Re: ED – Financial Instruments - Amortised cost and Impairment

Dear Sir or Madam,

MAZARS welcomes the opportunity to comment on the IASB Exposure Draft, *Financial Instruments - Amortised cost and Impairment*. Our answers to the Exposure Draft questions are shown in the appendix to this letter which summarises our concerns and opinion.

We welcome the Board’s proposal to develop an amortised cost impairment model based on an expected loss approach. We consider that an expected loss model would significantly improve the quality of financial reporting as it will provide a better representation of the effective return on financial assets measured at amortised cost thanks to the recognition of expected losses in the time pattern as interest revenue is accrued.

However the approach proposed by the Board raises major concerns summarised below.

We also consider that the proposed approach is too complex to be operational. This is mainly due to the exposure draft proposal to include the expected loss model into the existing effective yield mechanism. This approach is not operational for the main following reason: while an entity may be able to estimate expected losses, it is generally not possible to determine reliably the timing of these losses (i.e. timing of expected cash flows). In order to make this expected loss model operational as well as minimising the cost/benefit ratio of related IT development, we recommend disconnecting the expected loss recognition from the effective yield mechanism.

We consider that an expected loss model should be a complement to the current incurred loss model. We consider that information on the statement of comprehensive income about actual losses is key to financial statement users and would be lost under the proposed expected loss approach. A possible way forward would be to replicate the way financial institutions actually manage their loans, distinguishing:

- A “good book” composed of performing loans on which an expected loss model could be retained
- A “bad book” on which an impairment process similar to the current incurred loss model of IAS 39 could be applied
Combining these two approaches would also ensure avoiding some counter-intuitive outcome such as an allowance account that does not permit to cover incurred losses.

We acknowledge that estimating expected losses requires judgement. Therefore we consider that the approach implemented by the entity should in any case include a back testing mechanism and a periodic analysis of the allowance account variations.

In practice, loss estimates will be computed based on historical data. We consider that the approach should require:

- Adjusting these historical data to take into account the current conditions of the economic environment (i.e. the environment prevailing on the date of the expected loss assessment);

- Prohibiting any mechanism of “solidarity” between vintages of loans (i.e. allowance account created for a given loan vintages should be consumed by the end of the life of the loans).

Moreover, we question the Board’s choice to retain probability-weighted estimates since, based on our experience, this is not consistent with the way entities manage their credit risk (they rather apply a “best estimates” approach).

We also disagree with the application of the “catch-up” mechanism to changes in expected losses estimates. We feel that such a mechanism would open the door to account manipulation. We consider that the Board should make a distinction between:

- Changes in expected losses estimates which relates to the future estimated effective return and should therefore be spread over the remaining life of the instrument

- Incurred losses which relates to a credit event impacting the value of the asset though an incurred loss impairment which should be recognised on the period in which it occurred.

We support the Boards decision to promote a principle based standard in order to allow each entity to implement the approach consistently with its economic environment. However we question the applicability of an expected loss approach for entities with insufficient quantity of loans and/or receivables to perform a statistical approach. While expected losses are relevant and reliable on large portfolios, this approach is irrelevant on a loan by loan basis. Moreover, we are concerned about the consequences of such an approach for entities with only short term loans for which the difference between incurred loss and expected loss is not material enough to justify significant costs and IT developments.
We disagree with the paragraph 12 a) of the exposure draft which states that an entity shall provide as a minimum the information required by paragraph 13-22. We consider that this kind of “checklist” requirement should be subject to a condition on relevance and/or materiality. Besides, we disagree with the requirement of paragraph B29 on “loss triangle” as we consider this kind of information being very sensitive for financial institutions. Thus we feel that, if obliged to disclose it, the financial institutions would determine it at an aggregate level which would be meaningless.

Our detailed answers are set out in the Appendix.

Do not hesitate to contact us should you want to discuss any aspect of our comments.

Best regards,

Michel Barbet-Massin

Head of Financial Reporting Technical Support
APPENDIX

Objective of amortised cost measurement

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?

AND

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 welcome the Board’s proposal to develop an amortised cost impairment model based on an expected loss approach. We consider that an expected loss model would significantly improve the quality of financial reporting as it will lead to recognise expected losses following the same time pattern as interest revenue accrued.

However we consider that the proposed definition is too complex to be operational as it includes the expected loss concept within the EIR cost calculation. The position taken by the Board raises several concerns:

- While we consider that expected losses can be reliably estimated on large loan portfolios with similar risk profiles, we think that it is not operational to estimate expected losses on a loan by loan basis.

- While it is possible to estimate an expected loss, this may not be the case for cash flows since their timing usually cannot be assessed reliably.

As a consequence we consider:

i) That an expected loss approach should be an independent complement to the current amortised cost definition. A practical way to implement this would be to identify a “good book” on which an expected loss approach could be applied, and a “bad book” composed of impaired assets as currently defined under IAS 39 - 59. In our view this distinction would simplify the implementation of the approach as it is in line with the way financial institutions manage their financial assets.

ii) That, within the “good book” the expected loss mechanism should be dealt with separately from the existing effective yield mechanism and resulting amortised cost measurement.

We note that both proposals above (good book vs. bad book, and “decoupling”) are also discussed within the Expert Advisory Panel and several alternative proposals such as the EBF model.
In the current practice, most of loan commitments are outside the scope of IAS 39. An issuer of loan commitments shall apply IAS 37 when these instruments are outside the scope of IAS 39. Consequently, the credit risk borne by a loan commitment is assessed for provision under IAS 37 while the same credit risk borne by a loan is tested for impairment under IAS 39. As the nature of the credit risk is similar, we consider that it should be addressed by the same standards and principles. Therefore we encourage the Board to take the opportunity of this Exposure Draft to deal with this issue.

**Measurement principles**

**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 agree with the Board’s decision to keep a principle based approach and not to provide detailed implementation guidance which could be considered prescriptive.

It seems obvious that corporate entities will implement differently from banks the expected loss impairment model. And even within the banking industry, expected losses will be determined differently in retail banking (where portfolios contain thousands of loans with small nominal amounts) and project finance (where portfolios contain very few loans with individually significant nominal amounts).

Therefore we are convinced that the implementation of such an approach should depend on each entity. The entity will develop a model consistent with its own environment and internal organisation (IT capacity notably). Comparability between entities will be ensured since the approach implemented will have to comply with the principles detailed in the standard.

**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?

As already mentioned in our answer to question 2, we welcome the IASB decision to promote a credit risk impairment model based on expected losses.

However, we consider that the measurement principles set out in the Exposure Draft should be both simplified (to be more operational) and complemented. We sum up below our main concerns on the proposed measurement principles.
The expected loss model should be a complement to the current incurred loss approach

As already mentioned in our comment letter to the request for information on Impairment for financial assets – An expected loss approach, we are convinced that an expected loss approach should complement the existing incurred loss model, not replace it.

In our opinion, a loss shall be recognised in the profit or loss in the period a loss has been incurred since this is a key information for financial statements users and preparers. This profit or loss impact could be fully or partially offset by a reversal of the expected loss allowance account. But the cumulative loss recognised at the end of a period regarding the credit risk of a loan portfolio should at least be equal to the amount of the cumulative loss incurred at that time.

In other words, we strongly disagree with an approach that may result in an implicit or explicit negative allowance account in case of a loss being incurred in the early years of a long term loan (i.e. when the expected loss allowance account has not been sufficiently increased to date to fully offset the loss incurred during the period).

A simple way to implement this would be to reflect the way financial institutions actually manage their credit risk through the good book vs. bad book distinction mentioned in our answer to question 2. The expected loss model would be implemented within the good book (performing loans) whereas the bad book would remain under current IAS 39 incurred loss model.

The distinction between expected losses of the good book and incurred losses of the bad book would be clearly presented on the face of the statement of comprehensive income. Their interaction would be further detailed in the disclosures.

The major issue regarding this distinction is the way good book’s expected loss provisions interact with the bad book when an asset is transferred from the good book to the bad book. We understand that this issue has been identified by the Expert Advisory Panel who is currently considering different solutions.

Disconnecting effective interest rates mechanism from expected loss provisioning:

As mentioned in our answer to question 2, we consider that the inclusion of the expected loss model in the already complex effective interest rate approach results in a solution which is not operational.

Indeed, an effective interest rate approach requires not only to determine expected losses, but also to identify their timing of occurrence. It is our experience that the timing of expected cash flows usually varies from one period to another. Including an expected loss approach in the effective interest rate mechanism would therefore lead to increased variability. This conflicts with the project’s initial objectives.
We remain however convinced that expected losses constitute relevant information when it is used as a complement to the losses incurred to date. Therefore we propose that the Board considers an alternative approach where the expected loss model is simply added as an independent complement to the effective yield mechanism currently applied by preparers.

For cost/benefit considerations, we would recommend to deal separately with this complementary expected loss approach in order to minimise IT consequences on the existing effective yield process.

Impact of expected loss re-estimates

We disagree with the “catch up” mechanism proposed by the Exposure Draft for expected loss re-estimates. Our main reasons are presented below:

- This catch up impact is directly related to the effective interest yield mechanism. As previously mentioned, we do not consider that an approach relying on the inclusion of expected losses in the effective interest rate mechanism is operational. For example, the amount of the “catch-up” profit or loss impact is directly related to the timing of the expected loss which, in practice, cannot be estimated reliably. Addressing expected losses separately from the effective interest rate of the instrument enables to avoid the “catch up” impact.

- A “one shot” impact seems to be justified when it results from an identified event that occurred during the period. This profit or loss recognition is more consistent with an incurred loss approach than with an expected loss model.

- We consider that if expected losses estimates are increased compared to the initial assessment, the relevant information for the user of financial statement in the remaining periods is the new expected effective return rather than the original effective return. If expected losses increased, it is not consistent to continue to recognise the same original effective return over the remaining life of the asset. This contradicts the main benefit of the expected loss approach which is the recognition of revenue and corresponding losses on the same time pattern.

- In our view, expected losses should affect the expected return of an asset whereas incurred losses should affect its carrying amount. To a certain extent it is similar to the principles applied to property plant and equipment. Under IAS 16 depreciation is recognised under a method which reflects the time pattern in which the asset’s future economic benefits are to be consumed by the entity. In case of change in the expected pattern of consumption of the future economic benefits, the effect on future periods is recognised in those future periods. However, impairment identified under IAS 36 is recognised immediately. We consider that the same distinction exists between expected losses and incurred losses on a loan. Therefore a change in estimates related to expected losses affects the future expected return of the asset and should be spread over its remaining life whereas incurred losses affect the value of the asset and should therefore impact the profit or loss of the period.
Paragraph 38 of IAS 8 states “a change in the estimate of the amount of bad debts affects only the current period’s profit or loss and therefore is recognised in the current period”. We consider that this statement does not impair our analysis above as:

- it refers to the current IAS 39 incurred loss model and we agree with its accounting treatment regarding incurred losses
- Our proposal to make a distinction between good book and bad book leads to an application of this sentence only to the bad book assets as financial assets within the good book will not be “bad debts”.

Estimations require judgment. Allowing re-estimates that would generate a “one shot” profit or loss impact may increase the risk of financial statements manipulation.

On a pure conceptual basis, we would support a retrospective approach for expected loss re-estimates. This approach would consist in:

- First, determine what the recognised expected loss would have been at the re-estimation date if the correct estimate had been applied since inception.
- Second, recognise in the current period’s profit or loss the difference between the actual expected loss provision and the provision calculated as mentioned above.
- Third, recognise an expected loss provision in subsequent periods on the basis of the new estimation.

However we are convinced that this retrospective application of the new estimates is too complex to be implemented on large numbers of loans / portfolios.

Therefore we consider that spreading the impact of the loss re-estimates over the remaining life of the instrument (or the average life of the loans within the portfolio) maintains the best balance compromise between relevance of the financial information, and practicability for preparers.

Eventually, dealing with expected loss separately from the already existing effective interest rate mechanism will bring transparency to the users of financial statements. This will enable the users to clearly identify the relation between expected and incurred losses.

**Loss estimates assumptions**

We support the Board’s decision not to retain an impairment model based on fair value. This would have been inconsistent with the Board’s decision to retain a mixed measurement model under IFRS 9.

An expected loss approach implies to perform estimates. We identified two main approaches that may underlie loss estimates:
- “Through the cycle” estimates: This approach leads the entity to consider the average losses that it may incur over an economic cycle whatever the duration of the loan portfolio. This approach makes sense if there is some kind of “solidarity” between loans vintages. It leads to creating reserves when the economic environment is favourable and reversing them in difficult economic times.

- “Point in time” estimates: This approach leads the entity to estimate expected losses based on its understanding of the current economic environment. The main difficulty of this approach is to determine whether the current economic environment is favourable or not (e.g.: Will a crisis occur? Is the economic crisis about to end?).

We acknowledge that a “through the cycle” approach would probably lead to better counter-cyclical effects. We agree that this is desirable and we understand the benefits of the recommendation of the ECOFIN and the Basel committee to develop an approach that may reduce pro-cyclical variability in the financial system.

Nevertheless, we consider that from an accounting point of view (which could differ from a regulated one) promoting counter-cyclical effects is less important than the relevance and the reliability of the information provide the financial statements.

One may argue that a “point in time” approach does not improve reliability since it is not possible to predict when a financial crisis starts. However we consider this is inherent to an expected loss estimation process. Moreover, we do not consider that creating a “through the cycle” provision on a 2-year loan to take into account a crisis expected in 5 years provides relevant and transparent information on the entity’s exposure at that date. This materialises in the statement of financial position a risk that relates to a financial asset that does not exist yet (and may never exist).

From an operational point of view, expected losses will generally be computed based on historical data. We consider that the approach should require:

- Adjusting these historical data to take into account the current conditions of the economic environment (i.e. the environment prevailing on the date of the expected loss assessment);
- Prohibiting any mechanism of “solidarity” between vintages of loans (i.e. allowance account created for a given loan vintages should be consumed by the end of the life of the loans).

Use of probability-weighted possible outcome?

We consider that the expected losses estimates process should be consistent with the way the entity actually manages its credit risk exposure.

It is our experience that entities do not analyse several scenarios to perform a probability-weighted calculation. Their approach is rather based on a “best estimate” basis.
Therefore we recommend that the Board does not require the use of probability-weighted estimates when the entity does not actually use this method to manage its risks.

Closed portfolios or open portfolios?

It is our understanding of the Exposure Draft that the Board is applying the approach only to “closed” portfolios. We understand this choice as it makes it easier to understand how the allowance account fluctuates and it simplifies the back testing process.

However, in our experience, most entities dealing with large numbers of loans manage them through open portfolios. Therefore, we consider that an approach that would require expected losses estimates to be performed only on closed portfolios, if sound in theory, would not be operational in practice.

As a consequence, we recommend that the Board does not preclude the use of open portfolios. However, the process adopted by the entity must enable to perform back testing of the estimates and to audit the allowance account variations.

Objective of presentation and disclosure

Question 5

(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

We consider that the objective of presentation and disclosure is clear and relevant.

We support the Board’s requirement to provide both quantitative and qualitative disclosures. Additionally, entities shall explain how these disclosures interact.

However, we disagree with the paragraph 12 (a) of the Exposure Draft which states that an entity shall provide as a minimum the information required by paragraph 13-22.

We consider that the information listed in paragraph 13-22 of the Exposure Draft may be too detailed for some entities. This kind of “checklist” requirement should be subject to a condition on relevance and/or materiality.
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.

However we question whether the information required is relevant for all entities. For example, in the case of a corporate entity holding only short term receivables, the net interest revenue information may not be relevant as these financial assets are not held primarily in order to receive interest income. We therefore encourage the Board to add a relevance condition to its requirements.

Besides, should the Board follow our recommendation in question 4 (i.e. disconnect effective interest rates from expected loss and give up the catch up effect on re-estimates), it would be necessary to adjust the presentation requirements. For example, the line “gains and losses resulting from change in estimates” would no longer be relevant. The information about change in estimates will still be disclosed in accordance with paragraph 16 of the Exposure Draft.

As mentioned in our answer to question 4, should the Board adopt the distinction bad book vs. good book, it should require presenting expected losses of the good book separately from incurred losses of the bad book.

Disclosure

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 broadly agree with the disclosure requirements. However, we have the following concerns:

- With respect to stress testing requirement, we consider that comparative information will be difficult to obtain as the stress testing methodology is not standardised. It is therefore important that entities disclosing stress testing information explain clearly their methodologies and assumptions.

- We disagree with the requirement of paragraph B29 on “loss triangle”. We consider that this kind of information is very sensitive for financial institutions. As a consequence, we consider that it will probably be disclosed at a too high level of portfolio aggregation to be relevant to users of financial statements. Besides, providing detailed and relevant information in this area is not operational since it would lead to disclose series of tables with too many figures.
- We consider that non-performing loans need to be defined using principles rather than a universal trigger of 90 days. This would enable each entity to define non-performing loans in a way that is consistent with its own economic, legal and regulatory environment. On this respect, we consider the current definition of impaired loans under IAS 39-59 as adequate.

**Effective date and transition**

**Question 8**
Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

We consider that three years allows sufficient lead-time, especially if the Board chooses to follow our recommendation for a simplified approach.

However we have concerns on the Board’s proposal related to earlier application. In order to ensure comparability, we consider that early application should not be allowed before the completion of the 3 phases of IAS 39 replacement.

Should the Board permit early application of phase 2 of the project before the completion of phase 3, we consider that it should require early adoption of all previously finalised phases of the project in order to avoid any “cherry picking” opportunities.

**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.

Should the Board choose to follow our recommendation expressed in our answer to question 4 (e.g. disconnecting the effective interest rate mechanism from the expected loss recognition), the transition requirement would be significantly simplified.

On a conceptual basis we favour full retrospective application as it is the best way to ensure comparability between entities.
However we consider that it is not operational to determine what would have been the initial expected loss on a given instrument several years ago. Therefore, as a practical expedient, the entity should be allowed to assume that its initial expected loss is similar to a loss calculated using information available at the date of first application.

In our opinion, this practical expedient should not lead to reduce the 3-year lead-time which remains necessary to adapt IT systems and build up relevant historical loss data.

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

We agree with the proposed disclosure requirements in relation to transition.

**Practical expedients**

**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 strongly support the introduction of practical expedients in the Exposure Draft.

However we have concerns over the requirement set out in paragraph B15 of the Exposure Draft. Asking that the impact of practical expedients remains immaterial may make it impossible for entities to implement them in practice.

We welcome the practical expedient for trade receivables detailed in paragraph B16. However we have the following concerns:

- We do not understand why corporates should deduct their expected losses from their gross revenues. This is not in line with the current usage for revenue recognition, while we recognise credit risk might be an issue when recognising revenues. We urge the Board not to pre-empt the result of the Revenue Recognition project and not to change such a rule at that stage.

- Should the Board confirm its decision on short term receivables, we consider it should clarify the way re-estimates of expected losses should be presented in this specific case (adjustment to the sale of goods for the sake of consistency?).
Question 12
Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

We favour a principle based approach to additional guidance on practical expedients. In case of additional guidance, we recommend that the Board clarifies their objective and to what extent their impact must remain immaterial.