Organismo Italiano di Contabilità – OIC
(The Italian Standards Setter)
Italy, 00187 Roma, Via Poli 29
Tel. 0039/06/6976681 fax 0039/06/69766830
e-mail: presidenza@fondazioneoic.it

International Accounting Standards Board
30 Cannon Street
London, EC4M 6XH
United Kingdom
commentletters@iasb.org

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Re: ***Exposure Draft Financial Instruments*****:** ***Amortised Cost and Impairment***

Dear Sir/Madam

We are pleased to have an opportunity to provide our comments on the IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment*.

We understand that the current impairment model under IAS 39 allows entities to recognise only the credit losses related to events already occurred at balance sheet date. Such an impairment model has been criticized for its pro-cyclical effects.
We appreciate the IASB effort in dealing with the issues related to the current model, developing an impairment model that considers the losses expected rather than those already incurred, and the expected loss model seems to have merits in doing that.
In fact, the proposed expected loss approach is designed to result in earlier loss recognition compared to the incurred loss approach currently in IAS 39 by taking into account future credit losses expected over the life of the financial asset measured at amortised cost. Under this approach the initial estimate of expected future losses is gradually recognised over the life of the instrument as it is incorporated into the effective interest rate. This is conceptually right.

The OIC supports an impairment model based on expected losses rather than a model applicable only in circumstances in which trigger events occur. Thus, it broadly agrees with the general fundamentals on which the IASB model is based. There is a general belief that the impairment model should represent the way the entities manage the loans. A model that discloses figures not aligned to the amounts that the management expects to collect does not provide users with useful information on the cash flows that will probably flow to the entity.
Even if conceptually the IASB model reaches this objective, its implementation appears complex and it is too challenging to fit this model into the complex reality of the banks or other Legal Entities that are required to apply IFRS.
General concerns on the implementation of the model can be summarized as follows:

- the ED does not address the issue of sight deposit receivables which have no a schedule of contractual future cash flow and for which current IAS 39 does not allow the application of approaches which determine an expected maturity for such instruments;
- with regard to the estimate of the expected cash flows, we do not expect that entities will be able to determine at each measurement date the estimates of amounts and timing of cash flows. According to the current practice, such detailed information is not used for pricing either;
- we notice that the proposal is suitable to individual loans or closed portfolios, and perhaps not for financial assets managed on an open portfolio basis. If this is true, the model proposed is not fully compatible with a large number of assets;
- although we support the general principle of the IASB model, should the IASB adopt its proposed approach, we think that entities would face major implementation issues and costs both in terms of one-off costs and ongoing costs. On this matter, practical expedients might help;
- the simplification of the model could have consequences on the presentation. In such circumstances, we are not sure that the recognition of expected losses at direct reduction of interest revenue provides users with more decision useful information;
- we do not support the inclusion of stress testing in the disclosure requirements.

We are aware of other different accounting models that have been proposed. These models deal with the application to the open portfolio and in the meantime they retain some features of the current IAS 39. Some features of these methods may have some merits and the IASB could consider them to simplify the application of the principles, for example, expected losses considered at the initial recognition based on the available statistics of a given portfolio but with a reference to the timing expected or expected losses recognised in the statement of comprehensive income based on pro-rata criterion.

Our replies to IASB's questions are as follows.

Appendix
OIC's response to the questions asked in the ED

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?

We believe that the description of the objective of amortised cost measurement in the ED 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 described in the ED is appropriate for amortised cost measurement. Moreover, we have some concerns with the application of the objective to short-term trade receivables. In fact, in this case, we understand that the notion of effective return on financial assets has less relevance because the short-term trade receivables are not held to generate interest revenue and the impairment costs associated with such receivables are seen as a business expense. We believe that the objective of amortised cost to provide information about the effective return should be required when such information is relevant and significant.
Moreover, the ED does not address the issue of sight deposit receivables which have no a schedule of contractual future cash flow and for which current IAS 39 does not allow the application of approaches which determine an expected maturity for such instruments.

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 support a principles-based model and we believe that useful and relevant information in understanding the objectives and principles of the ED should be moved to the main text of the final standard rather than be explained within the Basis for Conclusions as at the moment.

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?

Conceptually, we broadly agree with the IASB model. The model has some merits in creating a link among performance measurement, risk, pricing and accounting.

Notwithstanding the conceptual merits of the IASB model, we have some significant concerns with the measurement principles set out in the ED.

The ED provides that the expected cash flows are estimated values based on the probability-weighted possible outcomes of both the amounts and timing of these amounts (i.e. even if the most likely outcome is full repayment, the likelihood of a debtor not repaying all contractual principal and interest amounts is also factored into the estimate). However, we are not aware of entities that manage this risk by adopting such a method; they usually estimate the expected cash flows on the basis of most likely outcome. We believe that a simplified approach to determining the timing and amount of credit losses over the entire life of the financial instrument is necessary. Otherwise, the information given will not be aligned to the way the management manages the credit risk. It is complex to calculate and then allocate the expected credit losses over the life of a financial asset. Financial institutions manage these assets on an expected loss basis that relies on statistical evidence to determine the amount but not the timing of the loss. The proposals would be a significant move away from the current credit management systems of these entities. We believe that some practical expedients on this issue should be included in the ED. We believe that the objective should be for entities to produce their best estimate given the information available. This would mean that in some cases the best estimate might be arrived at using the probability-weighted expected cash flow approach proposed in the ED. In other cases, the reporting entity's best estimate may not result from using the ED's expected cash flow approach.

The IASB model implies a loan-by-loan or closed portfolio approach. We believe that it is difficult to predict how the proposals would work on an open portfolio basis. For instance, it would be very difficult to estimate the timing and amount of expected credit losses over the entire life of the portfolio in instances where the composition of the portfolio changed. We are aware that financial assets are often managed on an open portfolio basis. We believe that the proposals in the ED are not fully compatible with open portfolios.
In fact, applying this individual approach to portfolios of high volume and low individual value loans would imply the need to use the expected future cash flows (including expected future losses) of the group initially and in subsequent periods. Probably, such data would not be available at the present time and would be very difficult to obtain in a precise and consistent way without incurring an undue cost. Unlike for individually significant loans, there is not a continued re-estimation of expected cash flows for these kinds of loans ("high volume and low value"). Therefore, the only available data are the total expected losses of the portfolio, not the future expected cash flows of the loans at each moment of time; any assignment to specific cash flows would be arbitrary and would imply a high degree of judgement.
If loans are grouped for the application of the IASB model, loans in the same group must have the same risks, the same starting date and the same finishing date. For each of these groups, a new EIR should be calculated (on a portfolio basis) and also the impairment in subsequent periods, but the provision will be traced on an individual basis. This approach is very complicated as it involves the establishment of an excessive number of portfolios according to the level of credit risk and year of inception/maturity.
Moreover, we consider that the subsequent allocation of the provision to the individual loans is not correct as the provision belongs to the portfolio as a whole, not to each of the loans in the portfolio. It does not make economic sense to allocate the provision to each of the loans in the portfolio (e.g. an EL of 4% in a consumer loan portfolio means that the bank expects to lose 4% of the portfolio, not that each of the loans would lose 4%), except in the case of identified specific losses. We believe that before implementing an expensive accounting

model the IASB should be sure that other ways are impracticable. We would suggest that the IASB be sure that the same result of introducing an expected loss model cannot be reached by a simple implementation of the current information systems of the banks designed to respond to regulatory requests.

We understand that the recognition of the changes in credit loss expectations immediately in profit or loss (i.e. catch-up adjustment approach) has some merits because it allows the immediate highlighting of the effects of these changes in profit or loss. We believe that this approach provides users with more decision useful information.
Para 36 of the basis for conclusions in the ED requires that *"The Board noted that because the initial estimate of the expected credit losses for a financial asset is included in determining the effective interest rate there could be a gain from a favourable change in credit loss expectations even if no impairment loss had previously been recognised. Hence, the carrying amount of the financial asset could exceed its initial carrying amount. The Board noted that economically, this increase in the carrying amount represented a gain from an improvement in the quality of the financial asset. Hence, the Board believed such a gain would be useful information and therefore saw no reason to preclude its recognition. The Board also noted that the extent of such a gain was inherently limited to the difference between the initial carrying amount and the present value of the full contractual cash flows discounted using the effective interest rate".* However, we do not support this para because we believe that the subsequent carrying amounts of the financial asset should never exceed its initial carrying amount and in particular its nominal value. We also believe that the approach should be consistent with the general principle for the impairment of assets that provides that *the increased carrying amount of an asset attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.* Accordingly, increase in credit worthyness after initial recognition that does not represent reversal of previous impairment shall be addressed through a revision of EIR rather than through the recognition of a gain.
However, we kindly suggest to evaluate also other approaches. For example, an alternative approach could be the recognition of the changes in the expected loss over the remaining life of the portfolio, consistently with the treatment of original estimate. According to this view there is no conceptual difference between the calculation of initial or subsequent loss expectation, both being the entity's best estimate of expected loss. Changes in expected loss may result from changes in current or expected credit risk conditions and changes in the composition of the loan portfolios since the last reporting period end. Therefore, any adjustments to the initial estimation of the expected loss should be accounted for prospectively. In addition, it should be considered that the calculation for expected loss requires a high degree of judgement; accordingly a different treatment for subsequent changes could lead to income statement manipulations by entities through different reporting periods.

Other comments on measurement principles regard the following.
Some believe that the IASB model is not adapted to the type of financial assets held by insurers. They note the model proposed in the ED seems to be mainly developed for the loan book of banks. IFRS 9 (and IAS 39) applies to all companies which hold financial assets, including insurers. Most financial assets of insurers consist of government bonds and investment grade corporate bonds. The impairment model needs to be designed to be equally adapted to bank loans and to bonds. Therefore, they recommend that the IASB

simplify the impairment model and allow for a model that fits with all types of financial assets, not just bank loans.

We are also aware that if adopted, the expected loss model would involve significant costs and an extended period of implementation given the expected significant changes required to financial systems, particularly in the financial services industry.

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 believe that the proposed objective should be clearly linked to the measurement objective. Moreover, we have some concerns with the adequacy of this objective for short-term trade receivables.

Presentation
Question 6

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

We do not agree with the proposed presentation requirements, especially for non-financial institutions.
Moreover, with regard to short-term trade receivables, we suggest the following presentation model:

- the estimates of the expected credit losses should always be presented in a same and unique line-item in the statement of comprehensive income regardless of whether they relate to initial recognition or subsequent reporting periods;
- consequently, the estimates of the expected credit losses should not be presented as a reduction in the invoice amount in determining the amount of revenue to be recognised;
- in fact, in this instance, there are no conceptual differences between initial estimate of expected future losses and any changes in subsequent periods;
- provide that the following line-items be presented in the statement of comprehensive income:

    a. Revenue;

    b. Expenses

        i. […]

        ii. Allowance account for expected credit losses.

Also with regard to financial institutions, we are not in favour of presenting contractual interest revenue adjusted for credit losses expected at initial recognition. The allowance accounts for expected credit loss are built up on the basis of a portfolio and it is not appropriate to allocate these allowance accounts to each credit. The combined presentation of contractual interest revenue and expected credit losses may result in a lack of transparency. We believe it is more appropriate to attribute the estimates of the expected credit losses to the portfolio and to allocate them on a pro-rata basis over its expected life. We suggest a presentation model that shows separately the periodic allocation of initially expected credit loss from the interest revenue and that includes the expected credit losses and related changes in a separate line-item “allowance accounts for expected credit losses”.

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 support most of the proposed disclosure requirements. We have some concerns with the inclusion of stress testing in the ED.
We also believe that the nature and volume of disclosures may not provide relevant information in the case of some non-financial entities whose core business is not the provision of finance.

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 believe that a mandatory effective date of at least 3 years after the date of the issuance of the IFRS would allow sufficient lead-time for implementing the proposals. However, we believe that the adoption of this phase of IFRS 9 should be allowed only if all other phases of that standard are adopted.

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.

We support the EFRAG's alternative transition approach.

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 disclosures 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?

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 believe that practical expedients are very useful for non-financial institutions. With regard to the presentation of the estimates of the expected short-term trade receivables, we believe that some practical expedients might help (see our reply to question 6 above). Moreover, with regard to the application of the IASB model to floating rate financial instruments, we believe that the IASB should provide a practical expedient to estimate the expected spread.

If you have any questions concerning our comments, please do not hesitate to contact us.

Yours faithfully,

Angelo Casò
(Chairman)