

1 April 2011

Technical Director
File Reference No. 2011-150,
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Dear Sir/Madam

**SAICA SUBMISSION ON THE SUPPLEMENT TO THE EXPOSURE DRAFT ON
*FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT***

In response to your request for comments on the IASB's Supplement to the Exposure draft on *Financial Instruments: Amortised Cost and Impairment*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

Included in our comment letter is Appendix A which sets out the alternative views of one of our South African Banks.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

SAICA SUBMISSION ON SUPPLEMENT TO THE EXPOSURE DRAFT *FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT*

GENERAL COMMENTS

We commend the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (together the Boards) for developing joint proposals on the impairment of financial assets carried at amortised cost based on an expected credit loss model. This will enhance the comparability of financial statements presented under International Financial Reporting Standards (IFRS) and United States Generally Accepted Accounting Principles (US GAAP).

A key feature of the model proposed in the supplemental document (SD) to ED/2009/twelve *Financial Instruments: Amortised Cost and Impairment* (ED) is the Boards' continued approach to the recognition of credit losses using an expected loss methodology. It is our view that an expected loss approach addresses the significant criticism that the current "incurred loss" approaches under IFRS and US GAAP result in delayed recognition of credit losses. We have however commented on situations where we believe the proposed model will continue to result in the delayed recognition of expected credit losses.

The Boards have proposed that the model will only apply to financial assets that are managed as part of an open portfolio, other than short-term receivables. We are concerned that the exclusion of certain financial assets measured at amortised cost from the proposed model may lead to the development of multiple impairment models and therefore decrease the consistency of application of the standard. We believe that the existence of one impairment model applicable to all financial assets is a key requirement for the Boards to meet their stated objective of simplifying the accounting for financial instruments.

We are supportive of the differential loss recognition of expected credit losses for financial assets within the 'good book' and the 'bad book'. We believe that the distinction between the 'good book' and the 'bad book' is based on an appropriate principle, i.e. management's response to internal credit risk changes from managing the profitability of an asset to recovery of amounts due.

The application of the floor principle will require the immediate recognition of a day one loss of a financial instrument. Our constituents have questioned what the relevant principle is for the inclusion of a 'floor' within the proposed model. They do not believe the inclusion of a floor for assets within the 'good book' is conceptually justifiable in a principles-based standard, and believe that this may lead to unintended consequences. For example, the application of the 'floor' to acquired open portfolios, either in a business combination or a separate acquisition; will lead to the recognition of significant 'day one' impairment losses. This will distort the decision usefulness of the amounts presented as impairment losses within profit or loss.

It is unclear from the statement whether the floor should be discounted as is the case with the time-proportional expected credit losses approach and suggest that this be made clearer. Further, the flexibility allowed by the Boards in determining the discount rate and whether expected credit losses should be discounted or not will result in excessive amounts of variations of the basic impairment model being applied in practice. Therefore, we would urge the Board to simplify the model by not requiring expected credit losses in the 'good

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book' to be discounted. We would also urge the Boards to define what expected credit losses are, because significant divergence could occur if a definition is not provided.

While we note that many of the proposed disclosures will provide information that may be useful to some users, we are concerned that the disclosure requirements may be overly onerous. The proposed disclosures will pose numerous and significant system challenges for many entities over and above the implementation of the proposed model. We are concerned that should the IASB not revise its mandatory effective date for all phases of IFRS 9 – *Financial Instruments* (IFRS 9) being annual periods beginning on or after 1 January 2013, entities will need to source certain disclosures for the financial periods beginning on or after 1 January 2009 [SD paragraph Z8 requires disclosure of four (4) comparative periods].

A further issue that arises is the extent to which major causes of the financial crisis have been addressed by the ED and SD. Every financial crisis has at its core two elements; credit quality and excessive leverage. Pro-cyclicality of the financial systems causes mispricing of credit risk over the economic cycle. In good economic times, as one approaches the peak of the cycle, risk sensitivity weakens and credit risk is historically underpriced. Collateral values are often accorded greater values than they merit. Competition between financial institutions exacerbates the problems and further encourages risk taking. Credit risk is overpriced in bad economic times. We do therefore note that pro-cyclicality will be inherent in any impairment model. While the proposed impairment model does not eliminate the potential pro-cyclicality consequences as well as fully eliminate the delayed reporting of credit losses, we do believe that the proposed impairment model is an improvement on the incurred loss model as articulated in IAS 39 – *Financial Instruments: Recognition and Measurement* (IAS 39).

SPECIFIC COMMENTS

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?

We agree that the approach proposed in the SD in the majority of situations will address the delayed recognition of expected credit losses, which has been identified as a significant weakness of the current “incurred loss” impairment models under IFRS and US GAAP.

While we believe that the proposed model is superior to the current “incurred loss” impairment models, we have concerns that the proposed model may continue to be criticised for the delayed recognition of expected credit losses for portfolios which have an earlier expected credit loss pattern. We have outlined our views on how the proposed model could be improved to address our concern in our response to Question 4.

Scope of the proposed model

Our constituents have expressed concern around how the scope of the SD has been articulated, i.e. the proposed model “*applies to financial assets that are measured at amortised cost if they are managed on an open portfolio basis, except short-term*

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receivables without a stated interest rate that are so short-term that the effect of discounting for the time value of money is immaterial.”

Our concerns can be summarised as follows:

- It is unclear under the proposals how an entity should assess whether “*the effect of discounting for the time value of money is immaterial.*” This assessment is dependent on how the entity views the unit of account used for assessing materiality, i.e. should the assessment be made for a portfolio of similar items or on an instrument-by-instrument basis. It is our experience that in high interest rate environments (e.g. nominal interest rates of greater than 10% per annum) that this assessment is operationally difficult to perform and usually material when performed on a portfolio basis. In addition, the assessment of the impact of discounting may change because of changes in the interest rate cycle;
- While we have expressed our concerns about the conceptual justification of including a floor within the proposed model (our concerns are discussed further in Question 9), if the Boards include a floor within the final model, it would be more practical to define a short-term receivable as an instrument with an expected life shorter than twelve months, because the expected credit losses on these instruments would not be apportioned over time. This is because the floor would require all expected losses within the foreseeable future (a period of at least twelve months) to be recognised; and
- We have noted certain financial assets in the South African market originated via the sale of goods that do have a stated interest rate, but where the levying of interest is dependent on the customer’s future actions. For example, the customer is granted a four month interest-free period over which to make payment for the goods. However, should the customer default on any payments during the four month period, the entity levies interest at a prescribed rate on all amounts due from the date of sale until final payment of the balance due. It is unclear whether these instruments fall within the scope of the SD, whether only the portion of the portfolio the entity expects to levy interest on should be included, or should the instruments be excluded from the proposed model until an event occurs resulting in interest being levied?

Therefore noting our concern above and our response to Question 11, we recommend that the scope exclusion for ‘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’, be removed. If however the Board retains this scope exclusion, we recommend that the Board make it clear how impairment should be determined for such assets.

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 relevant financial assets.

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We believe that the model proposed in the SD is at a minimum as operational for closed portfolios as it is for open portfolios. However, where the closed portfolio does not contain a significant number of individual financial assets or in the case of a single asset, we do not agree that an expected loss model based on a probability-weighted estimate of expected credit losses is appropriate because of the binary nature of the outcome, i.e. on a single asset the entity either recovers all capital plus interest or incurs a credit loss. We believe the Boards could address this concern by allowing entities to measure expected losses on closed portfolios that do not contain a significant number of individual financial assets and single assets using a single best estimate of the most likely credit losses.

While the Boards have proposed that the model will only apply to financial assets managed as part of an open portfolio, other than short-term receivables; we are concerned that this may result in the development of multiple inconsistent impairment models. We would not support the application of different impairment models based on whether the financial asset is within an open or closed portfolio, is defined as a short-term receivable or is a single financial asset. We believe that the existence of one impairment model applicable to all financial assets is a key requirement for the Boards to meet their stated objective of simplifying the accounting for financial instruments.

We note that the definition of a portfolio may not allow an entity to group portfolios together for the purposes of applying the proposed model, because the definition of a portfolio is based on how the entity internally segregates its assets into separate portfolios. The definition of a portfolio should explicitly allow, but not require, the grouping of similar portfolios when applying the proposed model.

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?

We agree that it is appropriate to recognise the expected credit losses on the ‘good book’ over a period of time; however, we have concerns around the floor concept required for the credit losses expected to occur within the foreseeable future period (refer to Question 9), the methods used for the time-proportional basis (refer to Question 4), and the flexibility related to using discounted amounts (refer to Question 10).

Question 4

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

We agree with the proposal to require impairment allowances to be raised on a time-proportional basis and believe that this model is operational. However, we believe that both the straight-line and annuity approaches may still result in delayed recognition of expected credit losses where the portfolio has an earlier expected loss pattern, i.e. where a significant portion of the portfolio’s losses occur in the earlier years of the portfolio’s life. Our constituents suggest that the Boards consider allowing entities to allocate impairment losses on a risk-based approach that would result in proportionally more losses being provided in the earlier stages of the lives for these types of portfolios.

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From an operational perspective, we do not believe that the SD appropriately defines what the expected credit losses are for the remaining life of the portfolio. It has been questioned whether the expected credit losses should include the following losses in addition to expected under-recoveries on write-off or foreclosure: expected losses on sale of the financial asset, where the entity is required to sell financial assets in the portfolio when the assets no longer meet the entity's investment mandate; and expected losses due to lost time value of money from expected re-negotiations. We further recommend that the determination of expected losses include consideration of the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, as is the case in IAS 39 AG84.

Question 5

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

Whilst noting our reservations in our response to question 9(a), we believe that the proposed approach would provide decision-useful information, because it aligns credit loss recognition with income recognition, which is over time through the application of the effective interest method.

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?

While some of our constituents raised concerns around how comparability between entities may be impacted by differences in entities' internal credit risk management policies; we believe that the distinction has been clearly described and is conceptually sound. We believe that the principles outlined in the SD are aligned with the principles contained in the current IFRS 9. We are concerned that the examples included in paragraph B3 of the SD (i.e. attempting to recover cash flows from an uncollateralised financial asset by making contact with the debtor by mail, telephone or other methods) may incorrectly suggest that the mere application of an entity's administrative procedures results in the financial asset moving into the 'bad book'. We suggest these examples are removed or that the wording clarify that such actions do not necessarily result in the reclassification of a financial asset to the 'bad book'. We recommend that the good book and bad book should be classified according to the method that management manages the book, and accordingly concur with the SD's statement that an entity shall differentiate the two groups on the basis of its internal risk management.

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?

We believe the proposed distinction between the 'good book' and the 'bad book' is operational, because the proposal is differentiated on the basis of an entity's internal credit risk management processes. In addition, we believe that the audit challenges posed by the SD's model are not significantly different from the current "incurred loss" model under

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IAS 39 because the auditor is required to gain comfort over judgements and estimates used in the credit model (e.g. loss emergence periods).

Question 8

Do you agree with the proposed requirement 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?

We agree with the requirement to differentiate the recognition of credit losses between the 'good book' and the 'bad book', because the focus of users is different for these two books. We agree that the apportionment of expected losses over time is appropriate where the portfolio is profitable, because the focus is on reporting the profitability of the portfolio, i.e. a profit or loss approach. However, where the entity is concerned with recovery, its focus shifts and the proposed model should ensure these assets are not over-stated in the statement of financial position. We believe that this differentiation provides decision useful information, is aligned to the current incurred loss approach (where specific impairments are determined on the basis) and will be operational.

We do not believe it is appropriate to apply the profit or loss approach or statement of financial position approach to both groups, because this ignores the differences in how the entity manages these separate books and it does not consider the evolution of risk within each of these books.

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?

We do not agree with the inclusion of a floor for the impairment allowance related to the 'good book', because the floor is not conceptually sound nor does it have a place in a principles-based standard. However, we understand the floor has been included as a compromise solution to achieve convergence and would support the inclusion of a floor over a non-converged IFRS and US GAAP standard on impairment.

(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?

No, we believe that if a floor is going to be required, it should be required in all instances.

(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?

If a floor is included within the financial reporting standard in order to achieve convergence we believe the Board should require the floor to be based on the credit losses

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that are expected to occur within the next twelve months and not the foreseeable future. As noted, we question what the relevant principle is for the inclusion of a ‘floor’ within the proposed model. Therefore the period covered by the floor is arguably arbitrary.

A significant shortcoming of linking the floor to the foreseeable future is that the foreseeable future generally decreases in times of economic difficulty. Credit losses expected to occur in the foreseeable future reflect an accumulation of losses during the forecasting period. The shortening of the forecasting period while holding everything else constant could result in a decreasing floor during periods of economic difficulty. This could result in gains being recognised in profit or loss, merely because of a decrease in the forecasting period. Therefore, we would recommend that the floor to be a fixed period of time from period to period to avoid the aforementioned concerns and further suggest that this period be equivalent to twelve months from the balance sheet date. Whilst this period of time may appear arbitrary, it would in some respects align with the going concern considerations as articulated by IAS 1 – *Presentation of Financial Statements* (IAS 1). More specifically, IAS 1, paragraph 24 states that, “*In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the balance sheet date.*” IAS 1 therefore refers to the future as being twelve months from the balance sheet which we believe should be an equivalent measure for the floor limit of expected losses.

Should the Board retain its reference to ‘foreseeable future’, we recommend that the Board clearly articulate what is meant by this concept and how it differs, from a time perspective, from other IFRSs that refer to ‘foreseeable future’. One example in IFRS where ‘foreseeable future’ is mentioned is in paragraphs 15 and 15A of IAS 21 – *The Effects of Changes in Foreign Exchange rates*.

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

Refer to our response above to Question 9(c).

(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.

Yes we do believe the foreseeable future could, in some instances, be a period of more than twelve months. However we believe (as discussed under Question 9(c)) that a fixed period of twelve months rather than a minimum period should be prescribed by the standard. We acknowledge that this could be seen as a ‘bright line’ which should not have a place in a principles-based standard, however this is a ‘bright line’ on a rule (the floor).

(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.

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We believe that comparability could be facilitated by specifying a fixed period for the floor rather than requiring a ceiling to the period used for determining the foreseeable future. As discussed in Question 9(c), it is not the length of period covered by the foreseeable future, but changes in the period covered by the assessment that may distort earnings.

Question 10

Do you believe that the floor will typically be equal to 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.

We believe that the floor will typically be equal to or higher than the time-apportioned amount for portfolios where credit losses occur relatively early in the portfolio's life. For example, the floor is expected to be effective for motor vehicle loan portfolios when the portfolio is increasing in size. The floor could however be greater where a loan book is amortising in nature, but would also depend on the relative size of changes in the book, i.e. whether the book is growing or declining and based on changes in the expectation of the age of the book.

The floor will always be greater than the amount calculated in accordance with paragraph 2(a)(i) for existing portfolios acquired as a portfolio or via a business combination. IFRS 9, IAS 39, and IFRS 3 – *Business Combinations* (IFRS 3) require the entity to measure an acquired portfolio at fair value, which includes an expectation of life-time expected credit losses for the portfolio. On the date of acquisition, the weighted average life of the portfolio is equal to nil, because the entity only becomes a party to the contractual provisions of the financial assets on the date of acquisition. Therefore, on the initial recognition of the acquired portfolio the amount calculated in accordance with paragraph 2(a)(i) would be nil, being the expected loss for remaining life of the portfolio multiplied by zero. However, the amount calculated in accordance with the floor would always be a number greater than zero to the extent the entity expects credit losses to occur within the acquired portfolio within the foreseeable future. The application of the floor in this instance would result in a day one impairment loss being recognised in profit or loss.

Question 11

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

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

No, we do not agree with the flexibility permitted to use either a discounted or undiscounted estimate of the expected loss within the 'good book'. The introduction of choices may lead to complexity in applying the proposals and interpreting the results of the impairment model. The proposed model has been developed to address the operational concerns inherent in the Board's initial expected loss model contained in the ED. Therefore, in order to achieve simplification, we would support the use of undiscounted credit loss estimates. Our constituents expressed discomfort with the concept of discounting a credit loss estimate, because discounting is usually applied to cash flows, whereas credit losses are a consequence of under-recovering previous advances.

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However, we believe that the effect of discounting should be required for financial assets within the ‘bad book’, because changes in the expected timing of the cash flows can result in a loss of time value of money, without the entity receiving additional compensation. While we understand this is the Board’s intention for impairment allowances within the ‘bad book’, we do not believe the SD is sufficiently clear on this point. We further recommend that the discount rate that should be used should rather be an entity’s cost of funds rate. This rate better reflects the entity’s cost of holding those non-performing advances.

(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?

No, we do not agree with the flexibility permitted to use a selection of discount rates when using a discounted expected loss amount. Our preference is for an undiscounted expected loss amount for the ‘good book’ and a discounted expected loss amount for the ‘bad book’. We also recommend that where the Boards require discounting of expected losses we believe only one discount rate should be allowed. In order to achieve simplification, we suggest that the cost of funds rate be used to discount expected loss amount. We believe that the cost of funds rate better reflects the costs of holding those advances in the financial statements.

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?

As discussed in our response to Question 9, our constituents have questioned the conceptual basis for the inclusion of a floor in the SD’s proposed model. Therefore, we believe that the IASB’s approach is conceptually sounder than the SD’s proposed model. However, our constituents believe that a converged IFRS/US GAAP standard should be a key priority of both Boards. As a consequence, we would not be supportive of the IASB’s proposal if it would lead to divergence in measurement of impairment of financial assets carried at amortised cost under IFRS and US GAAP.

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?

No, we do not prefer the FASB’s approach for assets within the scope of the SD because this approach ignores decision-useful information produced by a profit or loss based approach. The recognition of all expected credit losses for the foreseeable future is inconsistent with the principle that financial assets are initially recognised at fair value, which includes an expectation of future credit losses. It is counter-intuitive to recognise an instrument at fair value and then recognise in profit or loss an impairment loss, when

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circumstances have not changed from the date of recognition, nor has the entity recognised any of the interest income charged as a credit risk premium for the expected losses.

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?

We agree that the determination of the effective interest rate should be separate from the consideration of expected losses. We believe this should be the case for financial assets within open portfolios, closed portfolios, and individual assets. By retaining the calculation of the effective interest rate in accordance with IAS 39, in comparison to the Board's original proposal in the ED, we believe that the cost and operational complexity of implementation will be significantly reduced.

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?

As a principle we agree with subjecting loan commitments, not accounted for at fair value through profit or loss, to the impairment requirements of the SD. However, we believe there are significant operational challenges that should be addressed (refer to Question 16Z) before the Board considers subjecting loan commitments to the proposed impairment model.

To the extent the Board agrees to a single best estimate of the most likely credit losses (as discussed in Question 2) we believe there would not be a significant difference between the measurement of expected credit losses under our proposals and the amount calculated under IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* (IAS 37) as an onerous contract provision.

Question 16Z

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

Our constituents have expressed concern about the operational challenges of applying the proposed requirements to loan commitments and financial guarantee contracts. The constituents concerns include:

- Financial guarantees within the scope of IAS 39 (and thus IFRS 9) are less likely to be managed on a portfolio basis, compared to financial guarantees within the scope of IFRS 4 – *Insurance Contracts* (IFRS 4).
- We are unsure how the impairment allowance for loan commitments would be apportioned over the life of the portfolio. One suggestion raised was to add the expected losses from irrevocable loan commitments to the remaining expected credit losses for the portfolio into which the loan would be included on draw down. As a result the

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expected credit losses arising from the loan commitments would be recognised as part of the 'good book' portfolio allowance account. Alternatively, it was suggested that loan commitments could be treated as a separate portfolio with expected draw-down being treated as the commitment's expected maturity date. On draw-down the associated allowance account would effectively be transferred to the 'good book' allowance account.

Question 17Z

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

We agree with the proposed presentation requirement in paragraph Z5 of the SD that interest income using the effective interest method (as currently defined in IAS 39) and impairment losses are presented as separate line items. However, it is not clear from the SD whether the line will be presented separately on the face of the statement of comprehensive income or included within the notes to the financial statements.

Question 18Z

(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?

While we note that many of the proposed disclosures will provide information that may be useful to some users, we are concerned that the disclosure requirements are overly onerous. The proposed disclosures will pose a significant system challenge for many entities over and above the implementation of the proposed model.

We are concerned that should the Board not revise its mandatory effective date for all phases of IFRS 9 being annual periods beginning on or after 1 January 2013; entities will need to source certain disclosures for the financial periods beginning on or after 1 January 2009 [SD paragraph Z8 requires disclosure of four (4) comparative periods]. We suggest that the Board considers whether providing four (4) comparative periods of disclosure in this instance is necessary for users to understand the credit quality of the portfolio over time. However, should the Board wish to retain the proposed disclosure, we believe transitional relief will need to be provided to allow entities time to build up the history within the comparative period disclosure. This could be achieved by requiring the presentation of disclosures to be developed over time so as to ultimately provide four (4) years of comparatives.

It is also unclear whether the information required by paragraph Z8 will be provided in aggregate for all financial assets, by class of financial asset (as required for paragraph Z7's disclosure) or by portfolio or grouping of portfolios. We suggest the disclosure should be required by class of financial asset as disclosure at a portfolio level would be too granular for inclusion within a set of financial statements. It has also been questioned why the disclosure required by paragraph Z8 requires the nominal amounts of financial assets and not the carrying amounts. Nominal amounts may not represent the exposure to credit risk in the case of instruments such as zero coupon debt instruments (where nominal is defined as being the final maturity value). Accordingly, we recommend that the disclosure requirement rather refer to the 'carrying amount' of the financial assets. This would also

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ensure that there is consistency with other disclosures such as the credit risk quality disclosures in IFRS 7 – *Financial Instruments: Disclosures*.

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

We would prefer to see more disclosure about the credit quality of financial assets within the ‘good book’ and how that links with the amount of impairment allowances on the ‘good book’ over time. This will provide users with a better understanding of how the entity’s portfolios have performed through economic cycles.

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?

We do not agree that a portion of the allowance account moves from the ‘good book’ allowance account to the ‘bad book’ allowance account when the underlying financial asset is transferred between the two groups. Practically, financial assets within an open portfolio are not managed in this way, because individual loans lose their identity once included within the portfolio.

As required by the SD, the allowance account is only determined at the end of the reporting period and will be ‘trued up’ to the amount required to be provided in terms of paragraph 2(a) of the SD, with the difference recognised in profit or loss. A similar process would occur for the ‘bad book’ in terms of paragraph 2(b). Since paragraph 2 of the SD is required to be applied at each reporting date (annual or interim); an entity would not have inter-period transfers available in order to reconcile the allowance account separately for the ‘good book’ and the ‘bad book’.

We believe the reconciliation of the allowance account is primarily to provide visibility to write-offs made against the allowance account and these write-offs occur within the ‘bad book’. Therefore, we suggest the reconciliation be required on a combined ‘good book’ and ‘bad book’ basis with disclosure of what portion of the overall allowance is calculated in terms of paragraphs 2(a) and (b).

OTHER COMMENTS

Noting that the impairment phase of IFRS 9 still requires finalisation, we recommend that the effective date of this phase of the standard be for annual reporting periods beginning on or after 1 January 2015. These proposals are expected to require significant system changes to be implemented to recognise impairment losses under the proposed model and provide the required disclosures, which in some instances is required for five annual periods. We therefore urge the Board to reconsider the original mandatory effective date for all phases of IFRS 9, currently set at annual periods beginning on or after 1 January 2013, to rather be annual reporting periods beginning on or after 1 January 2015.

SAICA SUBMISSION ON SUPPLEMENT TO THE EXPOSURE DRAFT *FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT*

APPENDIX A

ALTERNATIVE VIEWS OF STANDARD BANK: STEPHEN BRICKETT

1. **Either a floor or the time proportionate approach**

We concur that we cannot link the concept of a floor with a principle. We would rather recommend that the final standard require an entity to either require an impairment provision to be determined based on the time proportionate basis or using a floor for each portfolio. We believe that more sophisticated entities will recognise impairment provisions using a time proportionate basis, with less sophisticated entities determining their impairment provisions using the floor concept. This in many respects aligns with the approach followed by Basel. Hence an entity could apply different approaches – this would be especially relevant in the case of a group that consolidates many entities where there could be a mixture of both the time proportionate and floor approaches. However, a legal entity could also apply either the time proportionate or floor approach – with the floor approach possibly being used for new portfolios or where the entity enters new markets. Sophisticated entities would tend to use the time proportionate basis as a basis to provide the best estimate of expected loss and it aligns with the manner in which income (that includes the charge for a credit spread) is recognised and hence should primarily achieve the objective whereby losses are recognised at the same time as which income is recognised (one of the IASB’s objective). Less sophisticated entities would be able to apply the floor as an easier alternative. I would suspect that most entities that are engaged in lending on a term basis would need to, and be able to apply the time proportionate approach whilst those that do short term lending, e.g. retailers, would apply a floor approach.

The clear preference should be for entities to use the time proportionate approach and hence it should be recommended that entities apply that approach. Disclosure of the approach(s) followed should be required. Changes in approaches should be permitted and would only generally be expected for a change in the floor to the time proportionate approach (not the other way around).

For entities that apply the floor approach, we support the period to be covered by the floor being 12 months or longer. We believe that the floor is somewhat an arbitrary reference point and hence defining a period of time would also be arbitrary. We do however believe that the 12 month period minimum is consistent with the period referred to in IAS 1 that covers the period under which the going concerns principle is required to be assessed – requiring that there be a floor to last until at least the next reporting period (12 months at least in the case of interims) would at least ensure that the entity has adequate provisions to align with its ability to be a going concern, and if not, consider strategic solutions to address that. Whilst keeping the length of the period open, we do believe that entities would naturally end up aligning themselves to some specific period.

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2. Discounting

We recommend that there be discounting applied to the ‘good book’ provision where a provision is determined using the time proportionate approach. For a provision determined using the floor approach, we recommend that no discounting be required. In the case of the floor, the floor is a somewhat arbitrary concept and hence requiring discounting would also be arbitrary. Also – not requiring discounting would align with our recommendation above of a more simplistic approach for where a floor is determined for less sophisticated entities.

3. Discounting should be required for the bad book.

We recommend that where discounting is required that it be determined using the entity’s cost of funds rate – using the risk free rate may not align with an entity’s cost of holding that debt instrument. Using a cost of funds rate would be more appropriate. The cost of funds is the opportunity cost of not investing money elsewhere and therefore is the best indicator of the time value of money effect on the impaired assets (excluding credit spreads).

3. Loan commitments and undrawn facilities

We do not believe that impairments in terms of the ED or SD should be recognised for exposures that are off balance sheet, such as on loan commitments and undrawn facilities. This is because the loans are not yet recognised and credit spreads to cover those risks are not yet being recognised. Accordingly, the IASB’s objective to achieve better alignment between the recognition of revenue and the recognition of losses will not be applicable until such time as the advanced/ drawn down loan is recognised on book. It may be true that fees are charged for the facility, but those fees may not arguably compensate the lender for the risk of the advances being lent, i.e. default risk – hence the recognition of expected losses may only be recognised when the advance arises. Financial guarantees are different in the sense that there is an existing exposure – albeit not on your balance sheet and hence an EL approach should be followed / follow existing IAS 39 principles.

We would however recommend that loan commitments, like FGs be assessed to determine whether a provision is required in terms of IAS 37.

4. Exemption for short term receivables

We do not believe that an exemption should be made for short term receivables. Where, in particular we state that the floor is not discounted (and the floor is used for such items), then the concept of receivables with no stated interest rate being in or out of scope of the standard becomes irrelevant. Further – by using the cost of funds rate, the concept of determining an EIR becomes less relevant and rather reflects the cost of holding those exposures on the balance sheet.

5. Open and closed portfolios

We fully support a single approach for both open and closed portfolios. This will eliminate the ability to be able to use each of the models to suit an accounting outcome. We believe that the model proposed in the SD can be used for closed portfolios or single financial assets.

**SAICA SUBMISSION ON SUPPLEMENT TO THE EXPOSURE DRAFT
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6. Items to be considered in the determination of EL

We believe that it is important that EL consider and incorporate the costs of recovery of the underlying cash flows and collateral as is currently the case under IAS 39.

7. Distinction between the good and bad book

We suggest that the distinction purely rely on an entity's internal risk management approach – that should be a concept that is included in the standard with examples being provided in the application guidance. I would take out examples of sending letters etc and rather merely state that the distinction changes based on how management manages and reports on those assets from an overall credit risk perspective. For SBG we currently split our loans between performing and non-performing loans and suggest that we would define our books along similar lines for the good/bad book distinction under this new model. The distinction (in our case) between the two is heavily reliant on 90 days threshold (supplemented with those loans that have material breaches of terms and conditions) which aligns more or less with the definition of non-performing from the earlier ED which was defined as: 'The status of a financial asset that is more than 90 days past due or is considered uncollectible.' We would recommend that the definition of non-performing in the IASB's ED in 2009 rather be used as a principle driver of defining the bad book. It is simpler, aligns with various regulatory definitions that would ease conversion processes and could achieve greater comparability.

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