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16 September 2009

Dear Kevin

AASB ED 184 and ED 186, Invitation to Comment ITC 21 and Discussion Paper AASB 139 DP

I am enclosing copies of the PricewaterhouseCoopers responses to the following International Accounting Standards Board's papers:

- IASB Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement* [AASB ED 184]
- IASB Exposure Draft ED/2009/9 *Classification of Rights Issues (Proposed amendments to IAS 32)* [AASB ED 186]
- IASB Discussion Paper DP/2009/2 *Credit Risk in Liability Measurement* [AASB ITC 21], and
- IASB Request for Information *Impairment of Financial Assets: Expected Cash Flow Approach (Expected Loss Model)* [AASB Discussion Paper - AASB 139 DP]

The letters reflect the views of the PricewaterhouseCoopers network of firms and as such include our own comments on the matters raised in the exposure drafts and the discussion papers.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (02) 8266 8350 if you would like to discuss this further.

Yours sincerely



Regina Fikkers
Partner
Assurance

Sir David Tweedie
Chairman
International Accounting Standards Board
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1 September 2009

Dear Sir

Request for Information ("Expected loss model") Impairment of Financial Assets: Expected Cash Flow Approach

We are pleased to respond to your Request for Information on Impairment of Financial Assets: Expected Cash Flow Approach on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of the member firms that commented on this Request for Information. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We support the Board's decision to explore alternative approaches to the current impairment model for financial instruments measured at amortised cost. The financial crisis has highlighted shortcomings of the incurred loss model, and the expected cash flow model is one approach that could help address some of those concerns. However, it will present preparers with a number of application challenges. Therefore, we believe that it is prudent for the Board to investigate its potential operational problems, as well as other impairment approaches.

Given that a large part of the Request for Information is concerned with the operational aspects of the expected cash flow approach, we discussed your request with a number of our clients around the world and across industries in order to get a first hand perspective of the impact this model is likely to have on preparers. We have reflected the feedback we have received in this response.

The Request for Information describes the main features of the expected cash flow approach at a high level. However, it neither clearly defines a principle, nor provides a framework for guiding preparers in its application. Such guidance would have been helpful in addressing many of the questions that our clients had in trying to apply the expected cash flow approach to their operations. These questions included:

- What is the appropriate unit of account for determining expected losses? When should the expected losses be determined at the individual instrument level versus on a portfolio basis? If a portfolio approach is appropriate, how should the portfolios be determined?
- In developing expected loss estimates, is there a bias towards the use of market data over internally developed information? For example, should credit default swaps prices, if available, be used instead of internally developed default rates?

- What is meant by expected loss? Should the expected losses/cash flows be based on a probability weighting of all potential outcomes or is a single best estimate acceptable? Should it include expected losses based on expected credit utilization or be limited to amounts drawn to date?

The answers to these questions are important to understanding how the expected cash flow approach should be applied. There isn't necessarily a right or wrong answer to these questions. Therefore, we believe the Board should, in providing application guidance, allow preparers considerable flexibility in determining their expected losses. What is more important is that preparers estimate those losses consistent with the Board's defined principle and broad framework, and that they provide sufficient transparent disclosure of their processes so that users can understand their approach and the key information upon which it is based.

Even with a clearly defined principle and a broad framework, there are likely to be significant operational challenges. Of particular concern to our clients was the amount of time it would take to develop models for the variety of instruments they hold, accumulate the necessary data to base those models and program the information systems to meet the requirements of the new impairment approach. We believe that this will require a significant amount of time, as we know that it took some preparers up to 2 or 3 years to develop the systems and procedures to apply the incurred loss model. An expected cash flow model could prove even more challenging for some preparers, especially those in developing territories where there is a greater absence of relevant historical data and the financial markets are continuing to evolve.

As a result, we believe that it will be difficult for the Board to conclude on the operational viability of the model (its implications for systems, cost and overall timeline for implementation) without allowing preparers time to conduct appropriate field tests. We encourage the Board to continue to engage in detailed discussions with the various industries and to become involved in their field tests so that the Board can understand the extent of the operational issues first hand. Furthermore, the Board should ensure that any field testing includes adequate representation from entities other than financial institutions. Manufacturers, distributors and service companies may be surprised at the potential impact of this project and could have unique operational challenges to consider.

On a final note, any evaluation of the expected cash flow model needs to have a full consideration of the presentation and disclosure changes being proposed. Preparers and users will be most interested in how this affects their key operating metrics (e.g. revenue, net interest margin, impairment charges). It would be helpful if the Board would provide guidance in this area.

We have expanded on the above and responded to the specific questions raised in your Request for Information in the appendix to this letter.

If you have any questions in relation to this letter please do not hesitate to contact Richard Keys, PwC Global Chief Accountant (+44 20 7802 4555), or John Althoff (+44 20 7213 1175).

Yours faithfully

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Appendix: Response to Detailed Questions

Question 1

Is the approach defined clearly? If not, what additional guidance is needed, and why?

Application guidance

The Request for Information describes the main features of the expected cash flow approach at a high level. However, it neither clearly defines a principle, nor provides a framework for guiding preparers in its application. We believe it would be helpful if the Board would provide such a principle and some practical guidance on the application of the model. We have spoken to a number of our clients across different industries. In trying to apply the expected cash flow approach to their own operations, they have raised a number of questions such as:

- Unit of account – whether loss expectations should be considered on an individual account basis or on a portfolio basis? If a portfolio approach is appropriate, how should the portfolio be determined (i.e. how "similar" do the loans/debtors need to be)?
- Sources of loss information – which sources of information are acceptable (e.g. market information, internal management information and information supplied by a Regulator)? Is there a bias towards market data over internally developed information (e.g. should credit default swaps prices, if available, be used instead of internally developed default rates)?
- The meaning of expected loss - should expected losses/cash flows be determined based on a single best estimate or should they be determined based on a probability weighting of potential outcomes? The staff paper uses the term best estimate of expected cash flows. IAS 36 uses expected cash flows in the context of a probability weighting.
- Committed lines of credit - whether, and if so how, the approach should be applied to undrawn lines of credit? Should provisions for loan commitments by loan providers be determined on the same basis as for drawn loans? Should expectations of loan draw downs be included in the overall EIR calculation? We note that, in practice, banks consider credit risk on a full facility basis and, as a result, would estimate expected losses based on the expected credit utilization at each point in time.
- Revolving credits - how should the model be applied to revolving credits such as credit card receivables or overdrafts? In particular, the guidance should distinguish between expected losses for existing financial instruments and those in respect of customer relationships.

This is not meant to be an exhaustive list, but an indication of some of the questions that entities are concerned about.

The answers to these questions are important to understanding how the expected cash flow approach should be applied. There isn't necessarily a right or wrong answer to these questions. Therefore, we believe the Board should, in providing application guidance, allow preparers considerable flexibility in determining their expected losses. What is more important is that preparers estimate those losses consistent with the Board's defined principle and broad framework, and that they provide sufficient transparent disclosure of their processes so that users can understand their approach and the key information upon which it is based.

We also urge the Board to consider their review of impairment in the context of their ongoing revenue recognition and non financial liability projects. Clearly the impact of the impairment model on revenue recognition needs to be consistent with the revenue recognition project conclusions. In

addition, the Board will need to decide whether losses on undrawn facilities should to be dealt with in the non financial liability project or in the impairment project.

Trade receivables

It is not clear how the approach should be applied by non financial institutions to short term trade receivables. The IASB staff indicated in their webcast that they believe this model would cause corporates to recognise less revenue. However, a number of our corporate clients have informed us that they do not normally expect credit losses when they invoice for goods sold (i.e. their day one loss expectation for an individual sale is zero). These entities would apply a single best estimate to the determination of loss and would consider losses on an individual account basis. They believe that they should record all of the revenue from the sale when its recovery is probable as required by IAS 18. A different position may arise if the expected losses were determined on a probability weighting of potential outcomes or on a portfolio basis. IAS 18 also requires that revenue is recognised at the fair value of the consideration received. Given the short term nature of many receivables, the sales price does not normally take into account the time value of money (including risk of default). Typically, such discounting is not considered material. Will this continue to be the case with the expected cash flow approach?

These are likely to be big issues for non financial institutions. It would be helpful for the Board to clarify the specific application of the expected cash flow approach for trade receivables.

Presentation and disclosure

The Request for Information does not give any guidance on the presentation and disclosure requirements of the expected cash flow model. We believe that an understanding of the presentation and disclosure aspects of the model is critical to a full understanding and evaluation of the model. In particular, a large number of the entities we have spoken to are not clear on the income statement presentation. Will entities be allowed to present interest/revenue gross of the deduction for expected impairment with separate disclosure of a deduction for initial expected losses or must they present interest/revenue net with no disclosed impairment charge (if loss expectations are met)? Some users and preparers have indicated that a comparison of actual losses incurred across entities is useful information. This comparison would be lost if impairment charges only reflect differences from expectations. In addition, net interest margin and revenue are key performance indicators. Some users and preparers believe comparability across entities would be obscured by the impact of removing the initial expected losses from the net interest margin or revenue. It would be helpful for the Board to provide guidance on presentation and disclosure in connection with further field testing of the expected cash flow approach.

Transition

The Request for Information does not provide guidance as to how this model should be applied on transition to IFRS for first time adopters. Our clients in developing countries transitioning to IFRS believe the operational issues discussed below, in our response to questions 2 and 3, will be greater for them. They believe guidance on the transition aspects of the new model for first time adopters is critical for a proper evaluation of the model.

Question 2

Is the approach operational (i.e. capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

A large number of the clients we have spoken to have indicated that it is difficult to conclude on the operational viability of the model from a cost/benefit perspective until they have had adequate time to determine the proper unit of account, develop the necessary models, accumulate the required

data, and assess the impact on their systems. To do this properly they would need to conduct an appropriate field test of the expected cash flow approach.

We encourage the IASB to continue to discuss these issues with the various industries and become involved in their field tests so they can understand the operational issues first hand. Furthermore, the Board should ensure that any field testing includes adequate representation from entities other than financial institutions.

The following operational aspects were of particular concern to some of our clients:

Unit of account

As the estimate of expected loss for assets will drive income recognition and subsequently impairment charges, it is essential that entities determine these losses with appropriate reliability. To do this they will have to consider the appropriate level of granularity when determining the unit of account to which they are going to apply the expected losses. The question entities are struggling with is whether this needs to be set on an individual asset level or whether this can be set at a portfolio level and if the portfolio approach is appropriate how granular the portfolios need to be to ensure an acceptable estimate of expected losses.

Different industries have identified different unit of account concerns. Some of our insurance clients have indicated that the unit of account for their corporate bond investments may need to be set at an individual investment level. They feel it may be very difficult to pool these assets into portfolios given their lack of homogeneity or diverse risk profile and the fact that they are not actively managed on such a basis. Given the size of the corporate bond holdings of the large insurers, determining expected loss at an individual account level will cause considerable operational issues.

Some of our banking clients believe they may be able to determine expected loss on a portfolio basis. However, they are not clear how small the portfolios need to be or how "similar" the loans in the portfolio need to be. Some banks believe they will need a more granular analysis of loans (by customer, region, collateral and origination dates), thereby creating more portfolios under the expected loss model than they currently have under the incurred loss model. They believe that even greater granularity may also be required to deal with the income recognition issues presented by repayments, prepayments and loan sales.

Many of the banking entities we have spoken to said they would like to leverage off their Basel II models to determine their expected losses given that the Basel II systems are already in place. However, these systems will need considerable enhancement to deal with the differences between Basel II and the expected cash flow model (e.g. 12 month expected losses under Basel II versus expected cash flows over the life of the loan under the expected cash flow approach).

Availability of and reliability of data

A major concern of a large number of entities we have spoken to is the availability and reliability of data to prepare the expected cash flows. Only some of the larger banks currently collect expected loss data on their loan books. Other entities, both financial and non financial, would not have expected loss data as: they would not have collected it in the past; it is not stored in an accessible manner; or it is not available in the market place. This would be particularly the case for smaller entities in developed countries and entities in emerging markets such as Latin America, Asia, CEE and Africa. Examples of difficulties include:

- Corporate bonds with no available credit default swap information or other credit indices with which to determine expected credit losses.
- Where credit default swaps are being used to determine expected losses for bonds or loans, how much of the spread reflects credit and how much reflects liquidity?
- Certain entities will not have details of loss given default (LGD) or probability of default (PD) over the life of the asset. The may even be the case for banks who apply Basel II.
- How to translate expected loss data, where collected/available, into expected cash flows over the life of the asset? Predicting when the losses will actually impact cash flows is very challenging.
- These difficulties increase when entities try to adjust historical data to reflect changes in future economic circumstances. The information upon which such adjustments will be based is likely to be unobservable and may be difficult to obtain.

Entities in emerging markets are particularly concerned that they will have to apply a greater level of estimation due to lack of historical data compared to their counterparts in the more developed markets.

Systems

Another concern of our clients was the amount of time it would take to develop credit models for the variety of instruments they hold and to program their information systems to meet the requirements of the new model.

In addition, the application of the expected cash flow method is likely to make the calculation of EIR more complex. Currently a large number of entities do not determine EIR on a loan by loan basis. They determine the EIR impact for transaction costs etc on a portfolio basis and then adjust the yield determined from front end loan accounting systems to materially approximate the EIR on a loan by loan basis. They question whether such an approach would still be workable given the substantial change to EIR caused by this model i.e. will such an approach still materially approximate the EIR on a loan by loan basis? They believe if changes to front end accounting systems are required, this could be very costly and could take a considerable period of time.

Question 3

What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

It is very difficult to be specific about the level of costs and lead times until field tests have been completed. While not necessarily comparable, many banks took up to 2 to 3 years installing their incurred loss models when they transitioned to IFRS. The expected loss model could prove more challenging for some preparers.

The financial institutions we have spoken to believe they will have to significantly change/enhance their credit and information systems which based on Basel II experience will be expensive. In addition, they believe, if changes to front end income recognition systems are required this will also be very costly.

Entities in emerging markets believe that the cost and lead times for them will be greater than for entities in developed markets.

Question 4

How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

We support Approach A for the amortisation of upfront costs. A large percentage of upfront costs and spreads are fixed. We believe the amortisation approach for these costs should be consistent with the approach applied for fixed rate products given both are fixed in nature. Approach A is consistent with the approach applied in the model for fixed rate products and AG8 in the current standard.

We believe that when a variable rate instrument is impaired the revised cash flows should be discounted based on the new benchmark variable interest rate holding the initial expected spread (adjusted for initial expected losses) constant. As a result, changes in the expected losses would not cause the spread to be revised and, therefore, would result in a "catch up" being booked to the income statement. This is consistent with the approach for fixed rate products and with AG8 in the current standard. However, changes in the variable benchmark rate would alter the EIR and, therefore, would not give rise to a "catch up". This is consistent with AG7 in the current standard. We believe that this is likely to be the easiest to apply for financial institutions as it is consistent with the approach they currently apply.

Question 5

How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

- (a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?**
- (b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?**

As mentioned above, we believe the model should provide adequate flexibility for entities to determine the appropriate expected loss for their assets based on their business model and the actual products they hold. In this regard, management should determine the appropriate level of granularity (i.e. portfolio) required to produce reliable expected loss estimates. They should also determine a policy for portfolio transfers and a mechanism for loss adjustments on portfolio transfers. If entities believe that expected loss can be reasonably determined at a level higher than an individual account then, in practice, we do not see how moving an individual loan, once impaired, out of its original portfolio will improve the reliability of the expected loss information. We do not believe the IASB model should be prescriptive in this regard. It should be left up to the entity to determine the appropriate attributes for each portfolio and then to decide whether, based on those attributes, it is appropriate to: (a) continue to include the individual impaired loan in the pool; (b) transfer it to another pool; or (c) assess it individually.

If there is a transfer between portfolios then the expected loss should be recalibrated for the changed portfolios for the next reporting period.

Question 6

What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

We believe that the provision of a framework for applying the principle underlying the overall approach, while allowing preparers a reasonable amount of flexibility in the approach to determining expected losses, would help simplify the overall model.