

**Financial Instruments: Amortised Cost and Impairment Exposure Draft  
Key points to consider for input to the IASB**

**Background**

1. In March 2010, the AASB held Roundtables for constituents and Board members to discuss the proposals included in the IASB's Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (Impairment ED). The AASB continues to speak to constituents and seek comments by 17 May 2010 to formulate its own submission to the IASB on the Impairment ED by 30 June 2010.
2. This agenda paper provides a high level summary of:
  - (a) key points raised by Roundtable participants regarding the proposals in the Impairment ED; and
  - (b) analysis and recommendations identified by AASB staff in relation to the main issues raised by participants.
3. The purpose of this agenda paper is for Board members to consider the key points identified by AASB staff for comment on the Impairment ED, to assist staff in preparing a paper for the June meeting that would form the basis of the AASB's submission to the IASB.
4. Board members should note that the key points identified in this agenda paper are not exhaustive. The views expressed in this agenda paper were raised by one or more participants, and the extent to which a particular view is shared by participants is only indicated where this is considered relevant. A summary of all findings from the Roundtable discussions can be found in Agenda paper 13.3 of this meeting.

**Key points for consideration**

5. In general, participants expressed support for a model that recognises expected losses but have reservations about the proposed basis and methodology for achieving the model's outcomes.

*Overall objective of the proposed model*

6. Conceptually, the proposed objective for amortised cost measurement is to reflect the 'effective return' of the financial assets by allocating the interest revenue or interest expense over the expected life of the financial instrument. The effective return is based on the

expected future cash flows from the financial assets after taking into consideration the contractual cash flows not expected to be received.

7. The expected loss model introduces the assessment of credit risk in revenue recognition, aimed at providing greater transparency and reflects more accurately the potential financial risk to an entity when estimated with a reasonable degree of consistency and discipline. However, a concern is that the proposed objective seems to be focused on the needs of financial institutions, and therefore is conceptually inappropriate for other entities that are not in the business of lending money to earn interest. If the objective were more principle-based, it may be more suitable for all types of entities.
8. Another concern is that the model departs from 'normal' revenue recognition treatments—under the proposed model, revenue is adjusted for initial estimates of credit losses. Accordingly, many participants ultimately prefer a model that accounts for amortised cost and impairments separately. As such, it was suggested that the objective should be broken down into: an objective of the measurement category; and an objective of impairment of amortised cost; because managements generally view impairments as a separate process from the amortised cost measurement. That is, whilst an amortised cost measurement objective is to reflect the remaining payments on assets, the objective of impairments is to represent 'losses' from an asset. Hence, the proposed model does not reflect an entity's business model. Paragraphs 12 and 13 provide more arguments for this case.

*Overall mechanism underlying the proposed model*

9. The proposed methodology seems to introduce fair value notions into the expected cash flow model—by incorporating management's expected credit losses into the carrying amounts of amortised cost assets—when the model is supposed to be based on historical cost. As a result, there is inconsistency between the objective of the amortised cost category and the mechanism of the model.
10. The logic of effectively recognising some losses over the life of an asset is compelling, and a form of expected loss model is supported, but not a completely new model that embeds the calculation of impairments into 'expected cash flows'. Participants are also of the view that the amortised cost balance simply includes some buffer created for expected future losses.
11. Accordingly, it is suggested that there should be more focus on the principles of the measurement basis, rather than the methodology. This is because the proposed model can be viewed as a loss provisioning tool at a micro level, however, in practice, loss provisioning

decisions are mostly made at a macro level, thus creating conflicting ideas on how 'expected loss' should be dealt with. Perhaps a methodology that is based on a 'through the eyes of management' approach might work.

**Question for the Board**

1. What are the Board's views on the concerns raised in relation to the objective of the proposed model?
2. What are the Board's views on the overall mechanism underlying the proposed model?

*Allocation of the initial credit loss estimate*

12. Participants acknowledged that incorporating initial credit loss estimates into the expected cash flows and effective interest rate, might reflect how some loans are priced, however history has shown that credit loss is often not priced well in the market. Banks will routinely and deliberately 'misprice' (in terms of creditworthiness) loans to meet conditions in the market—that is, underprice if the bank is trying to attract market share, or overprice if the market is tight. In the case of smaller banks, they generally look for other forms of security to gain assurance over expected credit losses, and are pressured to keep interest rates competitive regardless of a customer's credit risk.
13. Furthermore, irrespective of the type of entity, managements generally do not manage credit losses as a function of revenue. Managements often view credit losses as a form of business expense and prefer to account for them separately from revenue. This is consistent with the view in paragraph 8 that suggests segregating the objective of amortised cost from the objective of the impairment measurement. For financial institutions, the net interest margin (NIM) is often scrutinised by users of banks' financial statements—under the proposals, NIM will be presented net of expected loss, thus reflecting a lower NIM in the performance statement, which is not a reflection of an entity's own performance. In the case of non-financial institutions, credit terms that are provided as part of a sale transaction are more of an attraction for buying the products/services. Most non-financial institutions would deem their sales fully recoverable at the date of transaction—their view is, why make a sale when you expect losses? Accordingly, it can be argued that the ED proposals are not consistent with a 'through the eyes of management' approach and it would be unreasonable for entities to report (interest) revenue net of expected losses when it does not reflect their business model.

14. In addition, the proposed model will not easily provide information for the presentation and disclosure requirements as proposed in the ED. Measuring the assets and related provision in one methodology makes it difficult to ‘unbundle’ the information for disclosure purposes. Perhaps the IASB could approach the issue by considering the information entities should be presenting on the face of the financial statements and/or disclosing in notes, and then build the model around that information.

**Question for the Board**

What are the Board’s views on the:

- (i) allocation of initial credit loss estimate and its impact;
- (ii) impact of allocating initial credit losses on net interest margin; and
- (iii) approach in paragraph 14, to consider what information should be presented and disclosed in financial statements first, and then build the model around that information?

*Subsequent changes to expectations of cash flows*

15. The ED proposes a catch-up approach, where an entity would recognise the difference between the carrying amount and a revised present value of expected cash flows in the income statement, immediately in the same reporting period. There is a view that the ED has not articulated well the justification for a catch-up approach, particularly whether it is conceptually appropriate for recognising impairment. For example, the approach seems to be inconsistent with the treatment of initial expected credit losses, which is based on the notion of allocation through the life of a financial asset.
16. Furthermore, every time the yield curve moves in the case of variable rate instruments, the calculation is such that there will be a ‘catch up’ adjustment because expected losses are discounted—so changes to the discount rate have an impact on the provision itself, none of which will be transparent to users. It would not be clear whether changes in expectations are due to the quality of assets, under/over estimation of losses on day one or movements in the yield curve. Accordingly, it might be essential to distinguish between each type of adjustment when presenting/disclosing changes in expectations in the financial statements.
17. Participants also consider that there is a case for spreading the effect of subsequent changes in cash flow estimates over the remaining life of the instrument so as to be consistent with the

measurement principle of amortised cost. However, this might add complexity to the proposed model.

18. Regarding paragraph B8 of the ED, participants are seeking guidance on what is meant by:
- (a) future expectations – it is unclear whether an entity estimates future cash flows based on information prevailing at reporting date or on expectations of future changes beyond the reporting date (i.e. extrapolated data using current information). That is, under the proposed model it is not clear whether the entity can or must look at trends based on the information available today—beyond an assessment of existing information to make projections about future conditions over the life of loans. Most argue that the extent of impairment should be extrapolated and included as expected loss, from information that currently exists at reporting date. Accordingly, current information about house prices could be a ‘trigger’ for recognising further losses; and
  - (b) historical data – how far back should an entity analyse historical amounts to use as a basis for cash flow projections?

**Question for the Board**

What are the Board’s views on the:

- (i) catch-up adjustment approach and what it should represent; and
- (ii) interpretation of future expectations and what information it should include?

*Greater subjectivity involved*

19. Participants note that the IASB has acknowledged in the ED that there is concern about the degree of subjectivity with the proposed model. Participants are concerned that an increase in the reliance on management judgement to estimate future cash flows using the probability-weighted possible outcome approach may reduce the reliability of amortised cost information in the financial statements and may make auditing more difficult.
20. Participants support the proposals to apply periodic back testing of actual results against forecasts and the impairment methodology, and to make comprehensive disclosures about the credit quality and the assumptions used underlying the methodology, as this might place greater onus on management to exercise reasonable judgement in making loss provisions.

However, participants think that voluminous disclosures should not be a substitute for good measurement principles.

**Question for the Board**

What are the Board's views on the potential subjectivity of the proposed model?

**Next steps**

21. Submissions to the IASB on the proposals relating to the Impairment ED are due by 30 June 2010. Staff will prepare an issues paper outlining key issues and comments for the Board's consideration at the next Board meeting on 9-10 June 2010.