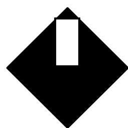

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International Accounting Standards Board
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Comments on the Request for Information ('Expected Loss Model') of *Impairment of Financial Assets : Expected Cash Flow Approach*

To the Board Members:

The Japanese Institute of Certified Public Accountants appreciates the continued efforts of the International Accounting Standards Board (IASB) on the financial crisis and welcomes the opportunity to comment on the Request for Information ('Expected Loss Model') of *Impairment of Financial Assets : Expected Cash Flow Approach.*

Since accounting standards for financial instruments have a significant impact on actual transactions and practices, we agree with the IASB's efforts to address such issue based on public comments. However, from the perspective of ensuring consistency, we believe that it is more desirable to examine such issue together with issues in other areas such as measurement, classification and hedging of financial instruments.

The following is our response to the items in 'invitation to comment' with which we disagree or have questions or concerns.

Request for Information 1

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

Comment:

We believe that additional guidance on the following areas is required to apply actual transactions and practices.

1. Estimation of "expected credit losses"

With respect to concerns about "expected credit losses" being estimated intentionally, it is in the Agenda paper 5A argued that market discipline is expected (Agenda Paper 5A (paragraph 45) and that as compared with non-financial instruments, for financial instruments with contractually specified cash flows there is less of a need for extensive guidance (paragraph 51). However, we believe that a careful consideration is required since an approach based on "expected credit losses" would have significant impact on business of banks and other financial institutions with a substantial portfolio of loans..

If this approach is adopted, it is no longer necessary to determine whether the loss event is an "incurred credit loss" or "future credit loss", which has been one of the major issues related to the incurred loss model. However, under the new approach, estimation of cash flow would be more important and difficult as the credit losses to be considered would no longer be limited to incurred losses. Furthermore, under the expected cash flow approach, regardless of the existence of impairment, all assets subject to the amortized cost method would be affected from the time of initial recognition through the effect on the effective interest rate. Therefore, requirements to be considered with respect to "expected credit losses" and their priority should be clarified, such as (a) credit loss forecast used for credit approval, (b) historical credit loss record, and (c) observable market price.

In addition, it has been pointed out, as one of the advantages of the expected cash flow approach as compared with the "incurred loss model", that it is consistent with credit approval (Agenda Paper 14 (issued in April), paragraphs 30 and 32). As it is expected that the lender normally reflects (b) historical credit loss record and (c) observable market price in the credit approval decisions, albeit implicitly, it may be reasonable to use (a) credit loss forecast used for credit approval as the basis for the estimation of "expected credit losses". However, as the component of the contractual interest rate representing compensation for the credit losses initially expected may not be clearly

separated from other components (Agenda Paper 14, paragraph 30), the nature of the "expected credit losses" should be clarified in advance. Furthermore, the Standard should clarify whether historical credit loss record or observable market price should be considered as part of the validity test for the estimate, including so-called backtesting.

2. Risk adjustment

We believe that it should clarify the treatment of the risk of "expected credit losses" being deviated from the actual result.

IAS 37 prescribes that risk should be considered in developing the best estimate of provisions (IAS 37.42) and the proposed revision of IAS 37 expands such treatment to include the method to reflect the risk. Also in the insurance contract project, it has been proposed that the degree of risk should be reflected to measurement (i.e., higher risk results in a higher measurement of a liability).

It is expected that in the application of the amortized cost method, such risk will not be reflected in the estimate of "expected credit losses" (i.e., the estimate of expected cash flow) and the compensation for such risk will be included in the effective interest rate and recognised in income through the application of the effective interest method (Agenda Pager 14 of April, paragraph 30). However, it is necessary in the Accounting Standard to clearly prescribe whether risk adjustment is required, and if it is not required, the Standard should clarify the reason for the difference with other standards (i.e., whether it is based on measurement attributes or customer relations). If risk adjustment is required, the method for risk adjustment (e.g., how to measure and reflect risk) should be clarified.

3. Cash flow estimates

The Standard should clarify whether cash flow estimates should be based on the "most likely outcome" or the "expected value".

The proposed revision to IAS 37 clearly prescribes that estimates should be based on the expected value (based on the probability-weighted average), while it does not require the reporting entity to explicitly consider all possible outcomes. In view of the consistency with the fact that in making credit approval decisions and in determination of the contractual interest rate, the lender considers not only the likely scenarios, but also less likely scenarios, it is appropriate to be required that the estimate of cash flow

to be based on the expected value.

With respect to the initial recognition of a portfolio with a small probability of credit losses, if the estimate is based on the "most likely outcome", the cash flow estimates would be different under (a) the method in which individual estimates are aggregated and (b) estimates are developed for a group of assets without considering individual assets within the portfolio. Therefore, guidance on the unit of such group will be necessary. However, if the estimate is required to be based on the "expected value", such guidance would be unnecessary as the estimates under both methods will coincide.

4. Assessment of the incurred loss

We believe that guidance on determining whether the actual credit losses are "expected credit losses" or not is necessary. This is also related to the guidance both on the revision of "expected credit losses" and on the losses incurred immediately after the end of reporting period.

Given that the "expected credit losses" are estimates based on the expected value and the actual credit losses involve the risk that the "expected credit losses" deviate from the expected value, even in the case where the expected value has not currently changed, the actual credit losses would not normally coincide with the expected value. Therefore, it cannot be concluded that the expected value has been changed since the time of the initial estimation based solely on the fact that the actual result deviated from the expected value. For these reasons, we believe that guidance is required on the determination of when the deviation between the "expected credit losses" and the actual result is large enough to warrant a revision of the "expected credit losses".

5. Future events

We believe that the treatment of future events should be clarified.

It is expected that future events are normally considered in developing the expected value as potential scenarios. However, permitting the reporting entity to consider future events without limitation may lead to the use of the "dynamic provisioning" approach which incorporates the future economic cycle. We believe that this is not the intent of the "expected loss model" under consideration.

6. Others

If the current treatment of collateral and guarantees under IAS 39 will be changed, the new treatment should be clarified. In particular, in the example included in Agenda Paper 5D of May, it is assumed, albeit implicitly, that the recovery from the defaulted receivables is nil without any further explanation. Therefore, the basis for such assumptions should be clearly stated.

Request for Information 4

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

Comment:

Under Approach A in Appendix, changes in the expected cash flow, including changes in the default pattern, are reflected in the effective interest rate, and therefore, impairment losses will not be recognised even in the case where the expected cash flow is expected to change due to a change in the credit risk. However, such treatment is inconsistent with the treatment of impairment recognition in the case of fixed rate instruments. On the other hand, Approach B is described as an approach in which the effective interest rate is fixed after impairment is recognized. However, this approach is also inconsistent with the treatment of impairment recognition in the case of fixed rate instruments in that it entails catch-up adjustments even in the case where the default pattern has not changed, but only the market interest rate has changed.

Request for Information 5

> How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:
> (a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?
> (b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?

Comment:

We believe that;

(a) Changing from a collective to an individual assessment should not be mandatory; and,

(b) Reporting entities should be permitted to continue to use a collective approach for those assets for which losses have been identified.

Whether changing from a collective to an individual assessment is required or not should be assessed in view of the most appropriate method from the perspective of the measurement of expected cash flow. As the most appropriate method varies depending on the reporting entity and the type of receivables, various assessment methods should be permitted. The fair value of financial instruments to be measured at fair value is almost invariably calculated as the present value of future cash flow. With respect to the estimate of such future cash flow, a variety of assessment methods should be permitted provided that they are reasonable. For these reasons, we believe that distinction between collective assessment and individual assessment is not necessarily required from the perspective of the measurement of expected cash flow.

Yours faithfully,

Kiyoshi Ichimura
Executive Board Member－Accounting Standards
The Japanese Institute of Certified Public Accountants