**AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL**

17 May 2010

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins St West
MELBOURNE VIC 8007

Dear Mr Stevenson

**EXPOSURE DRAFT 189 FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT**

Attached is the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above. The response includes replies to the additional questions from the Australian Accounting Standards Board Roundtables on ED 189 held in Sydney and Melbourne (questions indicated with asterisks ** and boxed).

The views expressed in this submission represent those of all Australian members of ACAG.

The opportunity to comment is appreciated and I trust you will find the attached comments useful.

Yours sincerely

Simon O'Neill
**Chairman**
**ACAG Financial Reporting and Auditing Committee**

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AUSTRALASIAN
COUNCIL OF
AUDITORS-GENERAL

17 May 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
1st Floor
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir David

**EXPOSURE DRAFT ED/2009/12 FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT**

Attached is the Australasian Council of Auditors-General (ACAG) response to the Exposure Draft referred to above. The response includes replies to the additional questions from the AASB Roundtables on ED 189 held in Sydney and Melbourne (questions indicated with asterisks ** and boxed).

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**cc: Mr Kevin Stevenson, Chairman, Australian Accounting Standards Board**

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## Section A: Questions from the IASB ED *Financial Instruments: Amortised Cost and Impairment* and additional questions from the AASB.

**Question 1**
***Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?***

Yes, the description of the objective is clear. Comments regarding perceived difficulties in auditing this mixed model of amortised cost measurement are discussed below.

**Question 2**
***Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?***

Yes, the objective is appropriate for that measurement category. Comments regarding perceived difficulties in auditing this mixed model of amortised cost measurement are discussed below.

**Question 3**
***Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?***

The principles-based approach accompanied by application guidance is useful, however, implementation guidance and illustrative examples have historically proven to be beneficial in interpreting the requirements of a standard, especially in areas that necessitate significant management assumptions and judgement. Given the potential challenges in auditing an entity's compliance with various aspects of this standard (especially in regards to auditing the estimates of expected cash flows, including the "probability-weighted possible outcomes" and expected loss calculations, etc), our preference would be for this standard to include implementation guidance with accompanying illustrative examples.

**Question 4**
***(a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?***

We agree with the measurement principles outlined in the exposure draft, however from an audit perspective, we foresee difficulties in auditing the 'probability-weighted possible outcomes' (paragraph 8) and the expected credit losses encapsulated within the calculation of 'expected cash flows over the remaining life of the financial instrument' (paragraph 6(a)). With this move from the incurred loss model to the expected loss approach (with earlier recognition of credit losses), there is also potential for management to use both of these areas to engage in 'earnings management', and we would support the provision of implementation guidance for this standard, particularly in respect of these two areas.

For financial instruments that have a remaining life longer than the observable market the requirement to forecast credit losses, where material, may result in the issue of an emphasis of matter opinion by the auditor on the basis of the inherent uncertainty of the forecast. It is our view that the approach taken in AASB 136 to limit the estimate of cash flows to 5 years is a more pragmatic approach to forecasting.

***(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?***

There need to be measurement principles (or at least some implementation guidance) for the allowance account. The measurement principles enunciated in paragraphs 6-10 do not directly address the credit impact on the amounts and timing of cash flows when clearly this is the key current input regarding the cashflow estimates. The presentation and disclosure paragraph 13(b) specifically refers to the presentation of "expected credit losses allocated to the period", however in paragraph 8, for example, the only reference to credit is inferred from the following statement "The estimates for the cash flow inputs are expected values. Hence, estimates of the amounts and timing of cash flows are the probability-weighted possible outcomes."

It is assumed that the estimation of the impact of credit on cashflows is undertaken utilising a probability-weighted outcomes process, however there appears to be little guidance on the appropriate approach to undertake this process. Application guidance paragraphs B3-B10 outline points to consider in estimating the credit impact on cashflows and avenues where information can be gained. The area of audit concern is the lack of guidance on the minimum principles expected to be applied in deriving the impact of credit on cashflows. For example, depending on the level of sophistication, entities will apply different forecasting approaches, however in practice each will attempt to access current credit information and will assess the effectiveness of their information sources. Some can afford to access current information, others can not. Some will engage specialists to review the assessment process whereas others will only apply their own judgement.

Paragraphs B8 and B9 allude to the principle of back-testing to determine whether the use of historical credit loss rates reflects relevant observable data. Such a principle is supported for all measures of credit risk and would provide greater guidance for entities (and their auditors) in providing the estimates of the impact on cashflows.

***** Do participants agree with the measurement model proposed in the IASB ED, which incorporates the accounting for impairment based on the assessment of expected cash flows? For example:***

***(a) Do participants believe that paragraph B8:***

***(i) is helpful when making the assessment of changes in expected cash flows; and***

The rationale for paragraph B8 makes sense but will be challenging to implement in practice. Given the move away from the incurred loss model, we believe implementation guidance is required to help ensure entities (and their auditors) clearly understand the requirements of this aspect of the standard.

***(ii) would change current practice when assessing for impairment?***

We expect that the move from the incurred loss model to the expected loss model will result in a change in current practice. The incurred loss model has a historical focus (collectability based on history), with losses expected as a result of future events, no matter how likely, not being recognised. Again we believe implementation guidance is required to help ensure entities (and their auditors) clearly understand the practicalities of calculating expected losses under this standard.

***(b) What are the participants' views on recognising gains from favourable changes in expectations, or from reversals of impairment losses, under the proposed measurement model?***

Accounting standards have traditionally tended to adopt a conservative recognition approach (lower 'hurdles' for recognising expenses than for recognising revenue). Other accounting standards tend to deal with less subjective measurements than credit risk. Accordingly, to allay concerns over the potential for 'earnings management', ED 189 should be more prescriptive around the principles to apply when estimating impairment losses and likewise reversals, and supplement this with illustrative guidance.

***(c) How difficult do you think it will be to use expected values (i.e. probability-weighted numbers) in determining the impairment amount?***

In practice it could be quite difficult to use expected values in determining the impairment amounts. From a conceptual viewpoint the level of rigour applied by entities around this process varies significantly by entity size and industry. In this respect we concur with the alternative views of Robert P Garnett and James J Leisenring in paragraph AV4 ('Alternative view on exposure draft' section), and in particular their expected cash flow assertion comment that "the loss expectations of management cannot be audited". Hence the expected cash flow cannot be audited.

Principles are therefore required to ensure that all expected value estimates meet the criteria promulgated in the accounting framework.

***(d) Would it be appropriate to use 'historical' effective interest rates (determined by iteration at inception of a financial asset) as opposed to current discount rates (consistent with IAS 36) at least when cash flows are reassessed, in determining the carrying amount for financial instruments measured at amortised cost?***

Given the intent of this standard to effectively shield these financial instruments measured at amortised cost from full fair value measurement (arguably to the potential detriment of the comparability and relevance of financial statements), it would seem appropriate to use 'historical' effective interest rates. The consequent difficulty will be in explaining to users what the amortised cost amounts disclosed in the financial statements actually purport to represent.

**Question 5**

***Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?***

The description of the objective is clear, however:

- It could make specific mention of the timing of the principal cashflows (when disclosing origination/maturity information required by paragraph 22). For example: 'An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effect of interest revenue and expense, <u>the timing of principal cashflows,</u> and the quality of financial assets including credit risk .' (Suggestion only)

- We would support the proposal in the box at the bottom of page 16, to treat the presentation and disclosure requirements as amendments of AASB 101 *Presentation of Financial Statements* and AASB 7 *Financial Instruments: Disclosures,* respectively (particularly in terms of integrating the credit and liquidity risk disclosures).

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

Given the objective of this ED, yes the objective of presentation and disclosure is appropriate, however, could be enhanced - refer (a) above.

**Question 6**
***Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?***

The proposed presentation requirements are somewhat cumbersome (especially when presented in the statement of comprehensive income along with other interest revenue from financial assets held at fair value), however, are considered necessary given the intent of this ED.

**Question 7**
***(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?***

As noted below, some of the proposed disclosure requirements may prove overly onerous for the non-banking sector, and the AASB/IASB may wish to consider a reduced level of disclosures for these other sectors.

Regarding paragraph 17, the practicality of actually ***identifying*** the inputs in determining expected credit losses is difficult and where material may impact the audit opinion where there is inherent uncertainty. In this respect we concur with the alternative views of Robert P Garnett and James J Leisenring in paragraph AV4 ('Alternative view on exposure draft' section) regarding their assertion that "the loss expectations of management cannot be audited". We would support the inclusion of particular implementation guidance on this aspect. From past experience in auditing areas involving the application of significant management assumptions and judgment, we expect some entities to tend towards standard pro-forma disclosures for an area such as this.

Regarding paragraphs 19 and 22, this information would be interesting and useful to users of financial statements, however could prove quite voluminous (where disclosed by class by year of origination and maturity per paragraph 22) and cumbersome to financial statement preparers, auditors and users alike, and may necessitate the use of appropriate timebands to display the required information.

The inclusion of stress testing information is supported, however it may well be very difficult (at least initially, until these disclosures 'evolve' over time), to compare the disclosures between entities, given the very different approaches to, purposes of, and varying sophistication levels of, stress testing performed by different entities (including tests performed over not just financial instruments held at amortised cost but also those held at fair value). We seek clarification as to whether it is only credit risk stress testing that would need to be disclosed? In any case, entities will need to very clearly disclose the nature, purpose, timing and extent of the stress testing performed, as well as the inherent limitations of any stress tests.

Another important consideration here is the potential impact of these disclosures on the audit opinion – will the auditor need to audit the stress test results if they are disclosed in the notes to the financial statements? Will the auditor effectively be certifying that the entity can withstand the stress scenario/s?

***(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?***

As part of disclosures made under paragraph 17, the disclosure of principles/approaches adopted by entities such as "backtesting credit estimation methodologies and performance attribution" would provide users with greater assurance that credit assessments are reliable in comparison with the more general pro-forma ('boiler plate') disclosures such as vague references to the use of inputs such as information from ratings agencies, etc.

**Question 8**
***Would a mandatory effective date of about three years after the date of issue of the IRS allow sufficient lead-time for implementing the proposed requirements?***
***If not, what would be an appropriate lead-time and why?***

From an audit perspective, the lead time appears reasonable.

**Question 9**
***(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?***

Yes.

***(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?***

No strong preference – entities should still have the relevant information to prepare restated comparative information (especially given the three year lead time for implementation).

***(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.***

Yes, the requirement to present restated comparative information appears reasonable given the length of the lead-time provided.

**Question 10**
***Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?***

The proposed disclosure requirements in relation to transition appear reasonable.

**Question 11**
***Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?***

Yes these are appropriate as they are principles based, and should assist those non-bank entities (with less sophisticated systems than big banks) in applying this standard.

**Question 12**
***Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements and what is the basis for your assessment?***

Yes, additional guidance on practical expedients should be provided and would be useful, particularly in regards to credit estimation techniques.

*** **Is there a need for more consideration to be given to financial assets that are not loan receivables? For instance, participants should consider how the proposed measurement model would apply to, for example medium to longer term trade receivables.***

Clearly the main focus of this ED is on financial institutions and the AASB should ensure that the principles are equally applicable to non loan receivables and other receivables held by other sectors. Some additional guidance may be required.

Section B: Questions Specifically Related to Public Sector/Not-For-Profit Entities

*** **Do you think there are any proposals in the ED that are inappropriate for public sector entities or not-for-profit entities in particular? If so, what are those proposals and why do you regard them as inappropriate?***

Some of the qualitative and quantitative disclosure requirements may prove particularly onerous for public sector entities to comply with (e.g. the disclosures by origination in paragraphs 19 and 22), and we would welcome any guidance on the extent of disclosures actually required for non-bank entities or non-central borrowing authorities.

The basic calculation examples provided on the IASB website are useful and we believe entities would find the provision of additional worked examples beneficial in understanding the calculation requirements of this ED.

In relation to the application of ED 189 to the public sector, there is one specific area in which we would welcome additional guidance – loans at no or low interest. (We note the recent AASB confirmation of its view that AASB 136 *Impairment of Assets* (rather than AASB 139 *Financial Instruments: Recognition and Measurement*) applies to the impairment of statutory receivables because of the non-contractual nature of such receivables, and so this area has not been re-considered here.)

**Loans at no or low interest**
Loan arrangements in government are sometimes used in lieu of grants – The terms and conditions of these loans typically include low or no interest payments. These loans, according to the accounting policies of both the borrower and lender, are often fair valued at inception based upon a market rate for similar loans. We believe that more specific guidance on these arrangements for not-for-profit entities (who don't apply AASB 120 *Accounting for Government Grants*) is required in (or issued in conjunction with) ED 189 – specifically:

- How amortised cost would apply to the loan?
- How credit is assessed for research and development (R&D) projects where collectability is contingent on the development of a commercially successful product. (E.g. how does the entity providing the loan assess the viability of the project?). Similar questions arise for green loans, loans to non-government organisations (NGOs), etc.