are often managed within the same business model. The same applies to financial guarantee contracts.

In our opinion, the proposed model can be applied to loan commitments and financial guarantee contracts.

In this context we would like to refer to our comment letter on the ED/2010/8 *Insurance Contracts* stating that we do not support the proposed approach that financial guarantee contracts as currently defined in IFRSs should be brought within the scope of the IFRS on insurance contracts. In our view, such a requirement causes practical application issues for non-insurance entities that have historically been accounting for such contracts under IAS 39.

Question 17Z

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

To make the impairment model more operational, the distinction between initial and subsequent estimates of expected credit losses has been eliminated. As a consequence, the two line items related to impairment for credit losses in the original proposals are no longer required leading to the proposed presentation requirements.

However, the GASB prefers – as it has repeatedly expressed in earlier comment letters - 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, whether an entity shall present interest revenue and/or impairment losses as separate lines on the face of the statement of comprehensive income or as a disclosure in the notes should be determined based on the general principle in IAS 1.

Question 18Z

(a) Do you agree with the proposed disclosure requirements? If not, which 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) for the proposed impairment model and why?

The GASB agrees with the proposed disclosure requirements. As mentioned above, we support that the proposed impairment approach is based on an entity's internal credit risk management. As this differs from entity to entity, users need corresponding information to gain a necessary understanding and are able to compare different entities. In our opinion, the proposed disclosure requirements are appropriate in this respect. In addition, due to the link to the credit risk management, an entity has all the necessary information available to comply with the requirements.

With regard to the proposed five year comparative disclosures we would suggest requiring a successive disclosure upon transition (e.g. only one year comparative figures on transition and building it up in the following three years). In our view requiring such a comparative disclosure for five years at transition would represent an inappropriate burden for preparers.

Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

The GASB agrees with the proposal to determine the amount of related allowance to be transferred when a financial asset is transferred between the 'good book' and the 'bad book' or vice versa. We believe that this a pragmatic proposal facilitating the required reconciliation in the allowance account for both books.