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Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

8 July 2010

Dear Kevin

Exposure Draft ED 189 *Financial Instruments: Amortised Cost and Impairment*

I am enclosing a copy of the PricewaterhouseCoopers response to the International Accounting Standards Board's exposure draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*. The letter reflects the views of the PricewaterhouseCoopers network of firms and as such includes our own comments on the matters raised in the exposure draft.

We would welcome the opportunity to discuss our views at your convenience. Please contact me on (03) 8603 3868 if you would like to discuss this further.

Yours sincerely

Jan McCahey
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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

30 June 2010

Dear Sir

Exposure Draft – Financial Instruments: Amortised Cost and Impairment

We are pleased to respond to your Exposure Draft – Financial Instruments: Amortised Cost and Impairment.

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

We recognise the significant efforts that the Board is making to respond to the accounting concerns raised by constituents as a result of the recent financial crisis. The financial crisis has highlighted the importance of having a consistent approach to the accounting for financial instruments, particularly with respect to impairment of financial assets. We therefore strongly support the development of a single converged model for impairment under both IFRS and US GAAP and urge both the IASB and the FASB to continue to work together during the re-deliberation process to achieve this goal.

Our response to the Exposure Draft addresses the IASB proposed amortised cost and impairment model only in the context of accounting for financial assets under IFRS 9, Financial Instruments. It does not consider the model proposed by the FASB in its Exposure Draft, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities. That Exposure Draft was only issued on 26 May 2010 with a comment period to 30 September 2010. Therefore, it was not possible to sufficiently consider both models together within the IASB comment period.

Overall, we conceptually support an expected loss approach to accounting for the impairment of financial assets carried at amortised cost. We believe an impairment model based on expected losses better reflects the economics and results in a more realistic and timely recognition of the effects of credit losses. However, we are concerned with the significance of the operational challenges that the proposed model presents. We therefore cannot support the IASB proposed model until it can be demonstrated that it can practically be applied on a basis consistent with the fundamental principles of an expected loss approach. We encourage the IASB to continue to explore potential solutions to the operational challenges of the expected loss approach as it re-deliberates the Exposure Draft.

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Conceptual Merits

We believe the proposed expected cash flow model is conceptually sound with two exceptions (see the following two paragraphs below). We note however, it is just one form of an expected loss approach. The IASB model addresses a major criticism of the current accounting model in that the incurred loss approach delays the recognition of impairment until there is objective evidence that impairment has occurred. Impairment will be recognised under the Exposure Draft based on loss expectations which will allow entities to start providing for impairment earlier than under the incurred loss model. At the same time, the model also recognises that many entities are compensated for credit losses (e.g. via credit spread in a loan) and, therefore, an impairment loss should not be recorded upon the initial recognition of a financial asset. Under the Exposure Draft, an allowance for the initial expected losses is effectively provided over the life of the asset through a reduction of interest revenue. Therefore the model also addresses the criticism of the incurred loss approach that too much interest income is recognised in the periods before a loss event occurs.

Measurement – changes in credit loss estimates

We agree that for specific financial assets no longer expected to generate income in the future, all changes in credit loss estimates should be recognised in profit or loss immediately. However other changes in credit loss estimates are similar to changes in estimates of variable consideration in the context of revenue recognition. An entity does not recognise revenue upon the initial funding of a financial asset. Instead, revenue is earned over the life of the financial asset. Therefore, consistent with the accounting for variable consideration, changes in credit loss estimates for assets generating a return should be recognised in the income statement to match the pattern of revenue recognition. Changes in estimates which relate to prior and current periods should be recorded in the income statement immediately. Changes which relate to future periods should be spread forward over the remaining life of the financial asset. This approach is consistent with the objective of amortised cost measurement set out in the Exposure Draft of providing information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument.

Measurement – probability-weighted approach

The Exposure Draft proposes that entities should apply a probability-weighted approach to the determination of expected cash flows. We believe that such an approach works well for large portfolios. Preparers know that these portfolios are likely to contain assets that will become impaired. However, they cannot identify the individual loans which will default. A probability-weighted approach allows them to make a reasonable estimate of the impact on the portfolio of expected impairment of these assets in the future. However, we question the use of such an approach when considering impairment at an individual asset or small portfolio level (i.e. not statistically significant). In these situations, such an approach would require entities to make a credit loss provision for individual assets where they do not believe it is probable or even likely that the asset will not generate all of its contractual cash flows. The cash flows expected to be collected from these assets are not the same as their expected cash flows based on a probability-weighted outcome. We believe the relevance and decision-usefulness of such a provision is questionable. In these circumstances, a single best estimate approach may provide more relevant information. We believe that rather than requiring a probability-weighted cash flow approach in all cases, the IASB should allow preparers the ability to select whichever of these two approaches yields the best estimate of expected loss in their particular circumstances.

Operational Issues

While the IASB proposed model has conceptual merit, it does have a number of serious operational issues many of which have been discussed at the Expert Advisory Panel (EAP). The more significant concerns raised by the EAP include:

- Most financial institutions manage interest income and credit risk separately. Interest is determined from the loan accounting systems and credit losses are determined via the credit systems. These systems are generally not integrated and, therefore, in their current form, cannot provide EIR net of credit losses.

- Expected cash flows are generally not stored in any systems. Most entities would calculate an expected loss rate for a specific period (e.g. 12 months as required by Basel), but would not record expected cash flows. It will be operationally challenging to turn this loss rate into an annual charge that takes account of the impact on credit loss of both timing and amount will be operationally challenging. It will also be challenging to develop credit expectations over the full life of the asset.

- Most portfolios are open rather than closed. This means that new loans are constantly being added to the portfolio. This substantially increases the complexity in tracking changes in estimates. The expected loss rates for these portfolios are point in time estimates which change as the portfolios change. However, current systems do not track whether the change in the expected loss rate arises from a new loan (i.e. impacts initial loss expectation) or an old loan (i.e. arises from a change in estimate). This makes it operationally challenging to correctly identify and account for changes in original estimates.

- When a credit loss occurs early in the life of a portfolio and the related loans are written off in accordance with the Exposure Draft, this can lead to an inadequate allowance for the loans remaining in the portfolio or in some circumstances to a negative (debit) allowance. This is due to the fact that the charge off is debited to the allowance account before all the expected losses are credited to this account. Negative provisions will not be widely understood by users or regulators.

The EAP has identified several potential solutions to some of these issues such as de-coupling interest income and expected loss estimates and differentiating between a good book (e.g. performing loans) and a bad book (e.g. non-performing loans). We believe these are good suggestions and support their further development. The solutions the EAP has developed to date focus on determining credit losses for amortised cost measurement from expected loss data derived from credit systems rather than expected cash flows which are not currently captured by credit systems. While the expected cash flow model is arguably a more conceptually pure expected loss approach, it is not the only way to apply it. We therefore believe it may be beneficial for the Board to revise the Exposure Draft to focus on an expected loss approach as the governing principle that may be met through an expected cash flow model or another method(s), such as those suggested by the EAP.

Furthermore, as the Board evaluates possible solutions, we believe it is very important to allow entities the ability to establish an overall framework for estimating expected losses that is reflective of their circumstances. Entities should have the flexibility to estimate losses over a reasonable forward period that is appropriate given their systems, financial products and economic environment and to assume a long-term average loss rate for the remaining term. This will help alleviate concerns over estimating the effect of economic cycles over a long term, as well as enable the model to be responsive to the unique nature of each entity.

However, the operational challenges are very significant. Therefore we cannot support the IASB proposed model until it can be demonstrated that the model can practically be applied on a basis consistent with the fundamental principles of an expected loss approach. We encourage the IASB to continue working with the EAP as the Board re-deliberates the model and considers solutions to the various operational issues. We believe that it is very important that the Board sufficiently field tests these solutions to ensure the model is operational. The operational issues will not necessarily be the same for all entities. Therefore, it is important that the Board incorporates into its operational assessment:

- both small and large entities,
- those from advanced economies and developing economies,
- both financial and non-financial institutions, and
- an appropriate cross section of industries.

Presentation and Disclosure

We support the IASB presentation model with one exception. We believe that changes in expected credit losses are similar to changes in variable consideration in the context of revenue recognition and, therefore, these changes should be reflected in revenue/net interest rather than outside revenue/net interest as proposed by the Exposure Draft.

We believe that the disclosure requirements of the Exposure Draft will be onerous for many preparers. In addition, we are not convinced that the proposed disclosures taken as a whole would necessarily reflect how entities assess and manage credit risk. Consistent with the approach taken in IFRS 7, we would encourage the IASB to apply a "through the eyes of management" approach to disclosure. This disclosure should help users to understand how management determines the credit quality of their financial assets, how they determine their credit losses and the accuracy of their estimation process.

Transition

The operational issues noted above apply equally to transition. We conceptually support the IASB proposal that the standard should be retrospective and believe the Board's approach for determining the transition adjustment is practical provided the operational issues are resolved. However, the Board should not underestimate the complexity of retrospective application. Many entities will need a minimum of 3 years after the above operational issues have been resolved to determine the transition adjustment and restate the comparative period. Therefore, if entities wish to adopt the standard earlier they should receive the same relief from restating comparative information as provided by the current IFRS 9.

The Board recently announced that it intends to issue a document soliciting stakeholder input regarding the effective date and transition methods for major Memorandum of Understanding projects. We support this plan and believe that a coordinated consideration of the most appropriate transition to all of the new accounting standards will be well received by the Board's constituents. We strongly encourage the Board to move quickly on this so the benefits of the input can be applied to this project prior to its completion.

We have expanded on the above and responded to the specific questions raised in your Exposure Draft in the appendix to this letter.

If you have any questions in relation to the letter please do not hesitate to contact John Hitchins, PwC Global Chief Accountant (+44 207 8042497) or John Althoff (+44 207 213 1175).

Yours faithfully

PricewaterhouseCoopers LLP

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Appendix: Response to Detailed Questions

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?

The objective of amortised cost measurement set out in the exposure draft is 'to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument'. We believe the objective is clear.

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?

We believe that the objective of amortised cost as set out in the exposure draft is appropriate. However we do not agree with the proposal in the Exposure Draft that only the initial estimate of expected credit losses is spread over the expected life of the financial asset and all revisions to this estimate are recognised in income immediately. We agree that for financial assets no longer expected to generate income in the future, all changes in credit loss estimates should be recognised in profit or loss immediately. However other changes in credit loss estimates are similar to changes in estimates of variable consideration in the context of revenue recognition. An entity does not recognise revenue upon the initial funding of a financial asset. Instead revenue is earned over the life of the financial asset. Therefore, consistent with the accounting for variable consideration, changes in credit loss estimates should be recognised in the income statement to match the pattern of revenue recognition. Changes in estimates which relate to the prior and current periods should be recorded in the income statement immediately. Changes which relate to future periods should be spread forward over the remaining life of the financial asset because the revenue related to those periods is not yet earned. This approach is consistent with the objective of amortised cost measurement set out in the Exposure Draft of providing information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument.

Question 3

Do you agree with the way that the exposure draft is drafted, which emphasises 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 support a principle-based approach to standard setting and believe that the principles should be supplemented with implementation guidance to the extent necessary depending on the nature and complexity of the area. As noted in our cover letter, the EAP has raised a number of operational issues with the proposed model and identified several potential solutions, such as de-coupling interest income and expected loss estimates and differentiating between a good book and a bad book. We believe these are good suggestions and support their further development. Furthermore, we believe it is very important that the Board allows entities the ability to establish an overall framework for estimating expected losses that is reflective of their circumstances. Entities

should have the flexibility to estimate losses over a reasonable forward period that is appropriate given their systems, financial products and economic environment and to assume a long-term average loss rate for the remaining term. Given the significance of the operational challenges and the nature of the suggested solutions, we believe that the Board should consider incorporating an appropriate amount of implementation guidance and illustrative examples in the final standard. However it should be clear that such guidance is illustrative and not necessarily prescriptive of the only approach to be used.

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?

We agree that amortised cost should reflect current inputs regarding cash flow estimates including credit losses and inputs related to initial recognition. However, while the expected cash flow model is arguably a more conceptually pure expected loss approach, it is not the only way to apply it. We believe it may be beneficial for the Board to revise the Exposure Draft to focus on an expected loss approach as the governing principle that may be met through an expected cash flow model or another method(s), such as those suggested by the EAP. In addition, as noted in our response to Question 2, we believe that changes in estimates of expected credit losses should be reflected in the income immediately to the extent they relate to prior and current periods and should be reflected in subsequent periods to the extent they relate to the future. We note that the application of this measurement principle to financial assets which are no longer expected to yield a return will result in immediate recognition of the entire expected loss.

We agree that a probability-weighted approach to the determination of expected cash flows works well for large portfolios. We are not convinced however, that this necessarily holds true for individual items and small portfolios. A probability-weighted outcome for small portfolios/individual items may not be statistically representative and may yield odd results. For example, a probability-weighted outcome would always result in reduced interest revenue on a financial asset even when probability of loss is very low. This is because the cash flows expected to be collected are not the same as expected cash flows based on a probability-weighted outcome. If the loss does not subsequently occur, this will result in a subsequent gain even though the asset has performed in line with the entity's best estimate. We question whether this provides decision-useful information. We believe the standard should not be prescriptive in terms of a methodology as to how to estimate expected cash flows, but should allow preparers the ability to select whichever of these two approaches yields the best estimate of expected losses for their particular circumstances. The approach used should be clearly disclosed in the financial statements.

Most loan commitments are outside the scope of IAS 39 and, as a consequence, provisions made against these commitments are determined in accordance with IAS 37. As many of these commitments will eventually become loans carried at amortised cost, we believe it would be appropriate to have the same impairment model for loans and those loan commitments that are not accounted for as derivatives. Financial institutions generally consider both loans and loan commitments together when completing their credit assessments. Therefore, including loan commitments within the scope of the Exposure Draft would be consistent with the way financial institutions manage their business.

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?

The objective of presentation and disclosure as set out in the exposure draft is to enable users to evaluate the financial effect of interest revenue and interest expense, and the quality of financial assets including credit risk. We believe that the objective is clear and appropriate. However, given the high degree of judgement involved in estimating expected credit losses and the latitude entities should have in developing those estimates, we believe the disclosure objective should be expanded to include information to enable users to understand the method(s) used to develop credit loss estimates.

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 and note that they are consistent with the presentation and disclosure objective set out in the Exposure Draft with one exception. We believe the allocation of expected losses is an integral part of the interest revenue recognition model and, therefore, changes in expected credit losses should also be reflected in interest income. We do not believe there should be a difference in the financial statement presentation between the initial estimate of credit losses and any subsequent adjustments as a result of a change in that estimate.

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?

We believe that the required disclosures taken as a whole will be onerous for many preparers. The requirement to disclose the loss triangle and vintage information by asset class is particularly burdensome when one considers the volume of disclosures that would be required for preparers, particularly for major financial institutions. Vintages and loss triangles are only useful for certain types of homogenous portfolios, for example credit cards and consumer loans, which are managed by a credit score process but not for other classes of financial assets. In addition, we are not convinced that the proposed disclosures taken as a whole would necessarily reflect how entities assess and manage credit risk. We encourage the IASB to adopt a 'through the eyes of management' approach to disclosure of the credit quality of financial assets consistent with IFRS 7. This disclosure should enable users to understand how management determines the credit quality of their financial assets, how they estimate credit losses, and the accuracy of their estimation process.

The amendment to IFRS 7 to incorporate the new impairment-related disclosure requirements raises a question as to whether the Board should reassess the overall disclosure requirements for financial instruments. IFRS 7 has been amended several times over the last few years, and the Board will likely be amending it further as it completes the remaining portions of its financial instruments project. At some point, it may be appropriate for the Board to consider comprehensively reassessing the financial instruments disclosure requirements to ensure the right balance is achieved. This is something that should be considered by the Board in setting its post-2011 agenda.

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?

It is very difficult to conclude on the adequacy of the implementation lead time until solutions are found for the various operational issues and appropriate field tests are performed. However, it may be worth noting that many financial institutions required 2 to 3 years to install the necessary systems and procedures for applying the current incurred loss model when they transitioned to IFRS. We expect that the lead time for applying the proposed expected cash flow model should be at least this long and therefore believe a minimum of a 3 year lead-time is needed.

Question 9

(a) **Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?**

(b) **Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?**

(c) **Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.**

The operational issues we noted in our response to Question 3 and our cover letter apply equally to transition. We conceptually support the Board's proposal that the standard should be applied retrospectively. While the alternative transition approach of applying the EIR as determined under IAS 39 may be operationally easier, we would not favour such an approach as it would mean interest income and impairment would be determined in a different manner for assets pre-transition and those originated post-transition. We believe it is more appropriate for entities to estimate the EIR, net of credit losses, for the pre-transition assets and consider the Board's approach to be practical provided the operational issues are resolved.

We agree that comparative information should be restated to reflect the new requirements in all circumstances except where the new impairment model is adopted before its mandatory effective date. The difficulty of retrospectively adopting the proposed standard should not be underestimated however. Many entities will likely need the full lead time of 3 years, after the operational issues are resolved, to determine the transition adjustment and restate the comparative period. Entities that wish to adopt the new standard early should receive the same relief from restatement of comparative information as is available in transition requirements in current IFRS 9.

The Board recently announced that it intends to issue a document soliciting stakeholder input regarding the effective date and transition methods for major Memorandum of Understanding projects. We support this plan and believe that a coordinated consideration of the most appropriate transition to all of the new accounting standards will be well received by the Board's constituents. We strongly encourage the Board to move quickly on this so the benefits of the input can be applied to this project prior to its completion.

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

We support the proposed disclosure requirements in relation to 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?

We consider the practical expedients included in the Exposure Draft to be helpful, but we do not believe they go far enough to address the operational issues. The development of appropriate implementation guidance along with practical expedients is critical to the implementation of an expected loss approach.

Question 12
Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

The development of appropriate implementation guidance along with some practical expedients is critical to implementation of an expected loss approach. The practical expedients proposed in the exposure draft are not sufficient to help preparers to address all of the operational challenges the IASB model presents. As noted in our cover letter, the EAP has raised a number of operational issues with the proposed model and identified several potential solutions, such as de-coupling interest income and expected loss estimates and differentiating between a good book and a bad book. We believe these are good suggestions and support their further development. Furthermore, we believe it is very important that the Board allows entities the ability to establish an overall framework for estimating expected losses that is reflective of their circumstances. Entities should have the flexibility to estimate losses over a reasonable forward period that is appropriate given their systems, financial products and economic environment and to assume a long-term average loss rate for the remaining term.

Given the significance of the operational challenges and the nature of the suggested solutions, we believe that the Board should consider incorporating an appropriate amount of implementation guidance and illustrative examples in the final standard. However it should be clear that such guidance is illustrative and not necessarily prescriptive of the only approach to be used.

Clearly an appropriate balance must be met between the desire for a principles-based standard and the need for some application/implementation guidance given the considerable operational issues. In this regard, it would also be helpful if the IASB would distinguish between guidance which is assumed by the standard to be consistent with an expected loss approach and practical expedients which can be applied provided the preparer can justify they are not materially different to an expected loss approach.