AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

c/o KAMMER DER WIRTSCHAFTSTREUHÄNDER
SCHOENBRUNNER STRASSE 222–228/1/6
A-1120 VIENNA
AUSTRIA

TEL +43 (1) 81173 228
FAX +43 (1) 81173 100
E-MAIL office@afrac.at
WEB http://www.afrac.at

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on Exposure Draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (ED). Principal authors of this comment letter were Peter Bitzyk, Andreas Gilly, Erich Kandler, Heiner Klein, Michael Laminger, Ernst Schönhuber, Andreas Rauter, Helmut Sorger, Bernd Spohn and Roland Nessmann.

General remarks

We agree with the IASB's intention to replace IAS 39 Financial Instruments: Recognition and Measurement with new Standards which will present the economic value of assets, liabilities and results of transactions in a better way than IAS 39 does, subject to cost/benefit constraints as well as practical expedients and availability of data.

The main goal of the new rules – as stated in the introduction to the exposure draft – should be to enhance investor confidence in financial markets (IN3) by including credit loss expectations in the amortised cost measurement of financial assets (IN6). In the light of the difficulty of deriving estimates of expected cash flows and missing historical data, the Board decided to appoint an expert advisory panel to give advice on the nature and extent of guidance necessary to derive the estimates of expected cash flows over the life of a financial asset (IN7). This advice, which is an integral part of the proposed plan (IN12) has not yet been given, and therefore is not part of the ED.

This ED claims to be compatible with the objectives of financial statements as established in the Framework. The rules proposed in the ED must therefore be compatible with the underlying assumptions of the Framework – accrual basis, substance over form, neutrality, prudence, completeness and comparability. Additionally, the constraints on relevant and reliable information – timeliness, balance between benefit and cost, balance between qualitative characteristics and true and fair view or fair presentation – must be taken into account.

At first sight these requirements may appear to be satisfied, but for the detailed reasons given in our answers below, we doubt whether the ED has achieved this and other goals – such as contributing to the stability of the financial industry, as a key component of economic welfare.

The first question is whose needs must be taken into account, how these needs are to be fulfilled, and what the effects the proposed rules may be.

1. The justified desire of investors to see the economic effects of all assets, liabilities and transactions of an entity in order to make sound decisions, is subject to the limitation that future developments are unknown and beyond management's ability to foresee.

2. Since different managements have differing expectations about future events and developments and their effects on assets, liabilities and income, enhancing the use of management expectations about such events and developments in financial reporting means reducing the comparability of financial reports, which will conflict with the comparability assumption of the Framework.

3. In addition, some aspects are not explained in sufficient detail for well-founded comment to be possible yet. For example, the method applied to estimate future cash flows: estimates could be based on current economic and market conditions, but just as well on expected changes in economic and market conditions after the reporting date. In our view, the second approach is more appropriate for calculating an effective interest rate because the outcome is a reflection of the management's expected economic return on the instrument. On the other hand, it increases implicit uncertainty and lack of comparability.

4. Other effects to be borne in mind when increasing the use of management expectations in financial reporting are the increasing (financial) cost of a lack of trust in published financial reports based on management expectations, as well as the self-fulfilling prophecy aspect of published expectations, which could reduce financial stability and endanger the prospects of recovery in times

of economic downturns. These effects result when for financial reporting based largely on management expectations impairment of assets needs to be recognised to reflect actual or anticipated economic downturns, as follows:

a) Impairment of long-term financial assets through the income statement reflecting anticipated negative future developments reduces the equity of the reporting entity immediately. This of course leads to a deterioration of the entity's credit rating.
b) This in turn reduces its refinancing ability and increases its liquidity costs, which further weakens its performance and financial status.
c) The entity must then reduce its lending to customers, which puts pressure on their financial status and activities.
d) Since all entities are now expecting a downturn (on the basis of declining ratings and general news-based expectations for the whole or a significant part of the economy), management of all entities collectively will have poor expectations for future development, leading to further impairment of financial assets – a self-fulfilling prophecy market mechanism.
e) The end result is that the whole economy faces a downturn as a result of immediate impairment of financial assets solely on the basis of expectations.

These consequences of the proposed changes deserve serious and detailed consideration, because by anticipating future developments they will in our view exacerbate cyclical effects.

5. Another major issue – which may yet precipitate financial turmoil – has been the problem of lack of trust in figures reported in financial statements. We do not believe that increased use of data based on management expectations about future economic and political developments – extending in some cases far beyond management's terms of office – can possibly strengthen the trust in financial statements: these expectations should be based on verifiable data, otherwise their use will undermine trust in financial reporting and comparability of financial statements.

6. We strongly support the IASB´s intention not to implement through the cycle provisioning, because in our view such implementation would lead to the problems discussed in point 3 above and bring additional problems, e.g., responsibility of management for financial reporting using external add-ons, differences between data used within the entity for management purposes and for financial reporting, as well as problems in the allocation of financial assets held to the portfolios which are used by external parties in calculating these add-ons.

7. We are astonished to learn that an Expert Advisory Panel is making a field test of the proposed new rules without sufficient clear guidance and illustrative examples to be able to understand the rules in detail properly and to plan for their implementation and application. The field test may prove to have been useless once the detailed guidance is available, and then need to be redone.

Response to Questions in the ED

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 is clearly described in the ED. We welcome the Board's decision to include a description, as it may help to determine the appropriate accounting treatment for unusual transactions. A crucial question is whether in normal lending business the estimates of amounts and timing of cash flows should really be based on probability-weighted possible outcomes: in practice, estimates are often made on a simpler basis – on whether the contracted cash flows are expected to be paid back when due. Only where this is in doubt is consideration given to the probabilities of the monies being paid later, only in part or not at all (see also our answer to Question 2).

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?

In principle we agree with the aim of presenting an effective return for financial instruments recognised at amortised cost. What in our view can and will lead to problems is the use of the initial estimate of expected credit losses on a financial asset throughout the expected life of the asset:

- Using probability-weighted possible outcomes to estimate future cash flows and not changing the initial estimated effective interest rate used as discount rate (as stated in p. 6) is not the way entities manage their risk on financial assets (especially loans) on a portfolio basis. With a portfolio of loans to the same counterparty, for example, the expected cash flows are based on a single binary decision: the counterparty will either pay back in full and honour all other obligations, or not. In such cases the use of probability-weighted possible outcomes reflects neither the economic realities nor the way the reporting entity's risk management treats the loans.
- Additionally, this initially estimated effective interest rate risk is used to decide which part of the interest payments is reset, which can – from a risk perspective - change over the lifetime of a loan. This means that in principle the composition of a pool may never change.
- Another problem we see is the problem with estimating the effective interest rate for a pool of similar loans: Must a separate pool be formed for every new financial asset with an actual effective interest rate which differs from the one calculated for the original pool? Or can pools be formed on a quarterly/yearly/significance basis? How many separate pools are envisaged?
- When following the rule that the initial estimated effective interest rate is not changed throughout the lifetime of the financial asset, for all financial assets forming a pool the problem of "living or changing pools" arises: do early repayments change the effective interest rate for the remaining

loans within the pool? How are "running accounts", i.e., loans with an indefinite maturity, to be treated? On the basis of contractual residual maturity or expected residual maturity?

– When using the initial estimated effective interest to differentiate between income statement and other comprehensive income for payments on the single loan within the pool for the whole lifetime of the loan, then – from this accounting point of view – the loan always belongs to the same risk category and duration as it did at initial recognition. For risk management purposes as well as for other disclosures in the notes – risk figures, remaining maturity – this is not the case, so there are essentially different views of the same loan within the same financial statements.

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?

In our view, when implementing such a fundamental shift in an important rule with major impacts on accounting and the understanding and interpretation of financial reports, the ED must include sufficiently clear guidance accompanied by illustrative examples for the new principles to be clearly understood and for reasoned comment on the proposed standard to be possible..

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?

Basically, we agree with the measurement principles set out in the ED. But we think that the effects and resulting problems have not yet been discussed thoroughly enough, far less resolved (see general remarks and answer to Question 2). For banks, an additional challenge is posed by the fact that Basel 2 capital requirements are calculated on probability of default within the next 12 months, as opposed to expected cash flows for the whole life time of a loan in the ED, which leads to a two, different assessments of one and the same loan. We strongly support alignment of the ED rules with Basel 2 or Base 3 requirements in order to reduce costs and complexity. Additionally, we wish to point out that estimating future cash flows and incorporating expected credit losses over the entire life of a financial asset will be very challenging especially for non-banks, which are at present totally unfamiliar with these concepts.

Some financial assets for which application of the effective interest method has been especially problematic in the past (e.g., loans for which returns are linked to distributable profits) are now to be excluded from amortised cost accounting under IFRS 9. These complications in calculating the effective interest rate are currently only avoided for financial assets; the application will still present a challenge in respect of revenue, profit-linked or similar financial liabilities.

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?

In principle, the objective described in paras 11 and 12 is clear and appropriate for financial instruments carried at amortised cost. In practice, however, presentation in this way creates all the problems discussed above. How the requirements are to be fulfilled is by no means yet sufficiently clear.

Question 6

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

In addition to the problems arising in the use of the initial estimated effective interest rate (see our answers to the questions above) the proposed presentation requirements bring new presentation and interpretation problems in practice.

The proposed presentation requires interest revenue to be presented net of expected credit losses. Net interest income (effective interest income less expected credit losses) should be presented together with gains and losses resulting from changes in estimates and interest expense calculated using the effective interest rate.

According to ED B19, interest received or paid on financial instruments classified as fair value through profit or loss should not be included in items that also include amounts calculated using the effective interest rate. Currently most entities, at least in the financial services industry, present interest on financial instruments by showing a net interest margin in one line of the statement of comprehensive income, without distinguishing between financial instruments recognised at fair value and at amortised cost. Details of interest income and expense are then presented in the notes. The reason for this net presentation is that financial institutions often invest in financial instruments that have to be classified at fair value through profit or loss while their funding liabilities are classified as amortised cost instruments. If entities were required to show a net interest margin excluding interest on financial instruments at fair value, it seems likely that many entities would show negative interest margins. This would not result in a true and fair view, as this negative net interest margin from financial instruments at amortised cost is offset by interest income from financial instruments at fair value. This could lead to misinterpretations by users of financial statements.

To give an appropriate picture of an entity's financial performance, in our view a net interest margin for all financial instruments (irrespective of classification) shown in the statement of comprehensive income better reflects economic reality and how the margin is managed. This line should include gross interest revenue calculated using the effective interest rate.

Expenses relating to the allocation of initial expected credit losses together with gains and losses resulting from changes in estimates in relation to financial instruments recognised at amortised cost should be presented in a separate line. Further details including composition of interest income and expense (e.g., interest relating to financial instruments recognised at fair value or amortised cost, or to trading instruments) should be shown in the notes. A breakdown of credit losses into initially expected credit losses and gains and losses from changes in estimates should also be presented in the notes, in order to ensure a simple und understandable statement of comprehensive income.

Corresponding to the separate presentation of credit losses from financial instruments at amortised cost, gains and losses relating to financial instruments at fair value should be shown as a separate line item with details presented in the notes.

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?

Disclosure requirements must follow the measurement and presentation requirements. Many of comments set out above are valid here as well.

According to ED B23, direct write-offs against the contractual amount of a financial asset without using an allowance account will be prohibited. This will lead to operational difficulties – increasing volume in the balance sheet without additional information benefit for investors. We propose that direct write-offs against financial assets should be permitted, and disclosed in the notes in the year of occurrence.

We also think that the definition of write-offs presented in Appendix A is too narrow. In particular, the ED requires that for there to be a write-off the entity should have discontinued recovery activities. However, there are situations in which entities write off loans as there is no reasonable expectation of further recoveries, even though the recovery process continues.

ED p. 18 requires entities to split gains and losses on re-estimations into those caused by credit risk and those caused by other factors. As credit risk and other factors, e.g., economic outlook, are often interdependent, this disaggregation may be difficult in practice, in particular if both events occur in the same period and have a joint impact on estimated cash flows. We therefore propose that this disaggregation should only be required if the change caused by other factors is significant compared to the total change of expected cash flows.

According to ED p. 21, an entity has to reconcile the changes in nominal amounts of non-performing financial assets during the period. The reconciliation should, amongst other things, include a separate line for decreases resulting from recoveries through enforcing securities and decreases resulting from payments by the debtor. This split may be difficult and we do not see a large benefit for users resulting from this information. We think that the costs of this detailed information will be much higher than its benefits.

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?

This question can only be answered when all the open issues are resolved: given the lack of sufficient statistical data, clarification, know-how and IT programs, which have to deployed in group members in various countries, we think that three years will be a minimum lead-time for the implementation of all requirements of the ED.

However, the board plans to issue a final standard on amortised cost and impairment only in the fourth quarter of 2010 and has expressed the intention that all phases of revision to IAS 39 should have a single effective date. The effective date for the recently issued IFRS 9 is 1 January 2013 which would imply that entities may have only approximately two years to implement the requirements of the final IFRS on impairment, which seems to be much too short. The proposed expected cash flow model will present a considerable operational challenge to implement and will require significant system changes and additional resources to generate the required information. We therefore think that a lead period shorter than 3 years will not be sufficient to implement the required changes in calculating amortised cost.

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.

This question can only be answered reasonably when the formulation of the standard is conceptually clear and the detailed rules for its application and implementation are clear and explicit and cover the issues raised in our general remarks and answers to the questions.

In general, we agree with the proposed approach to estimating effective interest rates for financial assets recognised before the date of initial application, as it seems to be a practical solution.

Question 10

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

Subject to the reservation that the above-mentioned requirements (see answer to Question 9) have still to be fulfilled, we agree with the proposed disclosure requirements.

Question 11

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

Subject to the general reservation that there is a major need for further clarification and more guidance, including Illustrative examples, the guidance given in ED B15–17 is consistent with the guidance in IAS 39 that permits short term receivables with no stated interest to be recognised at the original invoice amount if the effect of discounting is immaterial. In addition, the current ED requires the entity to deduct expected credit losses from the nominal amount, which is in line with the proposed expected cash flow method.

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?

As explained in our general remarks and answers to the questions, we see a serious need for additional guidance. Otherwise consistent application of the proposed new standards is unlikely.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman