Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valore

June 29, 2010

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

RE: Exposure Draft on *Financial Instruments: Amortized Cost and Impairment ED*

Dear IASB Members:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1) thanks you for the opportunity to provide our comments regarding the International Accounting Standards Board (IASB or the Board) Exposure Draft on *Financial Instruments: Amortized Cost and Impairment* (the Exposure Draft or ED).

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement. Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of Standing Committee No. 1 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

We have organized our letter in three sections. The first provides some general observations about the project and the second provides some general observations regarding the Board's proposal. The third, located after the signature page, answers the questions in the Exposure Draft's Invitation to Comment.

General Observations about the Project

Project Objective

We support the Board undertaking this project to determine how best to measure investments in financial instruments which pursuant to the provisions of IFRS 9, *Financial Instruments*, are accounted for under an amortized cost model. We believe that issues associated with the current approach to measuring impairment for these investments became more evident during the recent financial crisis and thus it is worthwhile for the Board to pursue improvements to the quality of the information provided to investors.

We support what we understand to be the Board's primary improvement objective which is to incorporate more forward-looking information about credit losses into the operation of the amortized cost model, and thus into the information reported to investors. Some have described this objective as "recognizing all

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impairment losses sooner than under today's incurred loss model." We do not use this description, however, because it emphasizes a result as opposed to an objective that would best serve investors.

The challenge for the Board in pursuing improvements to the current amortized cost model is to find ways to address matters in a way that yields better information for investors than under today's approach. As any possible approach will likely have shortcomings and thus involve trade-offs, the Board will in the end find itself choosing among them. For example, a model that calls for extended use of judgment in predicting future cash flows may provide a more faithful reflection of changes in economic conditions, but it may also be very difficult to know and thus to audit aspects such as the period over which data should be collected, whether average or period end data should be given more prominence, whether economic cycles should be taken into account, and so forth. Such a model also raises concerns in terms of comparability between issuers and difficulties for the issuers to communicate on the key assumptions used, in particular if numerous portfolios need to be considered. We think it is important that the Basis for Conclusions clearly explain to investors how the Board weighed the strengths and weaknesses inherent in the eventual chosen approach.

Convergence

Convergence may be particularly noteworthy for the accounting model for investments in financial instruments given the global comparisons that do occur within the financial services industry. For this reason, and the benefits that converged standards bring to the global capital markets more generally, we believe that the capital markets would benefit from converged approaches to measuring the amortized cost of financial instruments between IFRS and U.S. GAAP. A fully converged approach for the accounting for financial instruments would, however, also encompass the broader aspect of which financial instruments an issuer reports at amortized cost. We know the Board and the Financial Accounting Standards Board continue to evaluate this matter; we encourage this work. The Board should, however, balance the goal of convergence with the objective of issuing, in the end, a high quality and improved financial instrument standard.

Due Process

We found it difficult to appreciate exactly what the Board was proposing in its Exposure Draft because—as the Board acknowledged at the time it issued the ED—additional research was needed on the operational aspects of its proposal related to the nature and extent of guidance necessary to derive the estimates of expected cash flows over the life of a financial asset. We realize that the Board is now completing its consultations with its Expert Advisory Panel (EAP) which is addressing these operationality matters. We look forward to considering what the Board has learned from that process and how, if at all, it might revise its proposal accordingly.

We are concerned; however, that there will not be an opportunity for the Board's constituents to review and comment on any amended proposals. We urge the Board to consider due process implications surrounding any changes made to the proposed impairment model and/or additional application guidance that results from information gathered from the EAP, financial statement users and/or from other stakeholders. Even if the Board's enhancements are in the form of implementation guidance to the basic model that it has proposed, we believe it is important that any additional implementation guidance be authoritative, included in the standard, and therefore subject to appropriate due process.

General Observations about the Board's Proposed Approach

The Board's Proposed Model

We understand the Board's proposed measurement principles to, in summary, focus on the expected profitability of each of an issuer's investments by considering the sources of associated earnings (interest, fees, discounts, and so forth) and the sources of associated costs and losses from non-payment

(origination costs, premiums, credit losses, and so forth). Thus, an issuer recognizes the amount of the initially expected profitability—the instrument's initial effective yield—during the life of the instrument by attributing it among the reporting periods via the functioning of the effective interest rate method, adjusting the amount at which the investment is carried, accordingly. Additionally, when an issuer changes its expectations regarding the timing and/or amount of these future cash flows—whether it be a collective increase or decrease in the present value of the anticipated earnings, costs and credit losses—the issuer immediately recognizes in profit and loss on a present value basis the amount by which its expectations have changed.

By way of contrast, under today's approach the sources of an investment's earnings and costs are recognized under such an effective yield approach but the losses from non-payment are separately recorded at the time and in the amount at which they are incurred. Under today's model only changes in an issuer's estimates of incurred losses are immediately recognized in profit and loss.

General Observations about the Board's Proposed Model

The Proposed Approach

We support the fact that the Board's proposed amortized cost model incorporates more forward-looking information about credit losses than does the current amortized cost model. We understand that there is a trade-off between forward-looking measures that are subjective in nature and a measurement model that allows for a high degree of comparability between reporting entities.

We also support the fact that the Board's proposed model eliminates the complexities and the potential for diversity in practice associated with identifying whether, and if so when, a loss event has taken place. This feature addresses the criticism described in the Basis for Conclusions of the ED that the incurred loss model creates information deficiencies because the effect of cash flows not expected to be collected is recognized once the incurred threshold is crossed and the criticisms about the consistency of its application in practice.

Most SC 1 members are comfortable with the general approach and recognize the trade-offs inherent in how the Board proposes to incorporate more forward-looking information into the measurements of the amounts recognized in the financial statements, as provided for in the Board's proposed model. Most members see the conceptual merit to building from the amounts and timing of the expected future cash flows of an instrument over its life to derive its effective interest rate, and use of the expected effective interest rate at inception to calibrate how the amortized cost of the instrument is adjusted each period to reflect the expected effective yield on the investment in profit and loss. One SC 1 member reserves judgment on the general approach in light of a current proposal on these matters by its national standard setter.

All SC 1 members agree that it is difficult to conclude on the merits of the Board's proposed approach to embed and then recognize expected credit losses via the effective interest rate calculation without considering the potential alternative models and implementation approaches that we understand are currently being considered by others. Those SC 1 members who are comfortable with the Board's general approach reserve final judgment until we have sufficient information to conclude on whether the proposed model is operational by considering the results of the work of the Board's Expert Advisory Panel, and so forth.

Consequences of the Proposed Approach

To function as an improved amortized cost accounting model the measurement principles in a final Standard need to be operational. It is not clear to us whether the measurement principles proposed in this ED would be operational. More specifically, we are concerned that the application guidance provided in paragraphs B3-B10 will not be sufficient to provide for a reasonable level of consistently applied

judgments around estimation of expected future cash flows and future credit losses to prevent earnings management. Estimating both the amount and timing of future cash flows, including future credit losses is highly subjective and will require significant assumptions and judgments by management. This exercise will have to be performed for a significant number of closed portfolios, which we think would be quite difficult in practice. We understand that the EAP is undertaking further research on the operational aspects of the proposal related to the nature and extent of guidance necessary to derive the estimates of expected cash flows over the life of a financial asset. We believe that additional authoritative implementation guidance is essential.

While estimating future cash flows is important, of additional importance to the quality of the information provided to investors is how an issuer reports the inevitable changes in those estimates that arise during the life of the investment. During its redeliberations, the Board will inevitably reconsider its proposal that an issuer recognize the amount of the increase or decrease in expected credit loss estimates in the profit or loss of the period in which the re-estimation occurs. SC 1 members have expressed varying concerns regarding an approach which instead spreads changes in estimates over the remaining life of the investment because of its deferral nature compared with the proposed approach.

Because of the subjective nature of estimating expected future outcomes under the Board's proposed approach—even if it is accompanied by additional application guidance—we think adequate disclosures that provide users with sufficient information about the assumptions and models that underlie those estimates are essential. A goal of the disclosures should be to allow users to assess the effect on earnings of the judgments used and the reasonableness of those judgments. We acknowledge, however, the practical difficulty of disclosing quality information that is disaggregated enough to provide meaningful insight and yet concise enough to be understandable given that financial institutions have a great number of portfolios whose characteristics differ.

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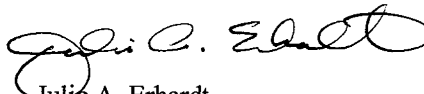
We appreciate your thoughtful consideration of the comments raised in this letter. If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at 202-551-5300.

Sincerely,



Julie A. Erhardt
Chairman
IOSCO Standing Committee No. 1

cc: Financial Accounting Standards Board

Appendix

Responses to the Board's Questions in its Invitation to Comment

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?

Yes, we believe the objective of amortised cost measurement is clear in the ED. Although we understand the objective, we think the description of the amortized cost measurement principles can be enhanced by:

- Within its measurement principles the ED states that "...amortized cost reflects at each measurement date current inputs regarding the cash flow estimates...." Consider providing a definition of "measurement date" so that issuers and investors know how frequently the estimate of expected future cash flows is to be updated.

- Moving the application guidance in paragraph B2 which provides for when and how to recognize changes in estimates in the timing and/or amount of expected future cash flows into the description of the measurement principles since a necessary element of measurement principles that involve the use of estimates is the principle with respect to how an issuer reports changes in those estimates.

- Clarifying that because the measurement principle requires estimates of cash flows to be based on an analysis of probability-weighted possible outcomes, there is no measurement principle regarding unit of account since groupings or changes in how financial assets are grouped for purposes of estimating expected cash flows should not affect the collective amortized cost measurement of the issuer's investments.

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?

As noted in our response to question 1, we understand the description of the objective of amortized cost. However, we do not fully understand how amortized cost would be effectively applied, and hence cannot fully evaluate what might be the result of its application. Therefore, it is difficult to provide views on whether the objective of amortized cost set out in the exposure draft is appropriate for the measurement category. We believe that having this objective be operational is dependent on there being sufficient application guidance (refer to our general observation about due process above and our response to question 3).

Further, some are concerned about how the objective of amortized cost set out in the ED relates to short-term trade receivables (i.e., receivables arising in the normal course of business that are due in customary terms). For example, many non-financial institutions have short-term trade receivables that are not held to generate interest revenue but rather are held as a means to facilitate the sale of their product by extending 'deferred' payment terms over a short period. Interest charged on such receivables is typically considered a penalty for non-payment as opposed to revenue from extension of credit. Impairment (or non-payment) of these trade receivables is considered an operating expense, and accordingly we raise whether it should be presented within operating profit. Therefore, some question the relevance of the objective of amortized cost (providing information about the 'effective return' of a financial instrument) in relation to short-term trade receivables. Others believe that the objective of amortized cost set out in

the ED is appropriate for short-term trade receivables. Refer to our response to Question 11 regarding the use of practical expedients.

Separately, we note that the EAP has been established to advise the Board on certain operational aspects of the proposed ED. As the IASB considers the information gathered from the EAP and other stakeholders and proposes changes to the standard, we urge the Board to be mindful that one of the aims of the project is to reduce complexity in accounting for financial instruments.

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?

We note that the IASB staff has prepared a few non-authoritative examples to demonstrate the mechanics of the proposed expected cash flow approach for educational and discussion purposes and we acknowledge that these basic examples are helpful for understanding the calculation mechanics of the expected cash flow approach. However, we believe the final standard must be operational on a stand alone basis. We support the Board's use of authoritative application guidance / examples to supplement the final standard in order to make it operational.

We recommend the Board include more comprehensive, illustrative examples (i.e., mathematical calculations, as well as examples of how judgmental factors such as the economic outlook are developed) in the application guidance of the standard.

We note that the Basis for Conclusions includes guidance that would be helpful in understanding and applying the standard (e. g., BC 25, 34-36). As such, we suggest that the Board move the relevant guidance into the standard and/or its application guidance.

Finally, we urge the Board to consider due process implications surrounding any changes made to the proposed impairment model and/or additional application guidance that results from information gathered from the EAP and/or from other stakeholders. See our general observation about due process.

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?

See our comments within the General Observations section of this letter. Further, as stated above in our response to Question 3, we have concerns regarding whether the measurement principles in the ED can be effectively implemented in a representationally faithful manner. As such, we believe other potentially more operational measurement principles should be considered.

Consistent with the objective of this project, we think it is important that any measurement principles considered incorporate forward-looking information in the determination of credit losses in order to reflect losses on a timelier basis. We also think that it is important that impairment measurement be based on existing financial assets as of the measurement date. That is, the model should not consider financial assets that will be originated or acquired in the future (after the measurement date).

Areas that we think should be considered in assessing alternative measurement principles include:

- Potential for Earnings Management/Auditability – An expected cash flow model requires significant management judgment to estimate future cash flows using inputs that in many cases would be considered highly subjective. Further, as the time horizon over which management must estimate cash flows increases, the more difficult and subjective the estimates will be. Although we appreciate that IFRS currently requires the use of management judgment in many of its standards (i.e., Level 3 inputs when determining fair value), we note application guidance and examples are provided in other standards to assist in making such judgments.

  In addition, the proposed model requires management to estimate expected future credit losses at origination of the instrument. An allowance for these expected losses is gradually built up over the life of the instrument. We believe the accounting for changes in management's estimates may create the possibility for earnings management.

  In dealing with these concerns, the Board will need to consider the inherent subjectivity in determining expected future cash flows and credit losses when determining the appropriate level of application guidance and examples to be included in the final standard. We believe robust disclosures will be an important element for the Board to consider when addressing these areas.

- Counterintuitive Results – The proposed model may result in counterintuitive results. For example:

  1. The proposed model gradually builds an allowance for expected future credit losses over the life of the loan instrument by deducting a margin for future credit losses in determining the effective yield that is recorded each period. However, in a fact pattern in which significant credit losses are expected in the early-term of the portfolio and do occur as expected, under the proposed model use of the blended effective yield to provide for the credit losses over the life of the portfolio effectively results in a credit loss provision recognized in the early years that is less than the incurred losses of the portfolio, or one might say it effectively defers recognition of those losses to future periods.

  2. A favorable change in credit loss expectations can result in recognition of a gain that is in excess of any impairment loss that had previously been recognized. The gain results from the fact that the initial estimate of the expected credit losses is included in determining the effective interest rate (BC 36) which is held constant over the term of the instrument and used to record the original expected yield over the life of the instrument. Under the change in estimate provisions of the Board's proposal, the amount of a subsequent increase in estimated expected cash flows is recognized immediately as a gain in profit or loss.

The Board will need to use judgment to address these areas when determining the final measurement principles. Additional disclosures should be considered to provide for transparency related to these areas.

We understand that groups, such as the EAP, are considering alternatives. We believe full consideration of alternatives is warranted and urge the Board to consider due process implications surrounding any changes made to the measurement principles that result from information gathered from the EAP or other input. See our General Observations about due process, above.

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?

We generally agree with the description and appropriateness of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft. The guidance provided in paragraph 12(b) is very high level. We recommend the Board provide application guidance and/or examples to illustrate the objective described in paragraph 12(b). Further, some question the relevance and application of paragraph 11 to, for example, short-term trade receivables of non-financial institutions (refer to Question 2).

Question 6
Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

We agree with the proposed presentation requirements. We think prominent presentation of the effects of credit losses on the statement of comprehensive income is important. However, we understand that the presentation requirement in paragraph 13(a) will result in a requirement for entities to calculate two effective interest rates (i.e., EIR excluding future credit losses and EIR including expected future credit losses). As such, we encourage the Board to consider whether this requirement is operational and ensure during field testing that this will not be cost prohibitive.

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?

As stated within our General Observations, we believe sufficient disclosures about the inputs and assumptions used in estimating expected credit losses are essential, because even with expanded implementation guidance we expect that these factors will vary from reporting entity to reporting entity. We have the following observations and recommendations regarding the disclosure requirements:

- Paragraph 14 – Include additional guidance on how to determine 'classes' of financial instruments.
- Paragraphs 15(b) and 19(a) - We think disclosure of an entity's write-off policy and cumulative write-offs by class of financial assets can provide meaningful information. We are concerned that comparability of this information will be limited by historical jurisdictional differences in write-off practices that we believe will continue under the definition of "write-off" provided in the ED because views will vary around what constitutes "collection efforts".
- Paragraphs 17(a), (c) and (d) – Provide additional guidance on the level of detail that should be disclosed about the inputs and model assumptions used to estimate expected credit losses. The purpose of the additional guidance should be to ensure that the disclosures provided about inputs and methods used are not so high-level and boiler-plate that a user cannot assess the appropriateness of those inputs and methods.
- Paragraphs 17(b) and 18(b) – Clarify and provide additional guidance on how 'significant' is to be defined in this context.

- Paragraph 20 – Clarify the objective of the stress testing disclosure requirement to differentiate this requirement from other disclosure requirements (i.e., sensitivity analysis). We believe this clarification should substantiate why the disclosure requirement is only required for those entities that prepare the analysis for internal risk management purposes. We are concerned that requiring stress testing information to be disclosed only when it is prepared for internal risk management purposes could result in changes to business practices.

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 defer to reporting entities and auditors to provide feedback on whether three years allows sufficient lead-time.

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.

Question 10
Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

The proposed transition requirements, particularly those related to determining the effective interest rate transition adjustment, appear complex and difficult to understand. As the Board considers the final transition approach we would encourage the Board to ensure the transition requirement is operational, clearly articulated and that the standard provides sufficient application guidance. Further, we believe the Board should ensure the transition disclosure requirements provide for useful disclosures to ensure transparency regarding the effect of the transition.

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?

We acknowledge that implementing the Board's proposed expected loss model would represent a significant operational challenge for many reporting entities. As such, we agree with the Board's general decision to address these concerns by allowing the use of practical expedients in calculating amortized

cost. However, the Board has stated in paragraph B15 that, "an entity may use practical expedients in calculating amortized cost if their overall effect is immaterial" (emphasis added). We are unsure how a reporting entity would be able to substantiate that the use of the practical expedient is immaterial without performing both calculations (i.e., the amortized cost calculation according to the standard and the practical expedient). Given these concerns we would encourage the IASB to provide additional guidance.

Further, we appreciate that the Board must balance the desire for additional guidance and examples with the overall objective of reducing complexity in accounting for financial instruments. However, we believe the Board should consider expanding implementation guidance and practical expedients to apply to a broader range of financial instruments.