

Issues and key comments on ED/2009/12

1 Measurement model – the absence of a conceptual basis

- 1.1 The subject of ED/2009/12 is impairment of financial assets measured at amortised cost. ED/2009/12 proposes changing the definition of ‘amortised cost’ in IFRS 9 to refer to “A cost-based measurement of a financial instrument that uses amortisation to allocate interest revenue or interest expense”. As further explained in ED/2009/12:

BC4 The exposure draft proposes requirements for the impairment of financial assets but also for amortised cost measurement as a whole.

In addition, at paragraph BC15, the IASB rejects a fair value approach to impairment on the basis that it is inconsistent with a cost measurement basis.

Staff comments

- 1.2 AASB staff consider that any model that purports to be cost-based should adhere to cost measurement principles. However, we are concerned that:
- (a) on the one hand, the IASB has not been consistent with its conclusion in paragraph BC15 because the proposed initial and subsequent measurement of financial assets is not cost; and
 - (b) on the other hand, because of its reasoning in paragraph BC15, the IASB may be excluding possible impairment models from its consideration, such as the model underlying IAS 36 *Impairment of Assets*.
- 1.3 AASB staff note that IAS 36 applies to assets measured at cost (including assets measured at revalued cost) and applies clear measurement principles involving the use of current value information. IAS 36 defines ‘recoverable amount’ in terms of the lower of fair value and value in use, and value in use is defined in terms of the present value of future cash flows expected to be derived from the asset.
- 1.4 The AASB staff view is that the IASB should explore an IAS 36-style approach to the impairment of financial assets measured at amortised cost.
- 1.5 Under an IAS 36-style approach, the initial measurement of financial assets measured at amortised cost would be based on the contractual rate embedded in the asset. This is in contrast with ED/2009/12 that proposes applying a credit-loss-adjusted effective interest rate

for the purposes of initial measurement. The proposed methodology introduces elements that move away from the cost-based initial measurement by incorporating credit loss expectations in the amortised cost measurement. Central to the definition of a financial instrument is the notion of a ‘contract’, and in an exchange transaction the contractual interest rate(s) at inception represents the market view at the date of the transaction. Having each entity determine a rate or rates at inception at other than the market rate(s) appears to be a departure from a transaction-based cost model.

- 1.6 Under an IAS 36-style approach, impairment would be measured using current value information. That is, subsequent to initial measurement at cost, an assessment could be made as to whether the ‘recoverable amount’ of the financial asset has fallen below the lower of its fair value and value in use, with value in use being determined by reference to an assessment of the expected future cash flows discounted at the relevant prevailing market rate.
- 1.7 AASB staff consider that the proposed impairment model is relatively complicated compared with the existing IFRS models of impairment (in IAS 36 and IAS 39) because it integrates revenue recognition and impairment.
- 1.8 Furthermore, ED/2009/12 is effectively elevating the effective interest rate method to the status of a measurement basis, which it is not

Question 1

Does the Board agree with the staff comments in paragraphs 1.2 to 1.8?

2 Issues concerning ‘interest’ and credit risk

- 2.1 IFRS 9 includes a definition of ‘interest’ in IFRS 9 to help identify ‘contractual cash flows that are solely payments of principal and interest’ for the purposes of classifying financial assets at amortised cost. IFRS 9 describes interest as follows:
 - 4.3 For the purpose of this Standard, interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.
- 2.2 Accordingly, interest is effectively ‘deemed’ to comprise only two components – time value of money and compensation for bearing credit risk. However, interest can be considered to

comprise a wider number of factors. The OECD¹, for example, regards interest as being a function of:

- * the amount, purpose and period of the transaction;
- * the credit-worthiness of the borrower;
- * the collateral offered and/or other guarantees/guarantors available;
- * the competition for the transaction; and
- * government policy.

Others specifically identify ‘liquidity risk’ as an element of interest rates.²

- 2.3 AASB staff acknowledge that it is probably feasible to loosely classify each of the factors identified above into either those that impact on the time value of money or factors that impact on creditworthiness. For example, ‘competition for the transaction’ and ‘government policy’ might be characterised as being influences on the time value of money.

Staff comments

- 2.4 AASB staff regard the IASB’s description of interest as an over-simplification that could lead to the objective of ED/2009/12 not being met. That is, the methodology of using the effective interest rate calculation as a means of accounting for credit losses might be regarded as being based on an over-simplified definition of interest and, therefore, some material component of the losses recognised under the proposed impairment model may be due to factors other than credit risk.
- 2.5 AASB staff note that the impacts of shifts in the yield curve on variable rate instruments would be recognised as credit losses (or gains) under the ED/2009/12 proposals. This is because the proposed model prescribes a ‘catch-up approach’ when there are subsequent changes to expectations about credit losses. The proposed impairment model is unable to distinguish catch-up adjustments that relate to the deterioration of the credit quality of assets (impairment) from adjustments that relate to other factors that might cause a shift in the relevant yield curve. This is because catch up adjustments are made for any shift in the yield curve, which may occur for reasons other than changes in credit risk, such as a change in

¹ <http://stats.oecd.org/mei/default.asp?lang=e&subject=15>

⁵ Working Paper Series No 1024 March 2009 *Funding Liquidity Risk – Definition and Measurement*

liquidity risk and other impacts of changed market expectations.³ This issue is particularly significant in the Australian environment where variable rate loans are common.

- 2.6 Accordingly, staff believe that the IASB has not achieved its aim of avoiding problems associated with recognising as credit losses amounts that arise from non-credit related factors in the existing IAS 39. The IASB comments:

BC19 ... The Board noted that this mixed approach (to measurement) in IAS 39 has created significant complexity, created application problems, and resulted in anomalous revenue recognition in periods subsequent to the impairment date to adjust for the effects of non-credit related factors.

- 2.7 The mechanics of the proposed model would mean a lack of transparency in identifying the impact of credit losses.

Question 2

Does the Board agree with the staff comments in paragraphs 2.4 to 2.7?

3 Concerns about recognising initial expected credit losses by adjusting contractual (interest) revenue

- 3.1 ED/2009/12 proposes that interest revenue be adjusted for initial credit losses on the basis that the holder of financial assets would otherwise be overstating revenue [paragraph BC11(a)]. The IASB also concludes that the proposed impairment model would reflect lending decisions more faithfully than the existing model [paragraph BC31]. The implication is that the proposed model better reflects the manner in which banks and similar financial institutions make lending decisions and, in turn, this would help users to analyse business models and performance.
- 3.2 Based on discussions with a range of Australian constituents, it is apparent that some large loans are specifically priced using cash flow analysis and that some entities undertake cash flow analysis for particular classes (or portfolios) of loans. However, because of the many factors that drive interest rates and the competitive markets in which lenders operate, many

³ Australian Treasurer, *Review of the Commonwealth Government Securities Market*, October 2002

(and probably most) loans are not priced in a manner consistent with the proposed impairment model or in the simplified way that the description of ‘interest’ in IFRS 9 implies.

- 3.3 In general, Australian lenders have indicated that they do not manage credit risk as a function of revenue recognition, and feedback from Australian analysts suggests that users are interested in knowing how a banking business is managed. This is consistent with the view that a ‘through the eyes of management’ approach can be helpful to users.⁴ AASB staff note that the approach taken by in the FASB ED to determine effective interest rates is to use the rate that equates the contractual cash flows with the initial cash outflows⁵, and excludes initial expected credit losses. The FASB proposals are more consistent with most Australian entities’ business models.
- 3.4 In relation to revenue recognition, most Australian lenders and users of their financial statements focus on the margin between the lending rates and the cost of funding—sometimes called the ‘net interest margin’. (IASB notes the significance of this in paragraph BC49, but only as a matter of presentation). AASB staff also observe that most Australian financial institutions and non-financial institutions present full year results to users in a format that clearly distinguishes ‘gross operating income’ from ‘impairment expense’. Users have advised that this format of presentation is important as it reflects the way entities are managed, and provides a clear message about what is contractually receivable and the total of recognised credit losses (impairment). Users have also commented that, because the expected loss model deals with initial expectations of impairment losses separately from subsequent impairment losses/gains, it obscures the overall picture of the level of impairments.
- 3.5 AASB staff note that the FASB also proposes a net interest income recognition approach in that, “the amount of interest income to be recognised in net income ... shall be determined by applying the financial asset’s effective interest rate to the amortised cost balance net of any allowance for credit losses” [paragraph 76 of the FASB ED]. However, in contrast to the IASB proposals, the FASB proposals do not include an initial adjustment to the effective interest rate for expected credit losses. The FASB acknowledges concerns about separating impairment amounts between initial and subsequent assessments and this is one of the reasons it decided not to pursue an expected loss model [paragraph BC175 of FASB ED].
- 3.6 In concept, if the net interest margin were to be assessed using the IASB’s proposed impairment model, the same model would need to be applied to the wholesale cost of funding.

⁴ For example IFRS 8 *Segment Reporting* adopts a ‘through the eyes of management’ approach

⁵ Paragraph 66 of FASB ED

That is, ‘own credit risk’ would need to be factored into the calculation of interest expense for the sake of comparing like with like. However, AASB staff note that ED/2009/12 explicitly states, without any supporting justification or acknowledgement of the asymmetry involved, that “For financial liabilities estimates of expected cash flows do not reflect the entity’s own non-performance risk.” (paragraph B3).

Staff comments

- 3.7 AASB staff do not believe that the IASB and FASB proposed models better reflect the manner in which banks and similar financial institutions make lending decisions and doubts that the IASB’s proposed impairment model would better meet the needs of users of their financial statements.
- 3.8 AASB staff consider that the IASB should exclude initial expected losses from the calculation of effective interest rates and that the effective interest rates should be based on contractual cash flows so that the model more closely aligns with entities’ business models and so that:
- (a) the net interest margin that shows the difference between the contractual rates at which an entity lends versus the cost of its funding can be clearly identified; and
 - (b) all credit losses are treated in the same way so that the aggregate impact of such losses is readily apparent.

Question 3

Does the Board agree with the staff comments in paragraphs 3.7 and 3.8?

4 Impact on non-financial institutions

- 4.1 AASB staff note that the IASB’s proposed impairment model is oriented to financial institutions whose main business is lending. Many other types of entities, such as those with long-term trade receivables, will be impacted by the proposals and the focus of these entities is on generated revenue from selling goods and services, not generating interest revenue. Credit provided by non-financial institutions is generally incidental to the sale of goods and services.
- 4.2 Accordingly, the proposed model, which deals with impairment through a revenue recognition methodology, is unlikely to be suitable for non-financial institutions in a number of respects. For example, it is unlikely to produce information that is relevant to users of their financial

statements who would be more focused on the information that drives these entities' business models. The risk of impairment of financial assets such as an entity's trade receivables is likely to be a business risk that is managed by the entity as a completely separate function from the management of the entity's core activities that produce revenue. Similarly, financial statement users have indicated to AASB staff that they would separately analyse the revenue generating functions and credit risk aspects of the businesses of non-financial institutions.

Staff comments

- 4.3 AASB staff consider that the proposed model, even taking into consideration the 'practical expedients' noted at paragraphs B15 to B17, would add a layer of complexity to the preparation of financial statements that is not warranted for entities whose main business activities are not lending. We are not aware of any evidence to suggest that the accounting policies applied to recognise impairment of financial assets such as trade receivables were a source of concern arising during the credit crisis.
- 4.4 AASB staff appreciate that 'transaction neutrality' is an important notion that underpins the development of most IFRSs, such that the accounting treatment of similar transactions involving financial assets should be treated similarly no matter which entity undertakes them. We support this notion and regard the inappropriateness of the proposed impairment model for financial assets such as trade receivables as another reason for not supporting the IASB's proposed impairment model for application to any financial assets.

Question 4

Does the Board agree with the staff comments in paragraphs 4.3 and 4.4?

5 Practical concerns about separating initial and subsequent impairment

- 5.1 A concern about the separation of initial and subsequent impairment assessments is that it may effectively force entities to adopt a 'closed portfolio' approach to impairment assessment. That is, under the proposed impairment model, entities would not find it feasible to add new loans to a portfolio for which the initial cash flow expectations have already been made and embedded in the effective interest rate calculation. There seems to be no facility under the proposed impairment model for entities to re-calculate the effective interest rate for initial expected cash flows associated with new loans. If new loans were added to an existing portfolio, any initial impairment losses on those new loans would presumably be included

with subsequent impairment losses on the existing loans in the portfolio, which seems to violate the notion underlying ED/2009/12 that initial and subsequent impairments are treated differently.

- 5.2 Australian banks and other financial institutions generally manage loans on an ‘open portfolio’ basis. Accordingly, the proposed impairment model would be inconsistent with the manner in which most banks and other financial institutions manage their businesses and would cause them to incur significant costs in creating or changing information systems. If the proposed impairment model were to be required, many entities may choose to continue to manage their businesses on an open portfolio basis (and report different information in their segment disclosures compared with their whole-of-entity financial statements) and need to incur the ongoing expense associated with maintaining two information systems.
- 5.3 AASB staff note that the European Banking Federation has commented that initial and subsequent impairments should be treated consistently. However, AASB staff do not support the EBF recommendation, which seeks to achieve consistency by adjusting the effective interest rate for subsequent impairments.

Staff comments

- 5.4 AASB staff consider that the IASB’s proposed impairment model would give rise to practical problems associated with the manner in which financial institutions currently manage their business – using an open portfolio approach.
- 5.5 AASB staff consider that the IASB’s proposed approach effectively requires information to be analysed on the basis of the ‘vintage’ of each loan or portfolio of loans, which is inconsistent with the perspective of financial institutions and the users of their financial statements, and could prove costly to implement.

Question 5

Does the Board agree with the staff comments in paragraphs 5.4 and 5.5?

6 AASB preferred position

- 6.1 The impetus for the proposed impairment model in ED/2009/12 was the criticisms of the incurred loss model for having a number of weaknesses—one of which is that the recognition of impairment losses has been delayed [paragraph BC11]. The proposed impairment model also corresponds to the recommendations of the FCAG to explore alternatives to the incurred

loss model that use more forward-looking information for loan loss provisioning [paragraph IN3]. In addition, as part of its features, the proposed impairment model would require expected credit losses to be incorporated into the calculation of effective interest rates, which results in lower revenue amounts being recognised.

Staff comments

- 6.2 AASB staff believe that the most logical and direct response to this proposition is a solution that focuses on the balance sheet, rather than a model that involves recognising losses via a revenue recognition methodology. Instead of providing for losses earlier than when ‘actual losses’ have occurred, the proposed impairment model initially focuses on delaying revenue recognition. It subsequently shifts focus to the balance sheet with expected losses subsequent to initial recognition being dealt with directly as balance sheet adjustments.
- 6.3 In many ways the IASB’s project on financial asset impairment seems to carry preconceptions about the label ‘incurred loss model’, and that any model with that name has weaknesses that cannot be rectified. It could equally have been said that the weaknesses identified are weaknesses of the existing ‘probable threshold’ incurred loss model (as the FASB labels it). The IASB could have followed the FCAG’s recommendation by exploring amendments to the existing incurred loss model by providing greater clarification about a wider range of events that could be taken to have occurred and which give rise to incurred losses.
- 6.4 In the context of the credit crisis of 2007/2008 it is probably fair to say that, although many banks found themselves under-provisioned, a number did not. AASB staff believe it is evident, from having observed the recent debates at the IASB and among national standard setters about the level of adequacy of loss provisioning and the timing of recognition of impairment losses by banks in various jurisdictions applying IAS 39, that there is diversity in practice [a weakness noted in paragraph BC11(d)]. That said, AASB staff believe that the proposed requirement to project expected cash flows is likely to involve significant subjectivity that will also give rise to a similar or possibly greater level of diversity.
- 6.5 Given that the focus is on determining the basis for amortised cost measurement, consistent with the cost basis of measurement, and given the FCAG’s recommendation to explore models that use more forward-looking information, the IASB could usefully examine the notion of incurred but not reported (IBNR) losses. The notion of IBNR is widely used in accounting for insurance contracts, with insurers providing for claims liabilities that relate to events they know have occurred from general information about the claims environment,

rather than from being advised of the occurrence of specific events. Accordingly, AASB staff is of the view that the basis for recognising losses using the IBNR notion is consistent with the principles of the incurred loss model, that is, there is the occurrence of a 'loss event', and historical evidence and observable data indicate that there are implications from the loss event that will affect future cash flows.

- 6.6 AASB staff observe similarities between an IBNR approach and the FASB Exposure Draft proposal that an entity consider all available information relating to past events and existing conditions and their implications for the collectability of cash flows. The FASB's proposal to remove the 'probable' threshold before which an impairment could be recognised is also consistent with an IBNR approach that draws on a broad range of information. That is, an entity would employ probability in a measurement context and recognise impairment losses once the available information is sufficient to alter the entity's view on the measurement of expected cash flows. This may be well before the entity would be able to accumulate sufficient evidence to justify that a particular loss meets the criterion of 'probable' in a recognition sense.
- 6.7 Although set in the context of determining that part of the 'qualifying portion of a change in fair value' that must be included in net income, the FASB's proposals appear to be consistent with a cost approach to measuring an asset subject to an impairment test because the focus is on past transactions and events. AASB staff would support the IASB considering the FASB's proposed approach in determining impairment losses for financial assets at amortised cost. AASB staff also concur with the FASB's proposed approach to distinguishing (a) information that provides the basis for determining that particular events have already occurred and which gives rise to impairments (or reversals of impairments) from (b) forecast information, which goes beyond a cost model and the IBNR approach.
- 6.8 Accordingly, AASB staff consider it may be premature to conclude that the incurred loss model is 'broken', and are not convinced that a completely new impairment model based on expected losses would resolve the issue of some entities having under-provisioned for losses. AASB staff recommends that the existing incurred loss model should be revised or clarified to achieve earlier loss recognition and greater consistency in the application of timing of loss recognition.

Question 6

Does the Board agree with the AASB staff comments in paragraphs 6.5 to 6.8?

7 Cost beneficial disclosures

- 7.1 ED/2009/12 proposes the objective of disclosure for financial instruments measured at amortised cost as ‘providing information that enables users of the financial statements to evaluate the financial effect of interest revenue and expense and the quality of financial assets including credit risk’. The proposed disclosures are in paragraphs 14 to 22 of ED/2009/12.
- 7.2 AASB staff note that the IASB has focused on user needs in considering the proposed disclosures for amortised cost assets and overall, constituents are supportive of the proposed disclosures. Some Australian constituents are concerned that in making its decision to propose the disclosures in ED/2009/12, the IASB has not given sufficient consideration to the increased difficulties of providing information that has not been maintained historically.

Staff comments

- 7.3 Most constituents were supportive of the following proposed disclosures due to the usefulness of information, irrespective of the impairment model used for financial reporting purposes. AASB staff agree and consider that the following disclosures should be required in the final standard:
- (a) a reconciliation of the allowance account showing changes during the period, including direct write-offs;
 - (b) estimates and changes in estimates; and
 - (c) a reconciliation of changes in non-performing financial assets, and a qualitative analysis of the interaction between changes in non-performing financial assets and changes in the allowance account.
- 7.4 Most preparers have highlighted difficulties in collecting information needed for some of the proposed disclosures, and have questioned the usefulness of the information to users. AASB staff agree with some of these concerns, and based on cost-benefit considerations, do not support the following disclosure requirements:
- (a) cumulative loss development. AASB staff note that the loss development disclosure in ED/2009/12 is similar to the claims development disclosure required under IFRS 4 *Insurance Contracts* paragraph 39(c)(iii) [paragraph BC59 of ED/2009/12]. AASB staff acknowledge that there are benefits to providing such information, for example, in showing an entity’s ‘track record’ in estimating credit losses. AASB staff note that the claims development disclosure in IFRS 4 is not required in respect of insurance

contracts for which uncertainty about the amount and timing of claims payments is typically resolved within one year, such as life insurance contracts [IFRS 4, paragraph BC220]. A result of the ‘relief’, is that the IASB has effectively exempted most insurance contracts with a contract period of more than one year from being the subject of claims development disclosures. Typically, only the one-year contracts have a large payment ‘tail’, such as workers compensation contracts. Because the insurance contracts to which the claims development disclosure requirement in IFRS 4 applies generally have one-year contract terms, tracking the claims experience on the basis of yearly cohorts is relatively straightforward. Accordingly, AASB staff are concerned that in making its decision to propose a similar disclosure requirement in ED/2009/12, the IASB has not given sufficient consideration to the increased difficulties of providing information on loss development experience for loan assets that generally have contractual (and actual) terms of two or more years. Accordingly, the IASB should reconsider proposing this disclosure requirement on the basis that the cost to provide this information might significantly outweigh its benefits. Alternatively, AASB staff consider that it may be appropriate to only require information on historical loss rates⁶ if such information is regularly reviewed by the chief operating decision maker to make decisions about allocation of resources and performance assessments, consistent with the ‘through the eyes of management’ principle under IFRS 8 paragraph 5(b);

- (b) general disclosures about stress testing. AASB staff appreciate that it is proposed that disclosures on stress testing (paragraph 20) would not be compulsory, and only entities that prepare stress testing information for internal risk management purposes would be required to make disclosures. However, AASB staff are concerned that this information may not be particularly relevant for financial reporting purposes, considering there is no clarity as to what constitutes ‘stress testing’ in ED/2009/12. Australian constituents have noted that a wide variety of stress testing is performed by some banks for regulatory and other purposes. Furthermore, AASB staff have been informed that, some of the stress testing information would only be meaningful if voluminous detail were provided. In order to provide some limits and consistency around the disclosure of stress testing information, AASB staff suggest that, if it is to be required, such information should be limited to that which is regularly reviewed by the entity’s chief operating decision maker; and

⁶ Commonwealth Bank Australia, *Full year results: Analyst presentation*, pages 100-101, August 2009.

- (c) vintage information. AASB staff understand that, in Australia, financial statement users and managements generally do not use vintage information when making estimates of, or analysing, credit losses. This is because loan assets, particularly housing loans, are generally managed and analysed on an open portfolio basis under which loans of various vintages are aggregated. Accordingly, vintage information would not reflect the basis on which management's expectations are formulated, and would therefore appear inconsistent with the proposed expected loss model. AASB staff also note that the proposed disclosure of vintage information relates to nominal amounts, which may be of limited use to users since the amounts would not reflect the extent to which an allowance for credit losses against these nominal amounts has been made. AASB staff suggest that disclosures based on management's expectations about the 'expected life' of assets would be more meaningful information to users. If the IASB persists with this proposed disclosure requirement, it should consider making it prospective on transition because, for example, Australian banks generally do not presently capture this information about financial assets on the basis of vintage.

Question 7

- (i) Does the Board agree with the staff comments in paragraphs 7.3 and 7.4; and
- (ii) Are there any underlying disclosure principles that the Board thinks we should suggest to the IASB?