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Mr. Steve Ong
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Hong Kong Institute of Certified Public Accountants
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Wanchai, Hong Kong

Dear Steve,

IASB Request for Information - Expected Loss Model for Impairment of Financial Assets: Expected Cash Flow Approach ("Request for Information")

I refer to your separate letters dated 10 July 2009 on the above to our Mr. Paul Chow and Mr. Archie Tsim which have been passed to me for my attention.

We have completed our review of the Request for Information and our views are set out in the paragraphs below.

General

As part of the IASB's project to replace IAS 39 Financial Instruments: Recognition and Measurement, the IASB is considering a new approach, the expected cash flow model, for the recognition of financial assets impairment. The purpose of the Request for Information is to seek comments on the feasibility of the expected cash flow model to replace the existing incurred loss model. We support the IASB's decision to obtain views early in the development of the project.

As a basic principle and to ensure consistency of concepts and approaches in practice, we believe that rather than developing separate rules on impairment for inclusion in an individual standard, the IASB should revisit the Framework and develop a principle-based impairment standard. The scope of the existing IAS 36 "Impairment of Assets" excludes many types of assets including financial instruments.

We believe that making impairment charges is the application of the principle of "Prudence" under the Conceptual Framework. Prudence is a qualitative characteristic of financial statements and paragraph 37 of the Framework states that:

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> *"The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability."*

The words underlined above for emphasis indicate the purpose of prudence and why impairment adjustments are made to reduce assets to their recoverable amounts.

Reversal of impairment losses

Under the incurred loss model, an impairment loss is recognised only if an impairment loss has been incurred. In contrast, under the expected cash flow model impairment is recognised when there is indication that losses are expected to arise from future events that are very likely to happen. We believe that the expected cash flow model is more in line with the principle of "prudence". However, the proposed expected cash flow model allows the reversal of impairment loss charges when there is a favourable change in credit loss expectations. Although at first sight allowing reversal of impairment charges appears reasonable we believe that this may encourage less diligent or thorough impairment assessments. Accordingly, we would suggest that the IASB should reconsider whether impairment charges once made should be allowed to be reversed so as to prevent possible manipulation of reported results.

Impact on the amortised cost model

Under the expected cash flow model, expected future credit losses on a financial asset will have an impact on future cash flows, and in particular it is proposed that there should be adjustments to effective interest rate calculations. We believe the IASB should consider whether such an approach would affect the concept of amortised cost. We believe that rather than treating expected future credit losses as adjustments to the effective interest rate, it should be treated separately.

Moreover, when assessing impairment, we believe "all relevant factors" that would affect the carrying value of a financial asset should be taken into account. For instance, if a company holds securities in a company whose principal activity is printing publications and there is a general and perceived permanent downward trend of stock prices for the companies in the printing industry, this factor should be considered since there would likely be a correlation and impact on the future cash flows of the printing company.

Portfolio versus individual financial asset impairment assessment

We believe that the benchmark approach should be the assessment of impairment of assets on an individual basis. However, we recognise that this may not be practical or cost effective and assessment on a portfolio basis may be appropriate in certain circumstances.

If assessing impairment on a portfolio basis is acceptable, we believe key requirements should be that the financial asset should be regarded as forming part of the group and the financial assets of the group should have similar characteristics and should normally be acquired and be disposed of as a group. However, when the characteristics of the financial asset change, we would suggest that the financial asset should be moved out of the portfolio to another portfolio of assets that have the same characteristics.

Implementation guidance

The Request for Information only highlights the conceptual issues of the expected cash flow model without explaining how to apply the model. Implementation of the model is likely to be challenging since it requires more judgment in assessing expected future credit losses. Information systems will be needed to collect and project expected cash flow data for formulating credit loss expectations and this will involve significant time and cost. If a decision is made to adopt the model, the following should be considered:

(a) additional guidance on how to formulate the credit loss expectations to ensure the reliability of the expectations, including what information that may be used to support the assessment; and

(b) adequate transitional provisions to allow preparers of financial statements to adapt their accounting systems for the changes.

We hope that the above comments are helpful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited

Colin Chau
Senior Vice President
Listing Division

CC/el

c.c. Mr. Paul Chow – Chief Executive
Mr. Archie Tsim – Chief Financial Officer
Mr. Mark Dickens – Head of Listing