



Australian Government
**Australian Accounting
Standards Board**

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Sir David Tweedie
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UNITED KINGDOM

Dear David

**AASB comments on IASB Exposure Draft ED/2009/12 *Financial Instruments:
Amortised Cost and Impairment***

The Australian Accounting Standards Board (AASB) welcomes the opportunity to provide comments on Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (ED/2009/12). In formulating its comments, the AASB sought and considered the views of Australian constituents through comment letters and Roundtables. The comment letters received are published on the AASB's website.

The AASB acknowledges that the global financial crisis has highlighted that users of general purpose financial statements require more forward-looking information to be incorporated in determining financial asset impairment, and that this featured in the letter from G-20 leaders to the IASB and the recommendations of the Financial Crisis Advisory Group. Accordingly, the AASB appreciates the IASB's efforts to improve on the IAS 39 *Financial Instruments: Recognition and Measurement* approach to accounting for impairment of financial assets measured at amortised cost.

However, the AASB does not support the IASB's ED/2009/12 proposals on both conceptual and practical grounds.

The AASB considers that the proposed expected loss model is not consistent with an amortised cost measurement attribute and lacks a conceptual basis. In particular, the AASB considers that the proposed model is unsuitable as the basis for measuring assets at amortised cost because it is not based on contractual rates at inception, which represents the market view at the date of the transaction. Furthermore, the AASB considers that the proposed impairment model is inconsistent with an amortised cost measure because it mixes asset measurement and revenue recognition and in some circumstances captures amounts that do not relate to changes in credit risk. The proposed impairment model also treats initial and subsequent impairments differently, which is unlike any other impairment approach applying to assets measured at cost.

The AASB further notes that the ED/2009/12 proposals centre on revenue recognition. That is, in order to accept the ED/2009/12 proposals it is necessary to agree that impairment is a function of revenue recognition for some assets measured on a cost basis. The complexity of this approach has meant that the IASB has had to create a practical expedient in respect of trade receivables, which indicates to the AASB that the IASB has not met the recommendation of the Financial Crisis Advisory Group for greater simplicity in accounting for financial instruments. Furthermore, even though the AASB appreciates the need for the practical expedient for trade receivables if the ED/2009/12 proposals proceed, in view of the proposals in ED/2010/6 *Revenue from Contracts with Customers*, it is not clear whether the IASB has adequately addressed cross-cutting issues. Although the gross receivable less the allowance account for expected credit losses that would be recognised under ED/2009/12 and the net amount of receivables that would be recognised under ED/2010/6 in balance sheets are consistent, one emphasises the need to show the gross amounts and the other does not. Furthermore, while the AASB notes it is proposed to scope out financial assets dealt with under IFRS 9 from the proposed IFRS on revenue from contracts with customers, the manner in which entities are supposed to distinguish between receivables falling under either of these IFRSs is not clear.

The AASB considers that there are significant practical problems with the proposed model on the basis that it is relatively complicated and does not generally reflect the manner in which both Australian financial and non-financial institutions operate. In particular, this is because the model treats the impacts of initial and subsequent impairment assessments differently. This would appear to compel financial institutions to assess loan impairment at the level of individual assets or to use a closed portfolio approach, and to force non-financial institutions to adopt a more complex impairment assessment process for trade receivables than may be warranted.

The AASB considers it may be premature to conclude that the incurred loss model is 'broken', and is not convinced that a completely new impairment model based on expected losses would resolve the issue of some entities having under-provisioned for losses. The AASB recommends that the existing incurred loss model should be revised or clarified to achieve earlier loss recognition and greater consistency in terms of the timing of loss recognition. In this respect, the AASB notes that the FASB Exposure Draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* includes proposals to modify the existing incurred loss model by removing the existing probable threshold requirement for recognising impairments on loans.

The AASB notes that the IASB has released a Request for comment on the FASB Exposure Draft, which is due for comment by 30 September 2010. The AASB considers that the different timing of the IASB and FASB proposals will require duplication of effort by the IASB and its constituents in striving for converged outcomes on financial instruments. The AASB urges the IASB and FASB to better coordinate their efforts in having converged proposals, or at least co-terminus comment timelines. This would help to make best use of limited standard setting resources and the limited time available to constituents to comment on proposals.

The AASB views, as summarised above, are explained in more detail in Appendix A. Although the AASB strongly recommends that the IASB does not proceed with the proposals in ED/2009/12, responses to the individual questions raised in ED/2009/12 are provided in Appendix B with cross-references to AASB views in Appendix A.

If you have any queries regarding any matters in this submission, please contact me or Christina Ng (cng@asb.gov.au).

Yours sincerely

A handwritten signature in black ink that reads "K.M. Stevenson". The signature is written in a cursive style with a large, sweeping flourish at the end.

Kevin M. Stevenson
Chairman



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1 Measurement model – the absence of a conceptual basis

- 1.1 The AASB is making this submission in the context of IFRS 9, which requires financial assets to be measured at either fair value or amortised cost when particular conditions are met. Accordingly, the AASB's comments are in the context of financial assets at amortised cost. However, the AASB notes that, in the absence of IFRS 9, it would prefer that there were a consistent measurement model for financial assets and notes the FASB is seeking to achieve this outcome with its proposals to measure all financial assets within the scope of its ED at fair value.
- 1.2 The AASB considers that the proposed measurement model in ED/2009/12 lacks a known measurement attribute for financial assets held at 'amortised cost'.
- 1.3 ED/2009/12 proposes changing the definition of 'amortised cost' to refer to "A cost-based measurement of a financial instrument that uses amortisation to allocate interest revenue or interest expense". Furthermore, as 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 that context, the AASB notes the IASB's rejection of a fair value approach to impairment on the basis that it is inconsistent with a cost measurement basis (paragraph BC15).

BC15 The Board considered an approach whereby an impairment loss would be measured by reference to the fair value of a financial asset at the impairment date. Proponents of that approach argue that fair value is the most relevant measure for impairment loss because it results in the immediate recognition of economic losses. The Board rejected that approach because it believed that measuring an impairment loss using the fair value of a financial asset is inconsistent with a cost-based approach and would introduce undue complexity.

- 1.4 The AASB notes that the definition of 'amortised cost' refers to 'cost-based', and acknowledges the view that any model that purports to be cost-based should adhere to cost measurement principles. However, the AASB is 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, which incorporates management's expectations of future credit losses, is not cost. Instead, the inclusion of management's expectations of future credit losses in the amortised cost measurement model seems to be a hybrid model that does not presently exist in IFRSs. The AASB is concerned that IFRSs are already a fusion of many different measurement models and methods, and these mixed measurements detract from the coherence of the financial statements. The AASB considers that the IASB has not justified adding a further variation on these existing IFRS measurements that would result from the proposals in ED/2009/12. Accordingly, the ED/2009/12 proposals seem to be at odds with the IASB's aims in replacing IAS 39 as indicated in the project summary, which notes "The objective of this project is to improve the decision-usefulness for users of financial statements by simplifying the classification and measurement requirements for financial instruments."¹; 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*. The AASB is of the view that by including management's expectations of future credit losses, the IASB is effectively combining cost and aspects of fair value attributes in the amortised cost measurement. As such, the measurement model underlying IAS 36 should be considered.

1.1 Exploring the IAS 36 impairment model

1.1.1 AASB notes that IAS 36 applies to assets measured at cost and applies clear measurement principles involving the use of current value information.

1.1.2 Under an IAS 36-style approach the initial measurement of financial assets measured at amortised cost would be based on the contractual interest rate embedded in the asset. 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. This is in contrast with ED/2009/12 that proposes applying a credit-loss-adjusted effective interest rate as a means of recognising the

1 <http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+A+Replacement+of+IAS+39+Financial+Instruments+Recognitio/Financial+Instruments+Replacement+of+IAS+39.htm>



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impact of ‘initial’ credit losses. The IASB’s proposed methodology introduces elements that move away from the cost-based initial measurement of financial assets by incorporating credit loss expectations in the amortised cost measurement. Having each entity determine an interest rate or rates at inception at other than the market rate(s) is a departure from a transaction-based cost model.

1.1.3 Subsequent to initial measurement, IAS 36 determines the assets’ impairment amounts, by comparing them against their recoverable amounts, being the higher of their fair values and values in use, and ‘value in use’ is defined in terms of the present value of future cash flows expected to be derived from an asset. The AASB considers that a similar approach could be applied to financial assets at amortised cost. 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 higher of its fair value and value in use, with value in use being determined by reference to management’s assessment of the expected future cash flows discounted at the relevant prevailing market rate. The focus of IAS 36 is directly on the measurement/impairment of the asset and not on revenue recognition, which the AASB believes is appropriate in a cost model.

1.1.4 Another feature of the IAS 36 impairment model is that, if fair value is above the carrying amount, there is no need to further test for impairment. This is in contrast with ED/2009/12 which requires the recognition of an impairment (or gain) for financial assets held at amortised cost at every reporting date and the recognition could be a write down or write up in value depending on the credit quality of the assets. The AASB further notes that a cost model usually only requires a write down for impairment, or reversal thereof, and not a write up for gains above the initial carrying amount.

1.1.5 If the IASB proceeds with its proposals in ED/2009/12, the AASB considers it would be appropriate to include an explanation in its Basis for Conclusions as to why an IAS 36 approach was rejected.

1.2 Incurred loss model and a focus on ‘incurred but not reported’ losses

1.2.1 In many ways the labels being used in the IASB’s project on financial asset impairment seem to carry with them preconceptions about how the IASB should proceed to developing solutions to the recommendations of the FCAG and other calls for action on asset impairment. The label ‘incurred loss model’ is being used in a manner that



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suggests any model with that name has weaknesses that cannot be rectified.

ED/2009/12 (in particular, paragraph BC11) refers to the incurred loss model having a number of weaknesses. It could equally have been said that the existing incurred loss model (one that can be interpreted as prescribing strict rules about what ‘incurred’ means and delaying the recognition of losses) has a number of weaknesses. The AASB considers that the weaknesses identified are criticisms of the existing incurred loss model and the manner in which it is applied rather than weaknesses of all such models. The AASB believes that those weaknesses can be rectified by providing greater clarification about a wider range of events that could be taken to have occurred and which give rise to incurred losses.

- 1.2.2 The AASB notes that the relevant recommendation of the FCAG is that the IASB explore alternatives to the incurred loss model that use more forward-looking information [paragraph IN3]. The AASB’s view is that the IASB could follow the FCAG’s recommendation by exploring amendments to the existing incurred loss model that would result in a greater use of current market inputs, or a greater consistency of the use of such inputs, than often occurs under the existing IAS 39 requirements.
- 1.2.3 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, the AASB 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.
- 1.2.4 In the context of financial assets within the scope of IFRS 9, the application of the notion of IBNR may mean that general information about the economic environment, such as rates of unemployment, rates of employment participation, asset price inflation and rates of economic growth, being leading indicators, can be used to infer the occurrence of specific events that give rise to impairment losses.



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1.2.5 The AASB observes similarities between an IBNR approach and the FASB ED 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.

1.2.6 The AASB supports this feature of the FASB proposed impairment model and, accordingly, the AASB recommends that the IASB consider the IBNR approach to assessing incurred losses.

1.2.7 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 also 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. The AASB would support the IASB considering the FASB's proposed approach in determining impairment losses for financial assets at amortised cost. The AASB also concurs 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.

1.3 Effective interest rate approach is a methodology not a measurement model

1.3.1 The IASB's response to some of the practical concerns raised about the ED/2009/12 proposals has been to establish an Expert Advisory Panel, and the AASB applauds the efforts of the Panel. However, the AASB is concerned that all the Panel's best endeavours to address concerns about the 'practicability' of the proposals may prove fruitless because the IASB's proposals are fundamentally flawed. This is because the IASB's proposals have oversimplified the effective interest rate methodology as a means of a single recognition and measurement method that aggregates revenue and impairment.



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1.3.2 The AASB also believes that the effective interest rate method was originally developed as a revenue recognition technique to allocate yields over the life of financial instruments so that, for example, a deep discount bond that is the economic equivalent of a bond that carries a coupon rate receives the same accounting treatment.

ED/2009/12 is effectively elevating the effective interest rate method to the status of a measurement basis, which it is not.

1.3.3 With the effective interest rate methodology being employed to integrate both revenue recognition and impairment, the AASB believes that the outcome is akin to something that presently only exists within a fair value model—because under a fair value model, both impairments and revenue are aggregated and recognised through fair value changes in the profit or loss or other comprehensive income. However, the AASB understands that the aim of the IASB as stated in paragraph BC15 is to develop a cost-based approach.

1.3.4 In this context, the AASB considers the existing IFRS models of impairment (in IAS 36 and IAS 39) would provide less complex measurement methods and are more aligned with entities' business models.

1.4 A forward-looking impairment model or delayed revenue recognition?

1.4.1 As alluded to in ED/2009/12 (for example, paragraph BC11), an impetus for the proposed impairment model is that the existing model in IAS 39 has led to the delayed recognition of impairment losses. At the time an entity makes loans, it might expect that some of the contractual cash flows may not be received. The AASB believes 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 and smooths loss recognition over a number of periods. Instead of providing for losses earlier than when 'actual losses' have occurred, the proposed impairment model initially focuses on delaying revenue recognition and arbitrarily spreading losses over the period of 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.

1.4.2 The complexity of this approach has meant that the IASB has had to create a practical expedient in respect to trade receivables, which indicates to the AASB that the IASB



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has not met the recommendation of the FCAG for greater simplicity in accounting for financial instruments.

1.5 Cross-cutting issues – inconsistent recognition and measurement across financial assets and liabilities

1.5.1 The AASB is concerned that the IASB is abandoning the notion that like transactions should be treated in like ways by using different measurement methods for different types of financial assets that are declared as being measured at cost. For example, it is not clear whether lease receivables under the proposals being developed in the IASB's Leases project are to be assessed for impairment using the impairment model proposed in ED/2009/12. Based on the tentative decisions taken to date by the IASB, the impairment model proposed in ED/2009/12 would probably not be readily applicable to the lessor accounting model being developed (the 'performance obligation model') under which a lessor would recognise lease receivables, leased assets and lease performance obligations. Under such a lessor accounting model, if the lease receivables were accounted for using the impairment model proposed in ED/2009/12, there would presumably also be a need to initially adjust the lease performance obligations over the life of the leases in some similar fashion to the adjusted effective interest revenue. The possible derecognition of lease performance obligations, based only on expectations, would be difficult to justify against other IFRS requirement relating to derecognition of liabilities.

1.5.2 Based on recent IASB agenda papers², it is evident that the IASB is contemplating a form of incurred loss impairment model to be applied to the net amount of the lessor's lease receivables, leased assets and lease performance obligations. As noted earlier in this submission, the AASB would favour achieving greater consistency between the accounting for financial instruments at amortised cost under IFRS 9 and lease receivables by amending the incurred loss model in IAS 39 rather than adopting an expected loss model.

1.5.3 The AASB also considers that the IASB would appear to be developing different approaches to expense recognition and measurement depending on whether it is driven from the impairment of assets or the recognition of liabilities. Under the proposed impairment model, the aim is to recognise losses as soon as feasible, yet the IASB's

2 For example, agenda paper 2B, IASB/FASB Joint Meeting April 2010



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approach to the recognition of restructuring provisions in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is completely the reverse. Under IAS 37 a constructive obligation to restructure can only be recognised once a number of strict criteria are met (IAS 37, paragraphs 72 to 74), and the IASB's 2005 ED of Amendments to IAS 37 include equally, if not more restrictive, proposed recognition criteria. The AASB considers that these different approaches should be compared and justified in the Basis for Conclusions.

1.5.4 The AASB notes that the IASB has recently released ED/2010/6 *Revenue from Contracts with Customers*. In terms of trade receivables accounted for using the practical expedient, the AASB notes inconsistencies in the proposed manner in which balance sheet amounts should be recognised and presented under ED/2009/12 and ED/2010/6. ED/2009/12 proposes a presentation of the gross receivable less an allowance for expected credit losses³, and ED/2010/6 proposes a presentation of net receivable amounts⁴, when goods/services have been delivered/performed. Furthermore, while the AASB notes it is proposed to scope out financial assets dealt with under IFRS 9 from the proposed IFRS on revenue from contracts with customers, the manner in which entities are supposed to distinguish between receivables falling under either of these IFRSs is not clear.

1.6 Financial reporting versus prudential approaches to impairment models

1.6.1 In relation to financial asset impairment, the AASB concurs with the view that the focus of financial reporting should be on portraying the economic characteristics of recognised financial assets.

1.6.2 Accordingly, the AASB supports the IASB's rejection of 'through the cycle' and 'cycle average' approaches to financial asset impairment for the reasons outlined in paragraphs BC23 and BC24. The AASB can understand the attraction of a through the cycle approach to prudential regulators whose primary focus is on the stability of the financial system and the survival of financial institutions through economic cycles. However, there is a distinction between many of the aims of regulatory reporting and the aims of financial reporting and the IASB and the FCAG have successfully raised awareness of these distinct aims.

3 IASB staff examples, Example 2: Short-term trade receivables

4 Example 20 of IASB Exposure Draft ED/2010/6 *Revenue from Contracts with Customers*



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2 Practical concerns about linking effective interest rates and initial expected credit losses

2.1 Cross-subsidisation of loans with different credit standing

2.1.1 A further concern is that, within many portfolios of loans that carry the same interest rate, there is a significant level of cross-subsidisation between borrowers with different credit standing. A typical example is a variable rate housing loan portfolio in which new borrowers who have a small percentage of equity in their homes are charged the same interest rate as existing borrowers who may have a substantial percentage of equity in their homes. In this case, the existing borrowers are cross-subsidising the new borrowers, a situation that many banks effectively use as a mechanism for attracting new business. This may not be a concern when the cross-subsidisation occurs within the one portfolio and the unit of account for applying the proposed impairment model is the portfolio. However, when the unit of account and the contracts across which cross-subsidisation takes place do not coincide, the proposed impairment model is likely to result in changes in interest rates that do not relate to credit risk being treated as if they were related to changes in credit risk. That is, for example, if a loan in one portfolio has an effective interest rate that is artificially low because it is effectively being cross-subsidised by another loan that is classified in another portfolio, the effective interest rates on both loans will not reflect the appropriate levels of credit risk.

2.1.2 The AASB considers that the above concerns related to cross-subsidisation could only be overcome by deliberately grouping all those loans that cross-subsidise one another with the one unit of account. However, the emphasis in ED/2009/12 is on either a contract-by-contract unit of account or a closed portfolio approach, which would prevent an entity from grouping all the loans that cross-subsidise one another into the one (open) portfolio. (See comments in Section 3.1 of this Appendix)

2.2 Comparison with entities' business models

2.2.1 The AASB notes that the IASB has concluded it is appropriate to adjust interest revenue 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.



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- 2.2.2 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 (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 9⁵ implies.
- 2.2.3 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 echoes the AASB’s earlier comments about seeking to clarify and amend the incurred loss model, which is more aligned to the manner in which banking business is managed, and to separately address the measurement attributes of the impairment model from the revenue recognition model. This AASB view also reflects the basis for much of the IASB’s recent requirements implementing a ‘through the eyes of management’ approach⁶ and could be helpful to users.
- 2.2.4 These concerns about a lack of transparency in the recognition and measurement model could potentially be overcome by disclosures, and the AASB notes that paragraph 13 of ED/2009/12 proposes that the gross interest revenue and the net interest revenue be presented. However, consistent with sentiments expressed in the *Framework*⁷, it would seem inappropriate to create a situation in which concerns arising from recognition and measurement requirements need to be rectified through disclosures. Furthermore, the presentation proposals in paragraph 13 of ED/2009/12 could be unduly burdensome to prepare. This is because, if banks were required to apply the proposed impairment model for recognition purposes and to also present amounts based on effective interest rates using contractual interest rates, they would need to maintain two information systems. The AASB is of the view that, if the IASB is confident that the proposed impairment model—that requires the effective interest rate to be adjusted for expected losses—is more beneficial than the current incurred loss model, it would be unnecessary to require entities to disclose both the contractual rates and the credit loss-adjusted rates.

5 Paragraph 4.3 states, “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.

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

7 In particular, paragraph 82 of the *Framework for the Preparation and Presentation of Financial Statements*



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2.2.5 The AASB notes 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 outflows⁸, and excludes initial expected credit losses. In this case, the FASB proposals are more consistent with the business models of Australian entities in determining impairment amounts. 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 the FASB ED].

2.3 Effects on net interest margin

2.3.1 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). The AASB also observes that most Australian financial institutions and non-financial institutions have presented 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 provides a clear message about what is contractually received/receivable and the total of recognised credit losses (impairment) and reflects the way in which entities are managed.

2.3.2 A number of users have commented to the AASB that they analyse ‘interest rate risk’ separately from ‘credit risk’. This focus in considering interest rate risk, is similar to that in other industries where the ‘gross margin’ before other costs is important in assessing ongoing profitability. A concern with the proposed impairment model is that it conceals the net interest margin by separately assessing initial and subsequent impairment losses/gains, which obscures the overall picture of the level of impairments.

2.3.3 The AASB notes that the FASB also proposes a similar interest income recognition approach to the IASB, 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.

8 Paragraph 66 of FASB ED



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- 2.3.4 In concept, if the net interest margin were to be assessed using the IASB's proposed impairment model, the same 'impairment' model would need to be applied to the wholesale cost of funding. 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, the AASB notes 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).
- 2.3.5 Accordingly, in the context of revenue recognition, the AASB does not believe that the IASB and FASB proposed models better reflect the manner in which Australian banks and similar financial institutions make lending decisions and doubts that the IASB's proposed impairment model and presentation requirements in profit or loss would better meet the needs of users of their financial statements.
- 2.3.6 Therefore, the AASB recommends 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 clearly shows the difference between the contractual rates at which an entity lends versus the cost of its funding; and
 - (b) all credit losses are treated in the same way so that the aggregate impact of such losses is readily apparent.

3 Practical concerns about separating initial and subsequent impairment

3.1 The impact of separating initial and subsequent impairment assessments

- 3.1.1 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



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

3.1.2 Australian banks and other financial institutions in generally manage loans on an ‘open portfolio’ basis. Accordingly, the proposed impairment model would be inconsistent with the manner in which most Australian 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.

3.1.3 The AASB also note that the European Banking Federation has commented that initial and subsequent impairments should be treated consistently. However, the European Banking Federation recommends seeking consistency in the treatment of initial and subsequent impairments by adjusting the effective interest rate for subsequent impairments, which the AASB does not support.

3.1.4 The AASB 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. The AASB also 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 Australian financial institutions and the users of their financial statements, and could prove costly to implement.

3.2 Issues relating to variable rate instruments

3.2.1 The proposed impairment model prescribes a ‘catch-up approach’ when there are subsequent changes to expectations about credit losses. The AASB appreciates the IASB’s efforts in communicating why the approach might be considered appropriate in concept through staff explanation and an example posted on the IASB website.

3.2.2 The AASB also notes recommendations by other organisations⁹, about spreading the impact of subsequent changes in expectations of credit losses over the remaining life of

⁹ European Banking Federation, , *Basic features of an alternative model to IASB expected cash flow model*, March 2010



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an asset by adjusting the effective interest rate, as opposed to a catch-up adjustment. The AASB disagrees with adjusting the effective interest rate to be consistent with the treatment of initial expected credit losses (as proposed by the European Banking Federation), as the AASB considers this would defer the appropriate recognition of credit loss relating to past transactions or events and would be a further corruption of the revenue recognition model. Accordingly, if the IASB's proposals were to proceed, the AASB would prefer the IASB's proposed catch-up approach.

3.2.3 However, the AASB considers that there is a flaw in the application of the catch-up approach in the case of variable rate instruments. The AASB understands that this is a significant issue in some jurisdictions, particularly in Australia, because variable rate instruments are more commonly transacted than fixed rate instruments.

3.2.4 The AASB's analysis of the impact on variable rate instruments of applying the proposed impairment model establishes that it can result in the recognition of amounts of impairment losses (or gains) that are not due to changes in expectations about credit risk. Indeed, paragraph BC29 of IFRS 9 notes "... For the purposes of this condition, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk.". Other literature in support of this argument specifically identify 'liquidity risk' as one of the elements of interest rates¹⁰ and accordingly, the AASB understands that a shift in the yield curve may be associated with events that are attributed to a change in liquidity risk and other impacts of changed market expectations.¹¹

3.2.5 Furthermore, the AASB observes that, under the proposed impairment model, in the case of variable rate instruments:

- (a) any movements in the relevant yield curve, even when expectations of recoverability are unchanged, would give rise to a catch-up adjustment because it changes expected cash flows¹²; and
- (b) a catch-up adjustment that results in recognition of a gain in a particular period may result from the yield curve moving downwards due to factors other than credit risk, which overwhelms the impact of an actual deterioration of credit risk.

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

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

12 IASB staff examples: Example 3 – Floating rate loan, tabs FRN t2 to FRN t4



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Accordingly, 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. The AASB finds the potential for the proposals resulting in this misleading impact to be unacceptable.

3.2.6 The AASB also notes that the FASB, in its ED, acknowledges that changes in cash flows expected to be collected as a result of changes in variable interest rates should not, of themselves, give rise to a credit impairment. However, in providing guidance on this issue, the FASB Exposure Draft concedes that “In some circumstances it may be difficult to isolate the effect of a change in one specific component from the overall change in cash flows. When changes in expected cash flows due to variable rates... cannot be separated from the overall decline in expected cash flows, an entity shall account for the entire decline in cash flows expected to be collected as a credit impairment” [paragraph 50 of the FASB ED]. In this respect, the AASB is also not supportive of the FASB’s approach in accounting for the entire decline in cash flows as a credit impairment. The AASB urges the IASB to address the case of catch-up adjustments for variable rate instruments if it is to proceed with the proposed impairment model.

3.2.7 It also seems that, because of the mechanics of the proposed model, the impact of changes in the yield curve on the provision itself will not be transparent to users—and this would contradict parts of the objectives of ED/2009/12:

- (a) to present useful information to users of financial statements [paragraph 1]; and
- (b) to rectify “... anomalous revenue recognition in periods subsequent to the impairment date to adjust for the effects of non-credit related factors” under IAS 39 [paragraph BC19].

4 Estimates of future cash flows

4.1 The proposed impairment model requires an entity to estimate expected cash flows over the remaining life of a financial asset, using current cash flow information at each measurement date [paragraphs 4 and 6]. It is unclear from the proposed requirement of ‘using current cash flow information at each measurement date’, whether an entity estimates future cash flows based on information prevailing at reporting date or on expectations of future changes beyond the reporting date extrapolated from currently



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available information. That is, under the proposed impairment model it is not clear whether the entity can or must consider trends based on the information available today to make projections about future conditions over the life of loans. For example, should a bank consider the possible impacts of the closing of a factory today when it is estimated that this event will affect factory employees who have borrowed from the bank and will probably lead to lower levels of economic activity that will in turn affect suppliers to the factory who have borrowed from the bank.

4.2 Based on discussions with Australian constituents, there are varying interpretations of using ‘current cash flow information’ to estimate future cash flows. In the case of the example, one view is that there is no observable data in relation to default payments, and therefore impairment losses should not be recognised. A second view is that, based on historical evidence, the closing of the factory is the observable evidence that future cash flows on loans to the factory employees and suppliers will be affected. A third view is similar to the second view, except that historical evidence shows that the closing of the factory also leads to lower levels of general economic activity. The AASB considers that the second and third views are consistent with the notion of the IBNR approach to impairment. The AASB suggests that the IASB provide clarification about the scope of current cash flow information, as this is critical to achieving consistency of application.

4.3 The AASB notes that the FASB ED proposes that:

42 ... an entity shall consider all available information relating to past and events and existing conditions and their implications for the collectability of the cash flows attributable to the financial asset(s) at the date of the financial statements. These conditions encompass both economic conditions and factors specific to the borrower or issuer of a financial asset that exist at the date of the financial statements. An entity shall incorporate into the impairment assessment the effect of those known conditions and factors in developing estimates of cash flows expected to be collected for financial assets over the remaining life of the assets. In estimating cash flows expected to be collected for its financial assets at each reporting date, an entity shall assume that the economic conditions existing at that point in time would remain unchanged for the remaining life of the financial assets.



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The AASB considers that the FASB proposals would be helpful in the context of the IASB proposed expected impairment loss model in identifying relevant cash flows for both initial and subsequent impairment assessments. The AASB also considers that the FASB guidance (in paragraph 42 of FASB ED) would be helpful in the context of an incurred loss model based on the notion of IBNR.

5 Impact on non-financial institutions

- 5.1 The AASB notes 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 generally on generating revenue from selling goods and services, not on generating interest revenue. Credit provided to customers by non-financial institutions is generally incidental to the sale of goods and services.
- 5.2 Accordingly, the proposed model, which deals with impairment through a revenue recognition methodology, is unlikely to be suitable for them 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 the AASB that they would separately analyse the revenue generating functions and credit risk aspects of the businesses of non-financial institutions.
- 5.3 The AASB acknowledges that the IASB identifies [at paragraphs B15 to B17] 'practical expedients' that an entity may apply in calculating amortised cost if the overall effect is immaterial. However, the AASB considers that the proposed model, even taking into consideration the practical expedients, would add a layer of complexity to the preparation of financial statements that is not warranted for entities whose main business involves activities that are not lending. The AASB is 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.



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5.4 The AASB appreciates 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. The AASB supports this notion and regards the inappropriateness of the proposed impairment model for financial assets, such as trade receivables, as another reason for not supporting the model for application to any financial assets.

6 Costs of implementing the proposed model

- 6.1 The IASB has acknowledged that the proposed approach will pose significant operational challenges [paragraph BC29]. However, the IASB seems to have deduced that the proposed impairment model, based on expected cash flows, reflects the manner in which lenders price loans, or is a rational basis on which lenders should price loans [paragraph BC31].
- 6.2 The significance of this presumption is it implies that, even if the proposed impairment model would be costly to implement, it would be of benefit to those entities applying it because it is (or should be) the basis on which they operate their businesses. The AASB considers that this is unlikely to be the case for most lenders. Although the primary benefits of concern to standard setters are those that might accrue to users of the financial statements (and the AASB questions whether the proposals offer any such benefits elsewhere in this submission), the significance of the costs to entities of implementing the proposed impairment model might be such that the outcome of any cost-benefit test would turn on whether the implementing entities would gain any benefit from using the model.
- 6.3 The comments received from Australian constituents suggest that many banks and other financial institutions do not generally use a model such as the proposed impairment model in pricing of their loans, and in managing their net interest margin and credit risk. Smaller financial institutions in particular are often ‘price takers’ and the level of analysis that they need to undertake in operating their businesses would not involve the types of cash flow estimates contemplated in the proposed impairment model. Even the larger, more sophisticated, financial institutions have noted that they consider the analysis of impairment and revenue recognition to be two separate functions and that the proposed impairment model does not correspond to the manner in which they operate their businesses.



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6.4 The AASB was informed that, on average, the costs that each of the major Australian banks faced in implementing changes to their information systems for the purpose of adopting IAS 39 as part of the adoption of IFRSs in 2006, was approximately A\$10 million to A\$15 million. The impairment model utilised by Australian banks prior to the adoption of IFRSs was generally based on IAS 39 and US GAAP. Accordingly, the extent of the changes required to be implemented, while significant, did not represent a complete change of all accounting policies. Therefore, the magnitude of the costs that might be involved in implementing the IASB's proposed impairment model are likely to be at least as significant as the costs incurred in adopting IAS 39 in 2005/2006.

7 AASB position

7.1 The AASB does not support the IASB's proposed impairment model using an expected cash flow approach. The AASB believes it is evident from having observed 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)]. Anecdotally, Australian and New Zealand banks appear to have provided for losses earlier than many of their North American and European counterparts, although the different degrees to which various banks have actually been exposed to problem loans makes this difficult to assess with any certainty. The AASB notes the criticism of the existing incurred loss model that "... it is not always clear when the loss event took place" [paragraph BC11(d)] is borne out by the anecdotal evidence of diverse application of the existing IAS 39 requirements. However, the AASB believes that the proposed requirement to project expected cash flows is likely to involve significant subjectivity that will give rise to a similar or possibly greater level of diversity.

7.2 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. Accordingly, it may be premature to conclude that the incurred loss model is 'broken' internationally, and it is perhaps more accurate to say that the existing incurred loss model needs to be revised or further clarified to achieve earlier loss recognition and greater consistency in its application. Many Australian and New Zealand banks have a practice of considering general information about the economic environment, such as rates of unemployment,



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rates of employment participation, asset price inflation and rates of economic growth, in order to infer the occurrence of specific events that give rise to credit losses.

- 7.3 Accordingly, the AASB is not convinced that a completely new impairment model based on expected losses would resolve the issue of at least some entities having under-provisioned for losses. There may be much to be learned from examining the manner in which some banks—including Australian banks—apply the existing incurred loss model, particularly those that appear to have adequately provisioned before, during and after the credit crisis. In saying that, the AASB is of the view that Australian banks appear to have implemented the incurred loss model using a notion of IBNR losses. Accordingly, the AASB is doubtful that the proposed impairment model would be likely to produce any significant change in the quantum of provisions among Australian banks at this stage.
- 7.4 The AASB would prefer to retain a form of incurred loss model, with modifications that better explain the extent to which forward-looking information is employed in the estimates of incurred losses. The AASB considers that an incurred loss model would better reflect a cost-based measurement, consistent with the notion of ‘amortised cost’ under IFRS 9, and consistent with the alternative views of Robert P Garnett and James J Leisenring [paragraph AV6, Basis for Conclusions].
- 7.5 Specifically, the AASB proposes the following modifications to the application of the incurred loss model in IAS 39 to enable a broader range of information to be captured for the assessment of impairments:
- (a) clarify the meaning of ‘incurred’ loss, and for the reasons set out in Section 1.2, consider expanding the notion of ‘incurred’ to cases of IBNR type events. The AASB recommends including an example of an IBNR event, similar to the example provided in paragraphs 4.1 and 4.2 of this Appendix, as guidance to the application of the notion of ‘incurred’;
 - (b) in paragraph 9 of IAS 39, under the definition of effective interest method, remove the reference to ‘... but shall not consider future credit losses’;
 - (c) in paragraph 59 of IAS 39, remove the reference to ‘Losses expected as a result of future events, no matter how likely, are not recognised’; and
 - (d) in paragraph 63 of IAS 39, remove the reference to ‘... (excluding future credit losses that have not been incurred)... .



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- 7.6 A further advantage of keeping the incurred loss model, is that it reduces the lead time to adopt a new impairment model and poses fewer changes and costs to modify entities' existing information systems.
- 7.7 If the IASB proceeds with the proposed impairment model, the AASB encourages the IASB to consider a measurement model with clear measurement attributes, even if it combines cost and fair value, to be articulated in the final standard. The AASB considers that the measurement basis is not clear under the proposed impairment model and that it might result in varied interpretation of impairment assessments—and would not be an improvement on the current impairment model.

8 Disclosure

- 8.1 Overall the AASB received encouraging feedback from Australian constituents, including preparers and users of financial statements, on the proposed disclosures. The AASB is also supportive of the IASB's view that, irrespective of the impairment model being used, disclosure of information about the credit quality of assets, and any inputs and assumptions used for determining impairment should be mandated [paragraph BC53]. In particular, the AASB supports the IASB proposals to require:
- (i) an allowance account showing the reconciliation of changes in credit losses during the period [paragraph 15]. This information is consistent with the principle of providing meaningful information about the quality of assets. The AASB would expect that a succinct reconciliation that shows movements of credit losses, including any write-offs, to be helpful for users to appreciate the credit standing of assets. Furthermore, the mandatory use and disclosure of an allowance account would promote consistency compared with the present IAS 39, which requires disclosure which varies depending on the entity's accounting policy;
 - (ii) information that explains estimates and changes in estimates pertaining to the impairment model [paragraphs 16, and 17(a) to 17(d)]. This information is important to an understanding of judgements that need to be made in determining credit losses. However, the AASB notes that this proposed requirement may duplicate paragraph 125 requirement of IAS 1 *Presentation of Financial Statements* requirement to disclose information about the assumptions made on estimates of uncertainty. The AASB considers that, if the IASB proposes the same disclosure requirement about 'estimates of uncertainty' relating specifically



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to financial assets at amortised cost, that requirement, and an explanation about the relationship with the IAS 1 requirement, would be best located in IFRS 7 *Financial Instruments: Disclosure*; and

- (iii) 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 [paragraphs 21(a) and 21(b)]. Providing commentary on the interaction may be onerous, however the AASB believes it is important in justifying the quality of assets and to provide context to management's expectations of credit losses.

8.1 Credit loss development

8.1.1 The AASB has been informed that, disclosures on the 'comparison between the development of credit loss allowance over time and cumulative write-offs' (loss development disclosure) may provide useful information to users about the reliability of management's estimates and establish some discipline on managements to apply reasonable assessments of credit loss allowances. However, the AASB has been informed that historical data is generally not stored by Australian financial institutions in the manner that would readily enable the information proposed in paragraph B24 to be prepared. As such, entities may face significant challenges and increased costs to establish and maintain the information systems that would be required.

8.1.2 The AASB notes 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]. The AASB acknowledges that there are benefits to providing such information, for example, in showing an entity's 'track record' in estimating credit losses. The AASB 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



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terms, tracking the claims experience on the basis of yearly cohorts is relatively straightforward.

8.1.3 Accordingly, the AASB is 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. Therefore, the IASB should reconsider proposing this disclosure requirement on the basis that the cost to provide this information might significantly outweigh its benefits. Alternatively, the AASB considers that it may be appropriate to only require information on historical loss rates¹³ by limiting the requirement to those circumstances in which 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 *Operating Segments* paragraph 5(b).

8.2 Stress testing

8.2.1 In paragraph BC60, the IASB comments that disclosure about stress testing is useful and could enhance the disclosures about the effect of assumptions and reasonably possible alternative assumptions. The AASB appreciates 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, the AASB is 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, the AASB has 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, the AASB suggests 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.

¹³ Commonwealth Bank Australia, *Full year results: Analyst presentation*, pages 100-101, August 2009.



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8.2.2 The AASB considers other types of information, for example, about the sensitivity of assets to changes in the business environment that are currently required in IFRS 7 and the proposals in paragraphs 17(a) to 17(d), would provide sufficient context for assessing the effects of assumptions.

8.3 Vintage information

8.3.1 The AASB questions the reasons provided in paragraph BC62 for proposing disclosures about financial assets based on their year of origination and year of maturity.

BC62 The Board was also informed that information about origination and maturity of financial assets (often called ‘vintage’ information) is useful information because:

- (a) it allows users to assess credit risk that is associated with particular vintages; and
- (b) it facilitates the analysis of the quality of the lending business that users of financial statements perform.

8.3.2 The AASB understands 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. The AASB also notes 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. The AASB suggests that disclosures based on management’s expectations about the ‘expected life’ of assets would be more meaningful information to users.

8.3.3 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.



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8.4 Underlying principles for disclosures

8.4.1 Overall, the AASB considers that the type of information that might be disclosed should support the information that is presented on the face of the financial statements.

Furthermore, the AASB considers that the principle of ‘through the eyes of management’—that is, information that is reviewed regularly by the entity’s CODM—should be considered in formulating disclosure requirements.

8.4.2 The AASB suggests that the IASB reviews all of its existing and proposed disclosure requirements that affect financial assets, including the disclosure requirements of IFRS 7, in light of the type of information that banks use in managing their loan portfolios and the types of information they present to analyst briefings. For example, a number of Australian banks present ‘coverage ratios’¹⁴ in the material they provide to analysts showing cumulative provision balances as a proportion of credit risk weighted assets or non-performing assets, to indicate the extent to which the bank has provided against the troubled parts of its loan portfolios.

¹⁴ For example, Commonwealth Bank Australia, *Full year results: Analyst presentation*, page 45, August 2009.

**IASB Exposure Draft ED/2009/12 *Financial Instruments:*
*Amortised Cost and Impairment***

AASB specific comments

The AASB provides the following responses to the IASB's ED/2009/12.

IASB ED Question 1

Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

The AASB considers the objective of amortised cost measurement in the ED/2009/12 unclear.

Refer to Section 1 of Appendix A for an explanation of the AASB's view.

IASB ED Question 2

Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

The AASB considers that the proposed impairment model is not consistent with an amortised cost measurement basis.

Refer to Sections 1 and 7 of Appendix A for the AASB's reasons and suggestions.

IASB ED Question 3

Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

The AASB believes that any principle-based standard should be accompanied by application guidance, particularly when it introduces significant change to existing accounting practices. Furthermore, the AASB considers that the standard should be accompanied by examples that help constituents in migrating from their existing impairment models. The AASB notes that the FASB has provided illustrative examples in its Exposure Draft in addition to application guidance and the AASB observes that those examples have helped members to understand the proposed requirements.



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IASB ED Question 4

- (a) **Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?**
- (b) **Are there any other measurement principles that should be added? If so, what are they and why should they be added?**

The AASB does not agree with the measurement principles set out in ED/2009/12 on both conceptual and practical grounds.

Refer to Sections 1 to 7 of Appendix A for an explanation of the AASB's views.

IASB ED Question 5

- (a) **Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?**
- (b) **Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?**

The AASB agrees with the proposed objective of presentation and disclosure in ED/2009/12 and believes that it is appropriate for financial instruments measured at amortised cost, irrespective of whether the IASB proceeds with the proposals.

IASB ED Question 6

Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

The AASB does not support the proposed presentation requirements.

Refer to paragraphs 2.2.4 and 2.3.1 to 2.3.6 of Appendix A for an explanation of the AASB's views and recommendation.

IASB ED Question 7

- (a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?**
- (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?**

Overall, the AASB is generally supportive of the proposed disclosures. However, the AASB has reservations about specific proposed disclosures.

Refer to Section 8 of Appendix A for an explanation of the AASB's views and alternative disclosures the AASB would prefer.

IASB ED Question 8

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

In the event that the IASB progresses its proposals, the AASB believes that there should be a lead-time of at least three years between the date of issue and the mandatory effective date, with early adoption permitted, in order to accommodate a smooth transition to IFRSs.

IASB ED Question 9

- (a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?**
- (b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?**
- (c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 13) please describe why and to what extent.**

If the IASB pursues its proposals, the AASB notes the IASB's rejection of both fully retrospective and fully prospective applications of the proposed impairment model for the reasons outlined in paragraphs BC69-70. However, the AASB considers that the proposed transition approach seems to approximate a fully retrospective application and would involve



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entities in considerable effort in calculating approximations of credit loss-adjusted effective interest rates.

In principle, the AASB agrees with the proposed transition approach as a basis for providing comparable information from the time of first application, subject to an impracticability override. The AASB also recommends that guidance in the form of illustrative examples on the approximation of effective interest rates should be included in the final standard.

In the event that retrospective application is impracticable, the AASB would support an opening balance transition adjustment.

IASB ED Question 10

Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

The AASB agrees with the proposed disclosure requirements in relation to transition.

IASB ED Question 11

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

Generally, the AASB agrees that the proposed guidance on practical expedients is appropriate. Refer to Section 5 of Appendix A for specific AASB's views and recommendation.

IASB ED Question 12

Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

Refer to Section 5 of Appendix A for AASB's views on additional guidance on practical expedients.