

Regulation Impact Statement

**Revision to AASB 9 *Financial Instruments*
relating to impairment of financial instruments
measured at amortised cost
and aspects of classification and measurement**

December 2014



Australian Government

**Australian Accounting
Standards Board**

Regulation Impact Statement

Revision to AASB 9 *Financial Instruments* relating to impairment of financial instruments measured at amortised cost and aspects of classification and measurement¹

Introduction

Why Accounting Standards Exist

- 1 Accounting standards exist to facilitate the preparation of high-quality and consistent general purpose financial statements that convey useful information about the financial position and performance of reporting entities, for example, companies, not-for-profit entities and governments. General purpose financial statements are used by investors, securities analysts and other members of the public interested in resource allocation.
- 2 Without standards investors and other users of financial statements could be expected to incur additional costs associated with obtaining, understanding and verifying the relevance of financial information. With standards these costs to users are reduced, but the costs of preparing financial statements are generally borne by the reporting entities, and include costs of understanding possibly complex standards, keeping up to date with changing standards, and developing and maintaining information systems capable of producing the relevant information. Common standards can also benefit the entities themselves where they give rise to increased confidence in financial statements among investors and lenders and this results in lower risk premiums and lower cost of capital. The extent to which this results in a more efficient allocation of resources, and therefore provides for a net benefit, depends on a range of assumptions, including those around transaction costs for investors and the costs of capital [refer to the section ‘Keeping Australia IFRS compliant’].
- 3 Australia has mandated a single set of accounting standards to be applied by reporting entities on the basis that the net benefit of mandated standards is considered to lead to better financial reporting and better overall economic outcomes than would emerge in the market in the absence of standards. This is accepted wisdom in all developed economies, but is dependent on there being a sound and thorough standard-setting process.²
- 4 Despite the general benefits to entities provided by standards there can be occasions where, under voluntary compliance, an entity would have reason to choose not to

1 The revision has involved making three standards:

- * a new principal version of AASB 9 Financial Instruments (2014);
- * AASB 2014-7 *Amendments to Australian Accounting Standards arising from AASB 9 (December 2014)*, which makes consequential amendments to other standards; and
- * AASB 2014-8 *Amendments to Australian Accounting Standards arising from AASB 9 (December 2014) – Application of AASB 9 (December 2009) and AASB 9 (December 2010)*, which makes consequential amendments to other versions of AASB 9.

2 For example, see Financial Accounting Foundation, *Overview: Accounting & Standards*, USA – accessed in December 2014 at:
<http://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1351027541272>

follow the standards, which has the potential to undermine confidence across the board.

- 5 Although Australia has had a robust standard-setting process since the 1980s, the AASB has also had a long association with accounting standard-setting at an international level, and from 2000 the international standard setting process underwent a complete reform and professionalisation, which prepared the way for jurisdictions to adopt International Financial Reporting Standards (IFRS).³

Why Australia adopted international standards

- 6 Australia adopted IFRS in 2005.⁴ The main benefits of international adoption were identified at the time to include:
- (a) removing barriers to international capital flows by reducing differences in financial reporting requirements for participants in international capital markets and by increasing the understanding by foreign investors of Australian financial reports;
 - (b) reducing financial reporting costs for Australian multinational companies and foreign companies operating in Australia and reporting elsewhere;
 - (c) facilitating more meaningful comparisons of the financial performance and financial position of Australian and foreign public sector reporting entities; and
 - (d) improving the quality of financial reporting in Australia to best international practice.⁵
- 7 The European Union countries also adopted IFRS in 2005. In the years since, more than 100 jurisdictions have elected to apply IFRS.⁶ Consequently, the benefits noted above have been enhanced as more jurisdictions have adopted IFRS.

What this RIS is about

- 8 This RIS is about changes to the accounting policy for loan impairments (losses) in general purpose financial statements.

What is the problem to be solved?

- 9 Under the current international accounting standards (and Australian accounting standards) loan losses are accounted for using an incurred loss model. This means that losses on assets are recognised when those losses occur.
- 10 The remainder of this section is in two parts: identification of the international problem and the Australian problem.

3 For more background on this development, see, for example:

<http://www.iasplus.com/en/resources/ifrsf/history/resource25>, accessed in December 2014.

4 As directed by the Financial Reporting Council in its 2002 directive to the AASB, see Financial Reporting Council Bulletin 2002/4 – 3 July 2002 Adoption of International Accounting Standards by 2005.

5 Source: AASB Policy Statement PS 4 *International Convergence and Harmonisation Policy*, April 2002, available at http://www.aasb.gov.au/admin/file/content102/c3/ACCPS4_4-02.pdf, accessed 2 December 2014

6 For further information, see: <http://www.ifrs.org/Use-around-the-world/Pages/Jurisdiction-profiles.aspx> -- accessed in December 2014.

The international problem

- 11 The G20 considered that this model can result in impairments (that is, value reducing impacts on assets) being recognised ‘too late’ for the purpose of understanding the financial position of the entity going forward. That is, financial asset impairments in financial reports have tended to be a lagging indicator of asset quality because the extent to which a loan portfolio is impaired may only become apparent well after the credit quality of those loans has deteriorated.
- 12 Under the existing incurred loss model, the lending entity needs to identify an event or events that have already occurred before recognising an impairment (for example, an event such as a borrower being more than 60 days late on a loan payment). This is in contrast with the fact that, generally, at the outset lenders do not expect all borrowers to pay all the interest on all loans or pay back all the loan principal. That is, for example, a bank that provides 1,000 loans to 1,000 borrowers to buy houses does so in the knowledge that it expects some of those lenders to default.
- 13 ‘Too late’ is the term that has been used to describe the recognition of a loss after it is known that the probability of a loss on an asset has increased.
- 14 A problem with losses being recognised ‘too late’ is that, on some occasions, some investors may not have as complete of a picture about the credit-worthiness of financial assets held by an entity as they could. This may result in some instances where investment decisions are being made that would have been different if more complete information had been available.
- 15 The number of investors who have made erroneous investment decisions because of the incurred loss model is not clear, given that there is other publicly available information that would also have been used to make an assessment of an entity’s financial position, including the extent of loan impairment.
- 16 The late recognition of loan losses by banks and similar financial institutions was identified by the G20 as a contributing factor to the Global Financial Crisis of 2007-2008. One element of that late recognition was attributed to the incurred loss model requirements in IAS 39.⁷
- 17 In brief, the G20’s concern was that late recognition of loan losses meant that investors, regulators and others were not alerted soon enough to the looming debt crisis. The G20 was effectively seeking greater market transparency around the reporting of loan losses.
- 18 Having said this, there were a number of factors contributing to the GFC and it is not entirely clear how central accounting standards were to this event.

7 Regulatory Reform Post the Global Financial Crisis: An Overview, Kevin Davis, Australian Centre for Financial Studies, University of Melbourne, page 18 – accessed November 2014 at: http://www.apec.org.au/docs/11_CON_GFC/Regulatory%20Reform%20Post%20GFC-%20Overview%20Paper.pdf

19 In response to these, and other, issues, the International Accounting Standards Board (IASB) developed International Financial Reporting Standard (IFRS) 9.⁸

20 In short, IFRS 9 requires that entities recognise losses on assets on an expected basis rather than an incurred basis (an outline of how this works is discussed in the options section).

The Problem in Australia

21 While Australia did not experience significant issues with the quality of loan assets during the GFC to the extent that occurred in many other jurisdictions, as Australia has adopted international financial reporting standards the underlying problems associated with the incurred loss model still exist.

22 As Australia has experienced relatively good economic conditions for a long time it is difficult to know what the precise magnitude of the problem in Australia is as it relates to accounting for assets. However, there is a risk that, if faced by comparable circumstances to those leading to the GFC, the accounting standards in Australia could result in similar issues to those identified internationally. The likelihood of these risks materialising is not known, nor is the expected cost of these risks if they did materialise.

23 In addition the IASB has sought to address some technical issues with IFRS 9, outlined below.

The need for simplification

24 There are two forms of the incurred loss model for impairment accounting under IAS 39 (AASB 139) – one that applies to financial instruments measured at ‘amortised cost’ and another that applies to financial instruments measured at ‘fair value through other comprehensive income’ (FVTOCI).⁹

25 Maintaining two forms of an impairment model creates costs for entities because they need to maintain two sets of processes, which can involve two completely separate information systems needing to be maintained and training new staff on two processes rather than just one. It also involves even experienced staff in having to analyse which type of instrument they are dealing with before being able to apply the relevant impairment model.

26 Entities would prefer to only have to apply one impairment model. The expected loss model would apply to financial instruments classified and measured at amortised cost or at FVTOCI.

8 The Financial Crisis Advisory Group report of 2009 provides a significant amount of detail on the various reasons behind the GFC – refer to: <http://www.ifrs.org/News/Press-Releases/Documents/FCAGReportJuly2009.pdf> -- accessed in December 2014.

9 Impairment models are not needed for financial assets measured at fair value through profit or loss (FVTPL), because the fair value movements (that would include impairments) would automatically already be recognised in profit or loss.

Classification and Measurement

- 27 There has been an adverse reaction from a broad range of constituents to an earlier change in IFRS 9 to remove the FVTOCI class of financial instruments that exists in the superseded IAS 39 (and AASB 139). Those constituents consider that there is a place for FVTOCI accounting for certain types of instruments that are generally managed for their contractual cash flows, but may be sold before maturity if the relevant opportunities arise.
- 28 The current revision to IFRS 9 (and AASB 9) effectively reinstates a FVTOCI classification and measurement.

Keeping Australia IFRS compliant

- 29 A consequence of the IASB issuing the completed version of IFRS 9 is that the AASB has to incorporate that standard into Australian accounting standards if Australian entities are to be able to continue to claim that their financial statements prepared in accordance with Australian accounting standards are also simultaneously prepared in compliance with IFRS.
- 30 If Australia were to become a non-IFRS compliant jurisdiction the following subparagraphs outline the likely costs.
- (a) The cost of capital for Australian businesses may be higher because not being IFRS compliant may lead to greater uncertainty about Australian entity financial reporting in international capital markets, which in turn may add an uncertainty premium to Australian entities' borrowing costs in international markets. That may have a spill-over effect on domestic borrowing costs because most major Australian banks and other lenders source a material percentage of their funds overseas and because domestic borrowing rates may be impacted by demand impact of higher overseas borrowing costs.¹⁰
 - (b) Entities applying Australian accounting standards that wish to access international capital markets (for example, US capital markets) are likely to be asked to provide either an IFRS set of financial statements, or a statement reconciling their Australian financial statements to IFRS. In this context, it is noted that existing Australian accounting standards require entities that comply with IFRS to make an unreserved statement of such compliance,¹¹ which would mean that each Australian entity would need to go to the effort of determining

10 Various research has been conducted on the benefits of IFRS adoption on entities' cost of capital. For example, see:
Kim, J-B., Shi, H. and Zhou, J. (2013), "International Financial Reporting Standards, institutional infrastructures, and implied of cost of equity capital around the world", *Review of Quantitative Finance and Accounting* 42(3):469-507
Covrig, M., Defond, M. and Hung, M. (2007), "Home Bias, Foreign Fund Holdings, and the Voluntary Adoption of International Accounting Standards", *Journal of Accounting Research* 45(1):41-70.
Li, S. (2010), "Does mandatory adoption of International Financial Reporting Standards in the European Union reduce the cost of equity capital?", *The Accounting Review* 85(2): 607-636.
Also see the 24 October 2005 IFRS Regional Policy Forum speech by Chris Pearce, Parliamentary Secretary to the Treasurer: "The importance of cross-border cooperation in an environment of global capital markets".

11 AASB 101 *Presentation of Financial Statements* (IAS 1), paragraph 16

whether or not, in its particular circumstances, it complies with IFRS. (That is, an entity would need to determine whether the fact that AASB 9 is not the same as the completed version of IFRS 9 has had an impact on the entity's compliance status.)¹²

- (c) In the long term, systems costs would be expected to be higher because Options 2 and 3 would mean that Australian entities would need to acquire or build systems that are different from those used in other parts of the world. It would probably not be feasible to acquire 'off-the-shelf' products from international markets. Furthermore, it may not be feasible to acquire offshore accounting services, or acquiring such services would involve paying a premium to cater for the Australian accounting policy on financial instrument impairment.¹³
- (d) Entities with international operations would need to maintain two sets of financial records in respect of financial asset impairment, which would be costly in terms of systems, labour costs and auditing.¹⁴ This applies to foreign-based banks operating in Australia and to Australian banks operating overseas. For example, most of the large Australian banks have substantial operations overseas, particularly in New Zealand. New Zealand has already adopted the completed version of IFRS 9.
- (e) In the long term, accounting education costs would be expected to be higher in Australia because both IFRS and the Australian accounting treatments of financial instrument impairment would need to be taught. This would be the case for university courses and for post-graduate training provided within accounting firms (which are generally international and roll out international training programs) or training acquired from third-party providers (many of which roll out international training programs).
- (f) In the long term, audit costs would be expected to be higher because Options 2 and 3 would mean that the many auditing firms that roll out auditing systems internationally would need to develop and maintain separate Australian systems to cater for the auditing of financial instrument impairment.¹⁵

12 For example, foreign issuers can lodge IFRS-compliant financial statements with the US Securities and Exchange Commission with no need for a US GAAP reconciliation. See: RIN 3235-AJ90 Acceptance from foreign private issuers of financial statements prepared in accordance with International Financial Reporting Standards without reconciliation to GAAP at <http://www.sec.gov/rules/final/2007/33-8879.pdf>

13 In respect of some of the potential systems implications of IFRS adoption see: "Technology implications of IFRS adoption for U.S. companies", Deloitte, 2008
<http://www.iasplus.com/en/binary/usa/0808ifrstechology.pdf>

14 For example, see:
Tweedie, D. and Seidenstein, T.R. (2005), "Setting a Global Standard: The Case for Accounting Convergence", *Northwestern Journal of International Law & Business* 25(3): 589-608.
<http://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1609&context=njilb>
Deming, H.S. (2005), "International Financial Reporting Standards: Their Importance to U.S. Business and Legal Practice", *Michigan BAR Journal* 84(12): 14-17.
<http://www.michbar.org/journal/pdf/pdf4article944.pdf>

15 For example, see: Campbell, K. and Helleloid, D. "Implications of IFRS Adoption on the Organization and Human Resource Management Practices of Global Firms", *Journal of International Business Research*, January 2011.

- (g) In the long term, staff costs are expected to be higher because Options 2 and 3 would mean that staff from overseas who are expert in financial asset impairment would not be readily transferable into the Australian environment. Similarly individuals who have worked in the Australian environment with expertise in financial asset impairment would be adversely affected because they would not be able to readily transfer their skills to positions in other jurisdictions.¹⁶

The above qualitative costs are widely acknowledged; however, the magnitude of the above costs is not known.¹⁷

Why is government action needed?

- 31 As Government has mandated accounting standards in Australia based on international standards, government action is needed if we are to remain IFRS aligned and to address the identified problems with the current standards.
- 32 The objectives of government action are to have accounting standards that contribute to Australian reporting entities making available financial information that allows users to make informed resource allocation decisions and facilitates the Australian economy.¹⁸

What policy options are being considered?

- 33 This RIS identifies the following three actions available to the AASB and the extent to which each of those options would achieve the objectives of:
- (a) maintaining the ability of Australian entities to claim that their financial statements are prepared in compliance with IFRS; and
 - (b) improving the requirements in Australian accounting standards for recognising loan impairments.

16 For example, see: Wells, M. “The Global View”, *IFRS Now*, Issue 3, KPMG, 2010

17 Effects Analysis Consultative Group – Report to the Trustees of the IFRS Foundation, November 2014 – see especially paragraphs 48 to 58 and paragraphs 136 to 143.

18 These are among the objectives of Part 12 of the *Australian Securities and Investments Commission Act 2001*, which is the AASB’s enabling legislation.

Option	Description
Option 1 – Replace incurred loss model with the expected loss model in IFRS 9	This option would replace the existing section of AASB 139 on loan impairment with the requirements of IFRS 9, which would be adopted into Australian accounting standards as part of AASB 9.
Option 2 – A domestic (Australian) expected loss model	This option would involve the AASB in replacing the incurred loss model in AASB 139 with its own expected loss model, which was outlined as part of an AASB submission to the IASB in response to the IASB Exposure Draft ED/2013/3 <i>Financial Instruments: Expected Credit Losses</i> in 2013. The AASB would need to consult with participants in the Australian financial reporting system before finalising this model.
Option 3 – Existing incurred loss model in AASB 139 (<i>status quo</i>)	This option would retain the incurred loss model in AASB 139. Under this option, entities would continue to apply their existing accounting policies to account for loan impairment.

Overview of Option 1

- 34 This option would implement an expected loss rather than incurred loss model for assets.
- 35 In general, if the credit risk on a loan asset (or portfolio of loan assets) has not increased significantly since initial recognition, an entity must recognise a loss allowance for that asset (or portfolio of assets) at an amount equal to the ‘12-month expected credit losses’. The 12-month expected credit losses are the portion of lifetime expected credit losses that represent the credit losses expected to result from default events on a loan asset (or portfolio of loan assets) that are possible within the 12 months after the reporting date. [For example, 12-month expected credit losses would include the credit losses expected to result from a rise in unemployment that is considered likely to occur over the next 12 months.]
- 36 In general, if the credit risk of a loan asset (or portfolio of loan assets) has increased significantly since initial recognition, an entity must recognise a loss allowance for that asset (or portfolio of assets) at an amount equal to the ‘lifetime expected credit losses’. In making that determination, the entity needs to consider all reasonable and supportable information, including forward-looking information. Lifetime expected credit losses are the credit losses expected to result from all possible default events over the expected life of a loan asset (or portfolio of loan assets). [For example, lifetime expected credit losses would include the credit losses expected to result from a rise in unemployment that is considered likely to occur over the life of the loans held.]
- 37 Credit losses (impairments) are recognised as expenses in profit or loss, and reversals of credit losses (impairments) are recognised as gains in profit or loss.

38 Entities need to determine whether or not there are significant increases in credit risk by comparing the risk of a default occurring on the loan asset (or the portfolio of loan assets) as at the reporting date with the risk of a default occurring as at the date of initial recognition. In doing this, an entity must consider reasonable and supportable information, that is available without undue cost or effort, and that is indicative of significant increases in credit risk since initial recognition.

Overview of Option 2

39 The AASB has considered an alternative model. This is based on the principle of recognising expected but not reported losses that reflect a change in an entity's financial asset credit risk assessment based on whether the same or similar pricing (credit terms) of the financial asset would continue to be accepted if the instrument were issued at the reporting date.

40 The AASB's suggested alternative model would not require any day-one loss recognition. An entity would assign a credit risk grade for each of its borrowers/debtors and every financial instrument subject to impairment would have a loss allowance subsequent to initial recognition reflecting changes in the borrowers'/debtors' credit-risk gradings since initial recognition or last re-assessment.

41 If an entity were to purchase or reissue a loan asset (or a portfolio of loan assets), and the entity would continue to accept the same or similar pricing (credit terms) with the knowledge of its borrower's/debtor's change in credit risk at that point in time, it could be assumed that there has been only an insignificant change in credit quality. Conversely, if an entity would not continue to accept the existing pricing (credit terms) to the extent that the entity would modify the pricing or credit terms of the asset to reflect the change in credit risk (or, in some circumstances, the entity might no longer continue its business relationship with the borrower/debtor), it is probable that there has been a significant change in credit risk. Such a change would trigger recognition of further expected credit losses.

Overview of Option 3

42 Option 3 would be to retain the existing requirements in AASB 139. Under this Option, entities would continue to apply the incurred loss model.

What is the likely net impact of each option?

Affected parties

43 The options are expected to directly impact on banks and similar financial institutions that prepare general purpose financial statements and must comply with the financial instruments standard.

44 It is also expected to affect the users of the financial statements of banks and similar financial institutions, such as:

- (a) existing and potential resource providers (including investors, creditors and employees);
- (b) participants in the Australian capital markets;

- (c) parties performing a review or oversight function (including analysts, Australian Securities and Investments Commission [ASIC], Australian Prudential Regulation Authority [APRA] and Australian Securities Exchange [ASX]); and
- (d) management and governing bodies (including use of these reports in the discharge of accountability).

The net impact of Option 1 – qualitative

- 45 Option 1 would replace the existing section of AASB 139 on loan impairment with the requirements of IFRS 9, which would be adopted into Australian accounting standards as part of AASB 9.

What entities practically need to do to comply

- 46 To comply with the requirements affected entities will need to train their staff in the expected loss model and some entities may need to update their information systems to provide the necessary information. Most of the affected entities are expected to use a mix of internal and external resources to undertake the necessary training and information system updates.
- 47 The affected entities' auditors are also expected to need to train their staff and alter their systems for auditing the outcomes of the expected loss model.

Qualitative assessment of benefits of adopting the completed version of AASB 9 (Option 1)

- 48 The level of impairments of financial assets may be important information to users of financial statements in assessing an entity's financial performance and financial position. The expected loss model may provide some benefits to users of financial statements, including:
- (a) greater comparability and consistency of reporting impairments, particularly across jurisdictions, due to a more robust reporting framework (more below);
 - (b) a better depiction of entities' performance; and
 - (c) improved understanding of impairment losses. In particular, the IFRS 9 expected loss model may provide for earlier recognition of financial instrument impairment and therefore help alert investors, regulators and other users to potentially serious economic problems earlier in an economic cycle.
- 49 Entities preparing financial statements in accordance with Australian accounting standards are also expected to benefit because the completed version of AASB 9:
- (a) provides a more robust framework for addressing impairment issues, which should therefore reduce the uncertainty and diversity associated with some existing impairment practices. While the existing incurred loss model provides

a framework for addressing impairment losses, it lacks the rigour of the expected loss model, which incorporates a greater level of guidance¹⁹; and

- (b) simplify the preparation of financial statements for some reporting entities by having the one impairment model applicable to financial assets measured at either amortised cost or FVTOCI (there are two different impairment models in AASB 139). This may reduce compliance costs for affected entities, especially where they are currently maintaining two systems to record the information.

50 Because the completed version of AASB 9 would incorporate all of the requirements of IFRS 9, issuing the completed version of AASB 9 would ensure that Australia is maintaining its policy of adopting IFRS and, as a consequence, Australian entities preparing financial statements in accordance with Australian accounting standards will be able to continue to claim that their financial statements are simultaneously IFRS compliant. Consequently, issuing the completed version of AASB 9 also benefits the Australian economy more broadly. The benefits to the Australian economy from the adoption of IFRS fall into three broad categories:

- (a) Access to lower costs of capital for Australian businesses because international capital market participants would be expected to charge an uncertainty premium for their capital if an Australian entity's financial statements were prepared on a basis that is different from the standards used internationally. A recent publication noted that "A comprehensive review of nearly 100 academic studies of the benefits of IFRS concluded that most of the studies 'provide evidence that IFRS has improved efficiency of capital market operations and promoted cross-border investment' ".²⁰
- (b) Reduced financial statement preparation costs for both Australian businesses with international subsidiaries that are required by overseas regulators to lodge financial statements in accordance with IFRS and for foreign businesses with Australian subsidiaries that are required to lodge financial statements in accordance with Australian accounting standards.
- (c) The market for accounting-related goods and services has increased in scale and opportunities. Australian businesses and universities are selling accounting professional services, training and education, and other goods and services such as accounting software solutions to international customers and Australian businesses are able to acquire accounting-related goods and services from international providers.

However, there is insufficient information available to assess the significance of these benefits other than in an intuitive sense.

19 For example, see the commentary in: *In Depth – A look at current financial reporting issues*, "IFRS 9 expected credit losses", PwC, 2014 – http://www.pwc.com/en_US/us/cfodirect/assets/pdf/in-depth/us2014-06-ifs-9-expected-credit-losses.pdf – accessed in December 2014.

20 Pacter, P, *IFRS as global standards: a pocket guide* (2014), IFRS Foundation, page 27

Qualitative assessment of compliance costs of adopting the completed version of AASB 9 (Option 1)

- 51 It is expected that most of the banks and similar financial institutions affected will incur costs to implement the completed version of AASB 9 in respect of accounting for impairment losses on financial assets. In broad terms, entities may incur costs in relation to one or more of the following activities in meeting the requirements of the completed version of AASB 9:
- (a) training and education of the staff involved in the preparation of the entity's financial statements and the costs of educating management and investors about the effects of the new standard on the financial statements; and
 - (b) external advice on the application of the new standard;
 - (c) review and revision of contracts, accounting systems and processes to ensure that the entity is capturing the information needed to comply with the expected loss model;
 - (d) the preparation and audit of the entity's financial statements relating to the period of initial application of the expected loss model.
- 52 The above is based on:
- (a) virtually all of the constituents consulted identifying internal training and education as an activity they would need to undertake. This is on the basis that most of the affected entities maintain a team of staff, many of whom are switched between work on financial reporting issues, taxation issues, prudential reporting and other issues connected with information systems on an 'as needs' basis;
 - (b) all those consulted identifying that they would need to hire experts to advise on at least some aspects of the implementation of the completed version of IFRS 9 into their financial reporting and processes;
 - (c) all those consulted identifying upgrades to information systems as being necessary. Some entities considered that they will need to substantively revise their systems, and others considered that already capture much of the relevant information for existing internal management purposes;
 - (d) all those consulted identifying that their staff and their auditors are highly likely to expend additional effort to finalise and audit the financial statements, particularly in the transition year.
- 53 Most of the above activities are expected to be non-recurring because they relate only to initial application of the standard. To mitigate the burden associated with the costs of these activities, a long period has been provided between making the completed version of AASB 9 and its mandatory application to annual reporting periods beginning on or after 1 January 2018. Because the annual reporting periods of many Australian banks and similar financial institutions end on 30 June or 30 September, those entities will not need to apply AASB 9 until the 30 June 2019 or

30 September 2019 financial year ends. [However, as noted elsewhere, entities can choose to adopt AASB 9 for earlier periods.]

- 54 In relation to some of the other start-up costs that entities might incur, information system upgrades tend to be ongoing; and, by having a long implementation period, there is a good chance that any changes required as a result of the new revenue standard can be undertaken in conjunction with other systems changes that may be necessary. Similarly, education and training about reporting requirements among preparers, auditors and users tend to be ongoing; and the long implementation period provides an opportunity to incorporate information on the replacement Standard in that ongoing education and training.
- 55 Some entities applying the completed version of IFRS 9 may incur increased ongoing costs of collecting information to facilitate their use of the expected loss model and maintaining improved systems to be able to recognise and measure expected losses. This is generally because the expected loss model requires a greater level of information to be incorporated in impairment determinations than does the incurred loss model. However, most of the direct feedback indicated that the ongoing costs would be a relatively small fraction of the transition costs (indicative quantitative estimates of these costs are included later in the RIS).
- 56 In light of the feedback received during consultations on the costs of complying with the various proposals put forward over the last five years, many aspects of the expected loss model proposals were modified or clarified to reduce the burden of implementing and applying the requirements. These are outlined earlier in this RIS.

Impacts on reported information

- 57 Other potential costs relate to the flow-on consequences of the expected loss model. For example, there may be at least a once-off impact on reported profits that could affect regulatory or contractual arrangements an entity might have that are based on reported profits.
- 58 Based on discussions with constituents from a variety of entities that will be subject to the revised impairment requirements, only those contemplating early adoption (earlier than reporting periods beginning on or after 1 January 2018) have been able to identify an approximation of the impact. Overall, those entities expect a once-off rise in their impairment loss provisions, which in turn would generally mean a once-off shrinkage in total net assets. However, it is not possible to say that this would be the impact on all entities, because of the differences between them in terms of their business models/product ranges, how they have been applying the incurred loss model and whether their businesses are growing /stable/or in run-off.
- 59 On the basis that many of the relevant entities are likely to be affected and that the general impact will be higher provisions and smaller net assets, there may be a consequential impact on contractual arrangements that entities have in place. These can include employee share schemes that often have hurdle rates for receiving options over shares or being able to exercise options over shares that benchmark to relative reported profits among a peer group of companies. However, these types of impacts are expected to be confined and small in their effect, because these types of

arrangements are periodically reviewed in any case to take account of recent developments in each industry or the performance of the share market more broadly.

60 In terms of potential consequential impacts on existing regulatory arrangements, it is relevant to briefly note the linkages between financial reporting, prudential reporting and tax reporting.

61 In relation to prudential regulation, APRA uses some accounting information as a foundation for its own use in regulation making purposes. When IFRS were first adopted, some entities that had ‘general’ loan loss provisions (that were forward-looking) removed those provisions in favour of only having ‘specific’ provisions that were considered more consistent with the incurred loss model (in IAS 39). At the time, an APRA Paper noted:

Entities will therefore need to reclassify a portion of general provisions as specific provisions (if they are raised to cover incurred and incurred-but-not-reported losses) and/or release the excess provision into retained earnings. This is in effect a reclassification of Upper Tier 2 capital to Tier 1 capital on IFRS adoption, which has prudential implications.²¹

The Paper goes on to note:

For the time being, APRA intends to replicate its current prudential approach to provisioning, in a format that is consistent with IFRS requirements. To achieve this, general provisions will become a reserve within equity.²²

62 Discussions with constituents indicate that in regulatory reporting allowances will be made for the potentially increased provisions that occur under the completed version of IFRS 9, such that they won’t, on their own, result in the relevant entities having to hold more capital. However, other factors may have that impact on the level of capital required, such as APRA’s response to the potentially different type of information that it can derive from the financial reporting under the completed version of IFRS 9, or other government policies that might build on the financial reporting as a result of one or more of the outcomes of the recent Financial System Inquiry.²³

63 In relation to information reported to the Australian Taxation Office (ATO), there is currently an arrangement in place that permits taxpaying entities to choose to use some of their financial reporting information as a basis for the information they lodge with the ATO. It is not expected that the issues resolved in the completed version of IFRS 9 will impact on this regime because the ATO already invokes its own ‘sufficiently certain’ test in relation to losses.²⁴

Re-introduction of FVTOCI classification

64 There has been a long lag time between the issue of previous versions of IFRS 9 (AASB 9) and the mandatory application dates of the those versions of IFRS 9

21 Discussion Paper *Adoption of International Financial Reporting Standards, Prudential Approach: Fair value and other issues*, APRA, 24 February 2005, section 2.7.1.

22 APRA, 24 February 2005, section 2.7.2.

23 Financial System Inquiry Final Report, Commonwealth of Australia, November 2014 – in particular, see page 41.

24 Please see, for example, [https://www.ato.gov.au/Business/Taxation-of-financial-arrangements/In-detail/Overview/Guide-to-the-taxation-of-financial-arrangements-\(TOFA\)/?page=5](https://www.ato.gov.au/Business/Taxation-of-financial-arrangements/In-detail/Overview/Guide-to-the-taxation-of-financial-arrangements-(TOFA)/?page=5)

(AASB 9), which are still in the future. Since the first version of IFRS 9 (and AASB 9) were originally issued in December 2009, very few entities have early adopted IFRS 9 (or AASB 9) – instead they have continued to apply IAS 39 (and AASB 139). And, of those Australian entities that have early adopted AASB 9, AASB staff are not aware of any entities that have been affected by the effective removal of a FVTOCI class of financial instruments through the earlier versions of AASB 9. Accordingly, entities that currently have financial instruments accounted for at FVTOCI under AASB 139²⁵ are generally expected to transition to AASB 9 in future and to continue accounting for them at FVTOCI.

- 65 This latter point is crucial, because it means that the accounting impact of the re-introduction of a FVTOCI class of financial instruments is expected to be largely business as usual.²⁶

The net impact of Option 2 – qualitative

- 66 Option 2 would replace the existing section of AASB 139 on loan impairment with an Australian version of an expected loss model. The practical actions to implement this for affected entities would be similar to option 1.

Qualitative assessment of benefits of adopting an Australian version of an expected loss model (Option 2)

- 67 The qualitative benefits of an Australian expected loss model are expected to be similar to those attaching to the adopting of the completed version of IFRS 9. They would include:
- (a) a better depiction of entities' performance; and
 - (b) an improved understanding of impairment losses. An Australian expected loss model would provide for earlier recognition of financial instrument impairment and therefore help alert investors, regulators and other users to potentially serious economic problems earlier in an economic cycle.
- 68 The benefit compared to Option 1 of not requiring any day-one loss recognition is that it would be closer to the existing incurred loss model (on initial recognition) and, accordingly, might be less difficult to implement than Option 1.

Qualitative assessment of costs of an Australian version of an expected loss model (Option 2)

- 69 The types of costs to implement an Australian version of an expected loss model would be highly similar to those for implementing the completed version of IFRS 9

25 The term used in IAS 39 (and AASB 139) is 'held-to-maturity' financial instruments, but the accounting (FVTOCI) is substantially the same.

26 In terms of any costs that might be incurred in respect of the classification and measurement changes, in the context of the RIS, these are rolled up as part of the costs of implementing the new impairment model. This classification and measurement and impairment changes are inextricably linked because the expected loss model applies to financial instruments measured at FVTOCI. In addition, feedback from the affected entities has been that any implementation costs associated with the classification and measurement changes will generally be indistinguishable from implementation costs associated with the expected loss model

(AASB 9) in respect of accounting for impairment losses on financial assets. In common with Option 1, those costs would include: training and education; external advice on the application of the new standard; a review and revision of contracts, accounting systems and processes to ensure that the entity is capturing the information needed to comply with the expected loss model; and the preparation and audit of the entity's financial statements relating to the period of initial application of the expected loss model. Consistent with Option 1, estimates of the relevant hours that would be required to implement and sustain Option 2 were obtained through consultation with affected constituents.

- 70 The one-off impact on reported profits noted for Option 1 would also apply for Option 2.
- 71 Under Option 2 the benefit of entities being able to state IFRS compliance would be lost. And those benefits of IFRS adoption are wide-ranging and the inability for banks and similar financial institutions to state IFRS compliance may have implications for all types of Australian entities because Australia as a whole would no longer be regarded as an IFRS compliant jurisdiction. This may cause there to be a general uncertainty in world capital markets about the quality of Australian financial reporting, which in turn would mean a generally higher cost of capital for Australian entities in international capital markets. These costs would likely significantly outweigh any benefits the option 2 methodology has over option 1 for Australian businesses.

Impact of Options 1 and 2 – quantitative

- 72 Since the types of compliance costs that are expected to be incurred for Options 1 and 2 are highly similar, the costs for each of these options is considered together.
- 73 The quantitative information in this Regulation Impact Statement relating to Options 1 and 2 is based on the general information and assumptions outlined below.

Types and numbers of entities that will be affected by the expected loss model

- 74 The expected loss model will have a potential impact on any entities that have material amounts of financial assets (mainly loans) that are not measured at FVTPL. The model does not apply to financial assets that are measured at FVTPL. For example, insurers and superannuation entities often hold portfolios of loans and other financial assets as investments and measure them at FVTPL. Consequently, their financial assets would be unaffected by the current revision to IFRS 9 (and AASB 9).
- 75 The main entities to be affected by the current revision to IFRS 9 (and AASB 9) are banks and similar financial institutions. This would include Approved Deposit-taking Institutions, such as banks, credit unions and building societies. It is not expected to have a material impact on Registered Financial Corporations (see discussion below).
- 76 For the purposes of analysis, the population of Australian banks has been divided into two categories; large & medium; and other. This is because the product offerings and therefore the complexity of operations varies between the two categories. Accordingly, the categorisation facilitates the consideration of the costs and benefits of applying the expected loss model.

- 77 The following table shows the number of banks operating in Australia in two size categories – large/medium and other. Large and medium-size banks are those with more than \$5b of assets as at August 2014. Other banks are those with fewer than \$5b of assets as at August 2014.

Table 1: showing Australian banks by total assets²⁷

Category		Number
Large & Medium	Each more than \$5b in assets	20
Other	Each less than \$5b in assets	54
Total		74

Source: Based on Australian Prudential Regulation Authority (APRA) Monthly Banking Statistics August 2014 (issued 30 September 2014)

- 78 The following table shows the categories of non-bank financial institutions that are authorised to take deposits and the total assets for each category as at June 2014.

Table 2: showing Australian financial institutions that are not banks

Category	Total assets for category	Number
Building Societies	\$23b	9
Credit Unions	\$41b	84
Other ADIs	\$7b	7
Total		100

Source: Based on APRA Quarterly Authorised Deposit-taking Institution performance June 2014 (issued 26 August 2014)

- 79 The following table combines the numbers of banks and non-bank financial institutions by size, assuming that all the non-bank entities are relatively small and have a similar product range and level of complexity associated with their operations as the ‘other’ banks, which is regarded as reasonable based on the level of assets shown in Table 2.

Table 3: showing Australian banks and similar financial institutions by total assets

Category		Number
Large & Medium	Each more than \$5b in assets	20
Other	Each less than \$5b in assets	154
Total		174

- 80 Many of the medium and ‘other’ banks and similar financial institutions in table 3 are subsidiaries of other financial institutions. Many of the parent entities of those

27 Includes Specialist Credit Card Institutions.

medium and ‘other’ banks and similar financial institutions are based overseas (in markets where IFRS are adopted).

- 81 The other group of entities that were considered as potentially being affected is Registered Financial Corporations. The following table shows the number of Registered Financial Corporations by category.

Category	Number
Money Market Corporations	28
Intra-group Financiers	13
Exempted Corporations	61
Other	240
Total	342

Source: APRA website²⁸

- 82 Money Market Corporations can be involved in a range of financial services, including: merchant banking (which includes capital raising services, advice on mergers and acquisitions); arranging foreign currency forward contracts and other derivatives; private banking; and securities brokerage.
- 83 Intra-group Financiers can be involved in: leasing; and speciality financing of particular types of assets. Some are very small and have few current operating activities.
- 84 Exempted Corporations can be involved in: assisting other entities with their banking needs (sometimes for a particular group of associated entities, for example, entities associated with a church); providing financial advice on mortgages, insurance, and annuities; managing the issue of a particular series of bonds of another entity; and loan brokerage services. Some are in administration or in the process of being liquidated. Some are very small and have few current operating activities.
- 85 Many Registered Financial Corporations (in all categories) are subsidiaries of other financial institutions operating in Australia (but operate in their own right with their own Australian Financial Services Licence). Many of the parent entities of those Registered Financial Corporations are based overseas (in markets where IFRS are adopted).
- 86 Overall, very few (if any) Registered Financial Corporations are expected to be affected by the completed version of AASB 9 (Option 1) or an Australian version of an expected loss model (Option 2). Furthermore, most of their issues are likely to relate to financial assets that are the subject of practical expedients, and the accounting will be largely business as usual.
- 87 For the purposes of the RIS, the affected entities are therefore taken to be the 174 banks and similar deposit-taking entities, of which, 20 are large or medium in size.

28 <http://www.apra.gov.au/NonReg/Pages/Registered-Financial-Corporations.aspx> – accessed October 2014.

Nature of transitional costs

- 88 The large and medium banks entities are expected to have relatively wide product ranges compared with the other entities. The wider the product range, the greater will be the expected costs of implementing an expected loss model (either Option 1 or Option 2).
- 89 Based on discussions with various constituents, the following table outlines estimates of the transitional costs involved in applying an expected loss model (either Option 1 or Option 2) compared with the status quo. The actual experience of an individual entity could be significantly different from the estimates below.

Transitional activity	Estimated effort/costs (very broadly approximated)
Internal training and education	<p>Banks and similar financial institutions are expected to spend time training staff who are tasked with implementing an expected loss model, including systems personnel and those who manage the data.</p> <p>In respect of both Option 1 and/or Option 2, for each of the large and medium entities this is estimated to be an average of 12,500 labour hours on training and education.</p> <p>In respect of both Option 1 and/or Option 2, for each of the other entities this is estimated to be an average of 2,500 labour hours on training and education.</p>
External advice	<p>Banks and similar financial institutions are expected to use the services of accounting and systems advisors in implementing an expected loss model.</p> <p>Because Option 1 is an international solution, the external advice costs associated with it are expected to be lower than the external advice costs associated with Option 2, which is a domestic solution. This is because, relative to the rest of the world, external advice on Option 2 would need to be custom-designed for the Australian market. External advice on Option 1 would be in line with advice being applied in other parts of the world (where IFRS are adopted) and would be expected to benefit from being the product of economies of scale.</p> <p>In respect of Option 1, for each of the large and medium entities this is estimated to be an average cost of 3,000 labour hours on external advice</p> <p>In respect of Option 1, for each of the other entities this is estimated to be an average of 600 labour hours on external advice.</p> <p>In respect of Option 2, for each of the large and medium entities this is estimated to be an average cost of 4,000 labour hours on external advice</p>

Transitional activity	Estimated effort/costs (very broadly approximated)
	<p>In respect of Option 2, for each of the other entities this is estimated to be an average of 800 labour hours on external advice.</p>
Systems changes	<p>Banks and similar financial institutions are expected to need to replace or revamp aspects of their IT systems in implementing an expected loss model.</p> <p>Because Option 1 is an international solution, the systems changes associated with it are expected to be lower than the systems changes associated with Option 2, which is a domestic solution. This is because, relative to the rest of the world, systems suitable for Option 2 would need to be custom-designed for the Australian market. Systems suitable for Option 1 would be in line with systems being designed and applied in other parts of the world (where IFRS are adopted) and would be expected to benefit from being the product of economies of scale.</p> <p>In respect of Option 1, for each of the large and medium entities the systems cost is estimated to involve an average of 9,000 hours of internal (employee) and external labour hours.</p> <p>In respect of Option 1, for each of the other entities the systems cost is estimated to involve an average of 1,800 hours of internal (employee) and external labour hours.</p> <p>In respect of Option 2, for each of the large and medium entities the systems cost is estimated to involve an average of 9,900 hours of internal (employee) and external labour hours.</p> <p>In respect of Option 2, for each of the other entities the systems cost is estimated to involve an average of 1,980 hours of internal (employee) and external labour hours.</p>
Preparation of initial financial statements	<p>There is usually an additional level of effort required to prepare financial statements when a new significant accounting policy (such as an expected loss model) is being adopted.</p> <p>In respect of both Option 1 and/or Option 2, for each of the large and medium entities this is estimated to be an average of 5,000 labour hours on financial statement preparation.</p> <p>In respect of both Option 1 and/or Option 2, for each of the other entities this is estimated to be an average of 1,000 labour hours on financial statement preparation.</p>

Transitional activity	Estimated effort/costs (very broadly approximated)
Audit of initial financial statements	<p>There is usually an additional level of effort required to audit financial statements when a new significant accounting policy (such as an expected loss model) is being adopted. This effort includes the ongoing training of audit firm staff about new requirements.</p> <p>In respect of Option 1, for each of the large and medium entities this is estimated to be an average of 500 labour hours on financial statement audit.</p> <p>In respect of Option 1, for each of the other entities this is estimated to be an average of 100 labour hours on financial statement audit.</p> <p>In respect of Option 2, for each of the large and medium entities this is estimated to be an average of 700 labour hours on financial statement audit.</p> <p>In respect of Option 2, for each of the other entities this is estimated to be an average of 140 labour hours on financial statement audit.</p>

Nature of recurring costs

- 90 The AASB expects that most of the recurring costs of adopting an expected loss model will relate to the collection and reporting of additional information. However, it is expected that these ongoing costs would be relatively small compared with the transitional costs.
- 91 Based on discussions with various constituents, the following table outlines estimates of the recurring costs involved in applying an expected loss model (either Option 1 or Option 2) compared with the status quo. The actual experience of an individual entity could be significantly different from the estimates below.

Recurring activity	Estimated effort/cost (very broadly approximated)
Preparation of financial statements	<p>The ongoing effort of collecting and reporting additional information associated with an expected loss model is expected to take up staff time.</p> <p>In respect of both Option 1 and/or Option 2, for each of the large and medium entities the estimated additional time spent on collecting information and reporting that information in the financial statements is expected to be an average cost of 200 labour hours.</p> <p>In respect of both Option 1 and/or Option 2, for each of the other entities the estimated additional time spent on collecting information and reporting that information in the financial statements is expected to</p>

Recurring activity	Estimated effort/cost (very broadly approximated)
	be an average cost of 40 labour hours.
Audit of financial statements	<p>The ongoing effort of auditing an expected loss model is expected to add to audit fees because the nature of some of that information will be forward-looking.</p> <p>In respect of Option 1, for each of the large and medium entities the estimated additional time spent on auditing financial statements is expected to be an average cost of 30 labour hours.</p> <p>In respect of Option 1, for each of the other entities the estimated additional time spent on auditing financial statements is expected to be an average cost of 6 labour hours.</p> <p>Most of the firms that are engaged in audits of banks and similar financial institutions have international connections. The Australian arms of those firms leverage off international audit methodologies and training for their staff. Option 2 is an Australian-specific solution and the firms would need to spend additional time training their staff and preparing for the audit of banks and similar financial institutions under Option 2 compared with Option 1 (an international solution).</p> <p>In respect of Option 2, for each of the large and medium entities the estimated additional time spent on auditing financial statements is expected to be an average cost of 50 labour hours.</p> <p>In respect of Option 2, for each of the other entities the estimated additional time spent on auditing financial statements is expected to be an average cost of 10 labour hours.</p>

Hourly labour costs Option 1

- 92 Banks and similar financial institutions each generally have a team of accounting and finance people who deal with financial reporting issues, including systems issues and the judgements and decision-making around implementing new and revised accounting requirements. Those people would normally occupy what might be called ‘middle management’ positions within their firms.
- 93 Internal labour rates for activities that are expected to be performed by the accounting and finance employees of the entity are based on an annual salary of \$130,000. In accordance with the Regulatory Burden Measurement methodology, this salary amount is adjusted using a default multiplier of 1.75 to account for non-wage on costs and overhead costs. Consequently, for the purposes of this costing, the computed rate

for internal labour is \$126 per hour (which assumes 4 weeks annual leave and a working week of 37.5 hours).

- 94 The AASB considers that an annual salary of \$130,000 is a reasonable estimate of the internal salary of the relevant accounting staff member that will be closely involved in implementing and applying the expected loss model. Using data from the *2014 Hays Salary Guide*, the AASB estimated the annual salary of \$130,000 by blending various salaries based on role and responsibility (for example, financial controller, finance manager, group accountant, financial accountant and systems accountant), business size, the environment for salaries in the banking industry (and related financial services industries) and the location of the employee.²⁹
- 95 AASB staff cross-checked the information obtained through the Hays Salary Guide in their discussions with staff from a number of the affected entities. Some of the constituents consulted tend to think in terms of total costs for a completing a particular activity, based on the costs of similar past activities and not necessarily on an hourly basis for the staff involved. Those who think more in terms of hourly rates and the hours involved, provided a reasonably firm estimate of which work they anticipated being done internally and which work they anticipated being done externally. Although the various constituents consulted advised ranges of (internal) salaries that fall either the side of \$130,000 a year; overall, across all the entities consulted, that information did not contradict the amounts determined by reference to the Hays Salary Guide. That is, general feedback from constituents suggests that the annual salary estimate of \$130,000 is reasonable.
- 96 As noted above, external services are expected to be obtained by an entity for the purposes of receiving external advice on the application of the expected loss model and the effort required to audit the entity's financial statements in respect of the expected loss model. As a broad estimate, the costing assumes an external rate of \$400 per hour for advice and auditing services because the information systems that are likely to be needed to cope with the expected loss model would be expected to be at the more complex end of the spectrum and be reasonably specialist in nature.
- 97 The above \$400 rate was the result of AASB staff consultation with accounting industry professionals to estimate rates that might be generally indicative of the rates charged for those activities. We note that the actual rates will vary based on many factors, including the length of the engagement, likelihood of future work and resource capacity factors. Furthermore, advice work and external audits may be priced at a fixed amount and subject to competitive tendering. Because the fixed price will be entity specific, for the purposes of this costing the incremental external advice and audit costs have been estimated based on hours of incremental activity required multiplied by an external hourly rate estimate.
- 98 For some tasks, such as re-building information systems, there is likely to be both internal and external labour input because employees of the entities adopting the

29 The Regulation Impact Statement for AASB 15 *Revenue from Contracts with Customers* used an annual salary of \$120,000 based on the *2014 Hays Salary Guide*. The higher (\$130,000) salary has been determined on the basis that most of the larger banks and similar financial institutions that are expected to be affected by the completed version of IFRS 9 are located in Sydney and Melbourne, where the salary costs are generally higher than the other state capitals. [By comparison, the entities expected to be affected by AASB 15 are generally spread out among all major centres in Australia.]

completed version of IFRS 9 (AASB 9) are expected to be working with external contractors. Accordingly, a blended labour rate of \$263 per hour has been used for costing information system-related activities.

Hourly labour costs Option 2

- 99 Internal labour rates for activities that are expected to be performed by employees of the entity are based on an annual salary of \$120,000. In accordance with the Regulatory Burden Measurement methodology, this salary amount is adjusted using a default multiplier of 1.75 to account for non-wage on costs and overhead costs. Consequently, for the purposes of this costing, the computed rate for internal labour is \$126 per hour (which assumes 4 weeks annual leave and a working week of 37.5 hours).
- 100 The AASB considers that an annual salary of \$130,000 is a reasonable estimate of the internal salary of a typical finance and accounting staff member that will be closely involved in implementing and applying the expected loss model. Using data from the *2014 Hays Salary Guide*, the AASB estimated the annual salary of \$130,000 by blending various salaries based on role and responsibility (for example, financial controller, finance manager, group accountant, financial accountant and systems accountant), business size, the employment environment in the banking and related industries, and the location of the employee.
- 101 Please see the section above (Hourly labour costs Option 1) for the context of the \$130,000 salary estimate.
- 102 As noted above, external services are expected to be obtained by an entity for the purposes of receiving external advice on the application of the expected loss model and the effort required to audit the entity’s financial statements in respect of the expected loss model. As a broad estimate, the costing assumes an external rate of \$400 per hour for advice and auditing services because the information systems that are likely to be needed to cope with the expected loss model would be expected to be at the more complex end of the spectrum and be reasonably specialist in nature.
- 103 Please see the section above (Hourly labour costs Option 1) for the context of the \$400 per hour estimate..

Impact of Option 1 – quantitative

- 104 The following table sets out the estimated transitional costs of Option 1 by activity, as outlined above.

Activity	Total (\$m)
Internal training and education	80.010
External advice	60.960
Systems changes	120.244
Preparation of financial statements	32.004
Audit of financial statements	10.160
	303.378

- 105 The following table sets out the estimated recurring costs of Option 1 by activity, as outlined above.

Activity	Total (\$m)
Preparation of financial statements	1.280
Audit of financial statements	0.610
	<u>1.890</u>

- 106 The following table sets out the estimated total costs of Option 1 relative to the status quo. No direct cost savings have been identified with Option 1. The amount of costs expected to be associated with applying the completed version of AASB 9 and identified in the Regulatory Burden Measurement Framework and in this table below are broad approximations. They are based on assumptions and estimates that would not necessarily apply in the case of individual entities. Furthermore, the costings have been prepared using the methodology prescribed by the Commonwealth Regulatory Burden Measurement Framework, which may differ from other bases for measuring costs of compliance.

Cost	Total (\$m)
Transition cost divided by 10 years	30.338
Ongoing cost	1.890
	<u>32.228</u>

- 107 In preparing this cost estimate, the AASB considers that it is reasonable to spread the transition costs over 10 years on the assumption that the completed version of AASB 9 would be applied for 10 years or more. The existing requirements on financial asset impairment (in AASB 139) have been in force in Australia since 2005.
- 108 Although a decision by the AASB to issue the completed version of AASB 9 would impose compliance costs on the Australian economy, the AASB's decision to make the completed version of AASB 9 is based on a cost-benefit analysis that differs from this prescribed quantitative assessment. As noted elsewhere in this Regulation Impact Statement, the AASB's decision to make the completed version of AASB 9 also takes into account other factors, including the benefits to users of financial statements (such as investors) and the benefits to the Australian economy as a whole from maintaining compliance between Australian accounting standards and IFRS, as outlined in paragraphs 3 and 4.
- 109 A regulatory burden and cost offset estimate table for Option 1 is included in section 8.

Impact of Option 2 – qualitative

- 110 The following table sets out the estimated transitional costs of Option 2 by activity, as outlined above.

Activity	Total (\$m)
Internal training and education	80.010
External advice	81.280
Systems changes	132.268
Preparation of financial statements	32.004
Audit of financial statements	14.224
	<hr/>
	339.786
	<hr/>

- 111 The following table sets out the estimated recurring costs of Option 2 by activity, as outlined above.

Activity	Total (\$m)
Preparation of financial statements	1.280
Audit of financial statements	1.016
	<hr/>
	2.296
	<hr/>

- 112 The following table sets out the estimated total costs of Option 2 relative to the status quo. No direct cost savings have been identified with Option 2. The amount of costs expected to be associated with applying an Australian version of an expected loss model and identified in the Regulatory Burden Measurement Framework and in this table below are broad approximations. They are based on assumptions and estimates that would not necessarily apply in the case of individual entities. Furthermore, the costings have been prepared using the methodology prescribed by the Commonwealth Regulatory Burden Measurement Framework, which may differ from other bases for measuring costs of compliance.

Cost	Total (\$m)
Transition cost divided by 10 years	33.979
Ongoing cost	2.296
	<hr/>
	36.275
	<hr/>

- 113 In preparing this cost estimate, the AASB considers that it is reasonable to spread the transition costs over 10 years on the assumption that the Option 2 expected loss model would be applied for 10 years or more. The existing requirements on financial asset impairment (in AASB 139) have been in force in Australia since 2005.
- 114 A decision by the AASB to require the Option 2 expected loss model would impose greater compliance costs on the Australian economy than issuing the completed version of AASB 9 (Option 1).
- 115 The Option 2 expected loss model would be generally expected to lead to higher costs in terms of the external advice and systems costs incurred in transitioning to the new accounting policy and in its ongoing application than would Option 1. This is because the transitional advice and systems costs and ongoing application work would be Australian-specific and would not benefit from being the product of economies of scale (that would be available in respect of the IFRS model).

- 116 The Option 2 expected loss model would also lead to entities not being able to claim IFRS compliance, which could have wide repercussions because it would result in a loss of the benefits attaching to IFRS compliance as outlined in paragraphs 3 and 4.
- 117 A regulatory burden and cost offset estimate table has also been prepared for Option 2 even though that option was assessed by the AASB as not being the preferred policy option. The completed table for Option 2 can be found in Appendix A.
- 118 The AASB considers that the Regulatory Burden Measurement framework understates the burden associated with Option 2 because the methodology prescribed by that framework does not measure the benefits and opportunity costs/savings of options that do not involve adopting IFRS. In the context of the AASB's decision-making framework, it is important to note that Option 2 (and Option 3) would be expected to give rise to substantial costs, including those identified in section 1 on assessing the problem.

Impact of Option 3

- 119 Option 3 would retain the existing incurred loss model in Australian accounting standards. Option 3 is the assumed base case scenario.

Qualitative assessment of benefits and costs of Option 3

- 120 Maintaining the status quo would not be expected to have any immediate effect on the direct costs incurred by an entity to prepare financial statements in accordance with Australian accounting standards. This is because, if the existing financial asset impairment requirements remain unchanged, the cost of complying with those requirements should equally remain unchanged.
- 121 A decision by the AASB to follow Option 3 would lead to entities not being able to claim IFRS compliance, which could have wide repercussions because it would result in a loss of the benefits attaching to IFRS compliance as outlined in paragraphs 3 and 4. In the context of banks and similar financial institutions, those costs would include:
- (a) a potentially higher cost of capital because fewer analysts (particularly those from offshore markets) who make decisions on providing funds will be prepared to lend to entities that are not IFRS compliant, or will demand a premium to lend to entities that do not state IFRS compliance; or the need to prepare two sets of financial statements – one for regulatory purposes and another (using the expected loss model) for analysts;
 - (b) over time, as information systems need to be changed (perhaps due to changed business requirements), the off-the-shelf solutions that are most readily available may not be suitable for an incurred loss model because they would incorporate the international expected loss model in IFRS 9;
 - (c) over time, as personnel come and go, the pool of talent available to the entity could be constrained, or more training costs may need to be expended, because international candidates may lose familiarity with the incurred loss model (but would be familiar with the international expected loss model in IFRS 9).

- 122 In relation to the cost of capital, Australian banks source a material portion of their funds from in international capital markets.³⁰
- 123 It is also possible that another financial crisis (such as the Global Financial Crisis, which led the G20 to recommend an expected loss model) will occur and expose further shortcomings of retaining the incurred loss model (Option 3).
- 124 A separate table has not been prepared for Option 3 (the status quo option) because, under the Government's Regulatory Burden Measurement framework, it would not impose any incremental regulatory costs.

Consultation

- 125 The AASB members, who other than the Chair are part-time, are appointed as individuals. They are also appointed for their expertise in a range of areas of business and government and bring to the board table a wealth of experience in preparing, auditing and using financial statements that comply with accounting standards. They therefore have a good appreciation of the impact of changes to accounting standards and strong contacts within the AASB's core constituencies, which the AASB consults. Accordingly, the AASB's public consultation processes are well-regarded and the AASB members are in a sound position to consider constituent responses.

Consultation on AASB 9

- 126 The current revisions to AASB 9 were developed and refined through extensive consultation undertaken internationally by the IASB and domestically by the AASB. The AASB published the following consultation documents for public comment (which were based on similar consultation documents issued internationally by the IASB):
- (a) Exposure Draft ED 189 *Financial Instruments: Amortised Cost and Impairment (proposed amendments to AASB 7 and AASB 139)* in November 2009, which incorporated the IASB Exposure Draft ED/2009/12 (of the same title);
 - (b) Exposure Draft ED 210 *A Supplement to ED 189* in February 2011, which incorporated the IASB Exposure Draft *A Supplement to ED/2009/12*;
 - (c) Exposure Draft ED 230 *Classification and Measurement: Limited Amendments to AASB 9* in December 2012, which incorporated the IASB Exposure Draft ED/2012/4 (of the same title); and
 - (d) Exposure Draft ED 237 *Financial Instruments: Expected Credit Losses* in March 2013, which incorporated the IASB Exposure Draft ED/2013/3 (of the same title).
- 127 A draft RIS was not prepared to accompany any of these Exposure Drafts. However, the Exposure Drafts were each accompanied by a Basis for Conclusions that included an outline of the potential benefits and costs of the respective proposals in qualitative

30 Owen Bailey, Luke Van Uffelen and Kerry Wood, *International Activities of Australian Banks*, Reserve Bank of Australian Bulletin, December Quarter 2013.

terms. Accordingly, constituents were made aware of the IASB's thinking on matters of costs and benefits of the proposals and were provided with ample opportunity to comment on those costs and benefits. Each Exposure Draft issued during the development of the 'completed' version of IFRS 9 also asked constituents whether they wish to raise any Australian-specific issues.

Financial Asset Impairment – consultation process

128 There were three formal rounds of consultation as the IASB developed its proposals. The AASB, Australian constituents, and many other from around the world, contributed to their development.

Early consultation

129 In response to ED 189, which incorporated IASB ED/2009/12, the AASB received seven submissions. The AASB also held roundtable discussions in March 2010 in Melbourne and Sydney that approximately 30 constituents attended.

130 The ED 189 proposals were generally not supported and various issues were raised for consideration. The AASB considered comments it received in making its submission to the IASB on ED/2009/12 and submitted to the IASB that the IASB's ED/2009/12 proposals are not supportable on both conceptual and practical grounds. Similar comments were made by a wide range of constituents (including other national standards setters) from around the world.

131 In February 2011 the AASB issued ED 210, which incorporated the IASB Exposure Draft, which was an attempt by the IASB to address the weaknesses that had been commented on in respect of ED/2009/12.

132 Two submissions were received by the AASB and face-to-face meetings conducted with key constituents in respect of the proposals in ED 210 raised various issues for consideration. The AASB considered comments it received in making its submission to the IASB on the Supplement to ED/2009/12.

133 The AASB expressed concerns about the proposed approach because it employed both the time-proportionate loss method and the foreseeable future loss method and lacked a conceptual basis.

Later consultation

134 Based on the feedback on ED/2009/12 and on the Supplement to ED/2009/12, the IASB developed completely different proposals for an expected loss model.

135 In response to ED 237, which incorporated IASB ED/2013/3, the AASB received nine submissions. The AASB also held roundtable discussions in Melbourne and Sydney that approximately 20 constituents attended.

136 There was general support for the proposals in ED 237, whilst various issues were raised for consideration. The AASB considered comments it received in making its submission to the IASB that expressed the view that while the AASB was not entirely in agreement with the ED/2013/3 proposals, with certain refinements, it could provide a workable solution to the issues being faced.

Limited Amendments to Classification and Measurement – consultation process

- 137 In response to ED, which incorporated IASB ED/2012/4 the AASB received eight submissions. Those submissions were generally supported adopting the proposals, whilst raising various issues for consideration. The AASB considered comments it received in making its submission to the IASB on ED/2012/4.
- 138 Although concerned about the reversal of the IASB’s previous position of not having a FVTOCI category for financial instruments in IFRS 9, the AASB broadly supported the proposals in ED/2012/4.

AOSSG consultation process

- 139 At each consultation stage noted above, the AASB led the Financial Instruments Working Group of the Asian-Oceanian Standard-Setters Group (AOSSG).³¹ As Working Group leader, the AASB organised the AOSSG’s feedback to the IASB on financial instruments proposals for the region and engaged with many constituents in the region on the various IASB proposals on financial instruments between 2009 and 2014. This role has helped form the AASB’s views, particularly in the need for a global solution to developing reforming the incurred loss model in IAS 39 (and AASB 139).

Key issues raised by constituents and addressed by the IASB over the course of consultation process

- 140 The above consultation processes revealed essentially two key issues that concerned constituents – one conceptual in nature and the other practical in nature.

Conceptual concern

- 141 The main conceptual concern was that an expected loss model would require entities to effectively forecast events, when forecasting is typically not within the realm of financial reporting. That is, financial reporting is essentially providing a picture of what has happened in the immediately preceding reporting period, not about what will happen next.
- 142 To address these concerns, the IASB has characterised the expected loss model as one that provides an up-to-date assessment of the credit quality of an entity’s financial assets that uses an entity’s experience of past events as a basis of estimating impairments that exist in the context of what is known about current economic conditions.
- 143 The IASB has also helped to overcome conceptual concerns by developing a notion of there being two groups of financial assets. One group comprises financial assets for which the credit quality remains the same as it did when the contract was written with the customer – lifetime losses expected as a result of events over the next year are recognised as losses for this group. The second group comprises financial assets for which the credit quality has deteriorated since the contract was written with the

31 For more information on the AOSSG and its activities, refer to: www.aossg.org

customer – lifetime losses expected as a result of events over the entire life of the instrument are recognised as losses for this group.

144 This approach has met with widespread acceptance among constituents.

Practical concern

145 The expected loss model proposed early in the consultation process would have involved entities tracking groups of financial assets, in part, by the interest rates that applied at the date that each instrument inception (each time money was lent to a customer). Some entities manage their financial assets in open portfolios – that is they keep adding new loans to a portfolio of existing loans and manage them as a group when they are written on the same terms. Managing using open portfolios is more common for variable interest rate loans than it is for fixed interest rate loans. Australia generally has a higher incidence of variable rate lending than most other jurisdictions, so the practical concerns with the early IASB proposals were particularly significant in Australia.

146 To address these concerns, the IASB changed its expected loss model to involve the two-group approach mentioned above in relation to the conceptual concerns with the early proposals. The two-group approach can function in the context of both open and closed portfolios of financial assets – so entities will be able to use the information generated by their systems for both management and financial reporting purposes.

Conclusions of the IASB

147 The IASB conducted an exhaustive consultative process with its world-wide constituency over a period of more than five years, and Australia was an active participant at each stage of that process. Overall, the IASB concluded that, based on the feedback received, the improvements to financial reporting would justify the costs of implementing the expected loss model in IFRS 9. In making this assessment, the IASB noted that its model will improve financial reporting because amounts reported about expected credit losses will better reflect the effective return and the changes in credit risk on financial instruments compared to the requirements in IAS 39.³²

148 The IASB and most constituents were also satisfied that the expected loss model in the 2013 ED, which has become the model in the completed version of IFRS 9, addresses the concerns of the G20 and others about the delayed recognition of credit losses under an incurred loss approach.³³ Furthermore, the Effects Analysis published by the IASB with the completed version of IFRS 9 it notes that, consistent with the recommendations by the G20 Leaders and others, IFRS 9 is more forward-looking and considers a broader range of information than the existing incurred loss model.³⁴

149 Consequentially, there is a general view that the revised impairment model achieves the outcome sought by the G20 in the wake of the global financial crisis.³⁵

32 IFRS 9 *Financial Instruments* (2014) Basis for Conclusions, paragraph BC5.135 (not yet published in Australia).

33 Ibid, paragraph 5.150.

34 IFRS 9 *Financial Instruments*, Effects Analysis, paragraph BCE.109 (not yet published in Australia).

35 IFRS 9 *Financial Instruments* Basis for Conclusions, paragraph BC5.150.

150 The IASB was mindful of the need to ensure that its expected loss model achieved its objective without requiring undue cost and effort by businesses in applying the model. This is a consistent theme running through the Effects Analysis issued by the IASB with the completed version of IFRS 9.

Conclusion

151 Option 1 is the preferred option because the AASB is confident that this option will yield the greatest net benefit to the Australian economy. This is because making a completed version of AASB 9 that adopts the IFRS 9 expected loss model will ensure that Australian entities can continue to obtain the benefits of preparing financial statements that are in compliance with IFRS. Adopting the IFRS 9 expected loss model will also help to address the deficiencies with the existing incurred loss model for accounting for the impairment of financial assets that were identified by the G20. No significant adverse impacts in the Australian context have been identified either through AASB analysis or consultation.

152 The costs of Option 1 are expected to be largely transitional in nature, rather than being recurring costs. The implementation compliance costs are estimated to be in the order of \$303 million, and recurring costs \$1.9 million per year. With ongoing efficiencies in the financial reporting process, many of those costs are expected to reduce over time in relative terms. The AASB considers that the benefits of Option 1 will exceed the costs, and those benefits are expected to be enduring.

153 Option 2 (an Australian-specific expected loss model) and Option 3 (the status quo or 'base case' option) are both expected to have a lower net benefit to all the parties involved than Option 1 because of the loss of the benefits of IFRS compliance.

Implementation and review

154 The AASB will monitor the implementation of the expected loss model in the completed version of AASB 9. Similarly, the IASB will be monitoring the implementation of its expected loss model. In accordance with its due process requirements, the IASB has indicated that it plans to conduct a post-implementation review of IFRS 9 in 2-3 years after the effective date of the standard.³⁶ Therefore, the review is expected to commence in either 2021 or 2022. The AASB expects to be an active participant and contributor to the IASB's review on behalf of Australian constituents and on behalf of the AOSSG. The AASB plans to also conduct a post-implementation review of AASB 9 which will enable the AASB to assess the impact of AASB 9 domestically and also provide the AASB with feedback to input into the IASB's review of IFRS 9.

36 Ibid, paragraph BCE.3.

Appendix A

Measurement of the Regulatory Burden of Option 1

155 The table below sets out the estimated compliance costs on business associated with moving from the existing incurred loss impairment model for financial instruments and the associated classification and measurement changes to the completed version of AASB 9 (Option 1). This estimate has been prepared using the methodology prescribed in the Government's Regulatory Burden Measurement framework.

Table 1: Regulatory burden and cost offset estimate table

Average annual regulatory costs (from business as usual)				
Change in costs (\$million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	\$32.228	\$0	\$0	\$32.228
Cost offset (\$ million)	Business	Community organisations	Individuals	Total, by source
Within portfolio	-\$32.228	\$0	\$0	-\$32.228
Are all new costs offset?				
<input checked="" type="checkbox"/> Yes, costs are offset <input type="checkbox"/> No, costs are not offset <input type="checkbox"/> Deregulatory—no offsets required				
Total (Change in costs – Cost offset) (\$million) = \$0				

156 A regulatory offset has been identified from within the Treasury portfolio. This offset relates to the Foreign Account Tax Compliance Act (FATFA).

Measurement of the Regulatory Burden for Option 2

Table A1: Regulatory burden and cost offset estimate table

Average annual regulatory costs (from business as usual)				
Change in costs (\$million)	Business	Community Organisations	Individuals	Total change in cost
Total, by sector	\$36.275	\$0	\$0	\$36.275
Cost offset (\$ million)	Business	Community organisations	Individuals	Total, by source
Within portfolio	-\$36.275	\$0	\$0	-\$36.275
Are all new costs offset?				
<input checked="" type="checkbox"/> Yes, costs are offset <input type="checkbox"/> No, costs are not offset <input type="checkbox"/> Deregulatory—no offsets required				
Total (Change in costs – Cost offset) (\$million) = \$0				

Appendix B: Functions of the AASB

Setting Australian accounting standards

- 157 Under section 227(1) of the *Australian Securities and Investments Commission Act 2001* (ASIC Act), the functions of the Australian Accounting Standards Board (AASB) are to:
- (a) develop a conceptual framework, not having the force of an accounting standard, for the purpose of evaluating proposed accounting standards and international standards;
 - (b) make accounting standards under section 334 of the *Corporations Act 2001* for the purposes of the corporations legislation;
 - (c) formulate accounting standards for other purposes; and
 - (d) participate in and contribute to the development of a single set of accounting standards for world-wide use having regard to the interests of Australian corporations that raise or propose to raise capital in major international financial centres.
- 158 In accordance with those functions, the AASB makes accounting standards for the preparation of general purpose financial statements by entities that operate in either the for-profit, not-for-profit or public sectors. The AASB makes those accounting standards with a view to requiring like transactions and events to be accounted for in a like manner for all types of entities. This is referred to as ‘transaction neutrality’. By making accounting standards that are transaction neutral, the AASB avoids unnecessary duplication of regulation that would otherwise be required under a sector-specific approach. The AASB only makes sector-specific Standards to extent they are essential to deal with issues that are specific to that sector.
- 159 In 2002, the Financial Reporting Council (FRC), which is a Ministerial Advisory Council, used its powers under section 225(2)(c) of the ASIC Act to direct the AASB to adopt International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) into Australian accounting standards from 1 January 2005. In making that decision, the FRC noted that a single set of high quality accounting standards which are accepted in major international capital markets will greatly facilitate cross-border comparisons by investors, reduce the cost of capital, and assist Australian companies wishing to raise capital or list overseas.³⁷ Together with European Union member countries, Australia was a leader in the adoption of IFRS. Since 2005, many other jurisdictions have followed Australia’s and Europe’s lead and there are now more than 100 countries that mandate the use of IFRS for most public companies and there are further countries (including the USA and Japan) that permit the use of IFRS in some circumstances.
- 160 The FRC decision in 2002 was, in effect, a decision to adopt the IFRS regime. This is because the adoption of IFRSs is an ongoing process that requires the AASB to continue to adopt new and revised IFRS as they are issued by the IASB so that Australian businesses can continue to state that their financial statements are IFRS

37 FRC Bulletin 2002/4 *Adoption of International Accounting Standards by 2005*

compliant. If the AASB instead chose either to not adopt an IFRS or to modify an IFRS, Australian entities would lose the ability to—and the benefits of—claiming that their financial statements are prepared in compliance with IFRS.