IASB
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

19 August 2009

Dear Sir or Madam,

RE: <u>REQUEST FOR INFORMATION ON IMPAIRMENT OF FINANCIAL ASSETS: EXPECTED CASH FLOW APPROACH</u>

BUSINESSEUROPE very much welcomes the Board's initiative to explore the practical implications of the approach being discussed. In principle we see certain advantages in the expected loss approach as it would, by definition, better reflect what cash an entity expects to ultimately receive from a group of assets. However, we see for corporates substantial practical application problems which could result in less useful information for capital providers. These are primarily in terms of the methodology (EIR etc.) and of the underlying data.

An important initial observation is the linkage to the IAS 39 classification and measurement project. The types of financial asset which end up as being measured at amortised cost would be a key determinant in the practical implications for the adoption of the ELM approach. In this response we take a broad view on this, to capture also assets that may nevertheless end up at fair value eventually.

At the outset we must stress that we perceive the thrust of the documentation made available as being very much oriented towards financial institutions. For example, it is implied that changes in expected losses would be reflected in "interest revenue", which is somewhat misleading when dealing with normal trade receivables for industrial and commercial entities. The fact that such entities would also be affected is mentioned only in one side remark, but the documentation otherwise bears no evidence of taking their circumstances into account. Hence, we see a danger that non-financial entities could be subjected to detailed application rules which go far beyond what is necessary to achieve the overall objective in their relatively simple circumstances and which impose substantial additional costs without actually producing any more decision-useful information. Many industrial and commercial groups have experienced this disadvantage in respect of IFRS 7, Financial Instruments: Disclosures.

We very much hope, therefore, that, if the Board decides to adopt the expected loss model (ELM), it lays down clear objectives and principles – perhaps with illustrative examples – without laying down stringent rules and detailed procedures which in our circumstances would be excessive. The extent to which the Board did this would have an appreciable influence on the costs and feasibility of adopting an ELM approach for industrial and commercial entities.

The whole EIR approach just does not fit together with corporates' normal trade receivables. Generally these have no specific interest element, though there may well be exceptions to this, as with financial leasing or with "interest" charges or discounts which may – but very often do not – reflect market interest-rates.

If we have understood correctly, the idea is that the cost of credit losses would in effect be spread over the life of the receivables as an interest adjustment. This is just not the way that most industrial and commercial entities view credit losses and would mean substantial system changes to deliver data which is not particularly meaningful as it does reflect the business approach (pricing etc.) behind the receivable. It also seems to involve "smoothing" which would make the balances at any point in time not very meaningful. In contrast to the establishment of an "allowance" at time of sale (based on expected credit losses), with running adjustment for changes in expectations, it would be much more difficult for companies to operate and for managers and capital providers to understand. In any case it appears to us quite misleading to portray credit losses from an interest perspective in the case of most corporates' trade receivables, where credit losses are regarded as a cost of doing business, not as an element of financing, even if the approach makes sense for financial institutions. The Board may find it helpful to consider extending to credit losses the approach taken in IAS 39 application guidance on discounting, namely to exclude short-term trade receivables without a specific interest/financing element based on market interest rates.

Apart from the suitability of the proposed methodology for corporates, we would foresee several major data issues, quite apart from the introduction into the process of a much more significant element of judgment (with potentially greater divergences in practice as a result) and the difficulty of verification. For instance, depending on the level of granularity for assessment for those entities which display some cyclical variability of credit experience, how are they going to approach this from an expected-loss viewpoint? It presumably presupposes (1) some reliable historical data on cyclicality of credit-losses and (2) a crystal-ball on where they are in the cycle at the end of the year. Thus, we foresee quite a few potential problems for corporates in general in deriving reliable data for developing expectations. One suggestion was that some sort of government statistical data on (e.g.) generic consumer credit losses could be used, but then we begin to ask ourselves whether the proposed cure is worse than the disease and will give users any more useful information.

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We note also that the recent discussions on leasing have highlighted that the extent to which expectations on uncertain future events are to be reflected in accounting measurements is not necessarily well defined in any generic fashion in IFRS (renewal options? contingent rentals?) This clearly also has implications for the conceptual validity of the ELM. Also, some principle explanation of the interrelationship of ELM with revenue recognition would be helpful.

Please see the Appendix for our answers to the specific questions asked in your request for Information.

Yours sincerely,

Jérôme P. Chauvin
Director
Legal Affairs Department
Internal Market Department

APPENDIX

RESPONSES TO THE QUESTIONS ASKED IN THE REQUEST FOR INFORMATION

Question 1—Is the approach defined clearly? If not, what additional guidance is needed, and why?

We think that the **overall objectives and principles** would need to be very clearly and succinctly defined. As mentioned in our covering letter, we fear that too tightly defined guidance could lead to overkill in many situations. Non-mandatory guidance or illustrative examples could help, e.g. on the type of sources to which an entity might look when considering how to allow for the impact of future cyclical movements. It must be made very clear what the basic approach to determining the expected future cash flows is. The final standard must in any case reflect the fact that the ELM, far more so than the incurred loss model, requires judgment: consistency in an entity's approach from period to period in the exercise of this "art" could in the end be far more important than pseudo-scientific rules and procedures giving an illusory aura of accuracy. Greater divergence in practice is in any case likely to arise.

Question 2—Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

Generally we believe that the principle *could* be operational, but much depends on the guidance finally laid down in the standard. If the estimation approach laid down is too rigid and regulated – perhaps oriented to the needs of financial institutions, for instance – it may become costly and impractical for industrial and commercial entities. In many non-financial sectors, for example, where cyclical influences on credit losses are minor, a simple extrapolation of past experience data on trade receivables may well give as accurate and useful information as more sophisticated techniques and be commensurately easy to operate. Similarly, the extent to which consideration of assets on a portfolio basis is permitted, in contrast to individual assets, would generally make the process more readily operational. With trade receivables, we see no other practical way than to use overall a portfolio approach, maybe with individual items taken out as actual losses occur. Some way to avoid double-counting would need to be established, but this should be kept simple: it would be an estimate anyway, and prescribed rocket-science procedures should be avoided that lend the information an unjustified aura of scientific accuracy and reliability.

As a simple rule of thumb, the more specific and rigid the guidance, the lower the extent of operationality and the higher the costs. Above all, it must be borne in mind that we are talking about the **art** of estimating.

In any case, there will, even for corporates, be varying degrees of difficulty of deriving basic data depending on (e.g.) the variability of credit losses with the general economic

cycle, as for retailers of consumer durables, and situations such as new businesses where historical data is unavailable.

Operationality is also extremely important with regard to transition. Again depending on the form of the final guidance, the process could be extremely cumbersome and costly, especially where, for instance, entities have to run the two approaches in parallel for a number of periods to generate data for retrospective application and comparative disclosures. Retrospective application would not be practicable without a period for parallel running.

Question 3—What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

It all depends, as mentioned at several points above, on the final form of the guidance. For industrial and commercial entities, we would anticipate that a pragmatic application at portfolio level, with some of the other simplifications mentioned in this letter, would not in general involve substantial implementation or on-going costs beyond those for parallel-running, *unless* systems have to be adapted for the change to the (in our case inappropriate) effective interest rate method.. However, if the guidance were not so helpful but rigid and pseudo-scientific – especially with individual-asset application - we fear that both initial and continuing costs could be substantial.

Question 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.

On the *amortisation of upfront fees* on variable rate instruments, we support using the effective interest rate calculated upon initial recognition of the instrument. This would be easier to operate and is more in line with the overall amortised cost approach.

On the *amortisation on impaired variable interest rate loans,* we prefer the recalculation of the effective interest rate so that the still expected future interest and principal receipts are discounted to the carrying amount.

Question 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?

We think that the principle should be that, so long as double-counting is avoided and satisfactory assessments are being made of expected loss, an entity should be allowed to exercise judgment on whether it removes a financial asset for which an impairment loss has been identified from a portfolio of performing assets, depending on what gives the most meaningful information.

Question 6—What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

We have already mentioned above several ideas for practical simplification:

- Make proper allowance for the differing nature of trade receivables.
- Focus the standard on the objective and principles rather than on specific rules so that entities can adopt the approach most suitable for their circumstances, rather than all having to do the same as large banks.
- As far as possible, permit a portfolio rather than individual-asset approach.

In addition we warmly recommend the Board to retain some form of "trigger" approach for individual assets so that the clearly resource-intensive calculations of expected cash flows need only be carried out if there is some specific indication that they have changed.