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Mr Kevin Stevenson
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Dear ~~Mr Stevenson~~ Kevin

AASB EXPOSURE DRAFT 189 FINANCIAL INSTRUMENTS: AMORTISED COST AND IMPAIRMENT

The Heads of Treasuries Accounting and Reporting Advisory Committee welcomes the opportunity to provide comments to the Australian Accounting Standards Board on Exposure Draft 189 *Financial Instruments: Amortised Cost and Impairment*.

Comments by HoTARAC on questions from the Exposure Draft are in Attachment 1.

HoTARAC commends the IASB on its endeavours to reduce the complexity of accounting for financial instruments and address some of the issues raised during the Global Financial Crisis. Overall, however, HoTARAC disagrees with the proposals. In particular, HoTARAC does not believe that it is appropriate to include credit loss expectations in the amortised cost measurement of financial assets.

As previously expressed in the Request for Information, HoTARAC holds a number of conceptual and practical concerns with the proposed approach. HoTARAC is concerned about the subjective nature of the information and the ability to obtain access to reliable information on which to base estimates. Further, HoTARAC believes the ability to recognise impairment gains may result in manipulation by management.

In particular, HoTARAC considers the presentation and disclosure requirements to be onerous for non-financial institutions, including origination and maturity (vintage) information, and the requirement to disclose a reconciliation for each class of financial asset with an explanation of non-performing assets. In addition, HoTARAC does not support the disclosure of stress testing information, which is dependent on whether this information is prepared for internal risk management purposes, as this may lead to a reduction in the comparability of financial reports.

In response to the AASB's specific matters for comment, HoTARAC does not consider there to be any regulatory or other issues which may affect the implementation of the proposals, other than the availability of information on which to base estimates.

Conceptually, HoTARAC does not consider the proposals will improve the usefulness of financial statements for users where non-financial institutions are concerned, as the proposed disclosures for such entities will be extensive and may impede the understandability of those financial statements by users. In addition, the subjectivity of estimated credit losses, in the measurement of amortised cost, may reduce the reliability of estimates and could potentially be misleading to users, given other asset measurement principles do not include such forward looking information.

HoTARAC offers no comment on whether the proposals are in the best interests of the Australian and New Zealand economies.

If you have any queries regarding HoTARAC's comments, please contact Peter Gibson from the Australian Department of Finance and Deregulation on (02) 6215 3551.

Yours sincerely

Don Challen

D W Challen
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

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Encl

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HoTARAC Comments Exposure Draft 189 Financial Instruments: Amortised Cost and Impairment

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

The majority of HoTARAC members consider the description of the objective of amortised cost measurement to be clear.

A minority of HoTARAC members consider the description of the objective of amortised cost measurement to be unclear due to the mix of historic cost, current information, impairment and amortised cost concepts. It is recommended that this should be made transparent and that the IASB should acknowledge that this is a consequence of a mixed measurement model. This may be achieved through the objective of amortised cost measurement being separated from the objective of impairment of financial assets.

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

The majority of HoTARAC members believe the objective of amortised cost set out in the ED is appropriate for the measurement category. However, HoTARAC does not support the inclusion of expected credit losses for financial assets in the calculation of amortised cost.

A minority of HoTARAC members do not consider that the objective of amortised cost is appropriate for this measurement category. In addition to the concerns expressed above, these members do not believe the objective is sufficiently broad to cover all financial assets required to be measured at amortised cost; for example the objective concentrates on the effective return and interest which is not relevant to short term receivables. It also does not adequately reflect the impact on the Balance Sheet.

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?

HoTARAC agrees with the way the ED is drafted, which emphasises measurement principles accompanied by application guidance. HoTARAC considers that this approach is clearer and less complex than IAS 39 *Financial Instruments: Recognition and Measurement*, where measurement guidance was contained within the definitions. However, HoTARAC considers the final Standard should provide an explicit link to the application guidance as the guidance is an integral part of the Standard. A minority of HoTARAC members consider that application guidance is best located within the body of the Standard.

HoTARAC considers that illustrative examples would be beneficial, particularly for non-financial institutions, given the complexity of the Standard and the reliability/comparability issues. HoTARAC considers the following illustrative examples, similar to the IASB staff examples, to accompany the Standard would be useful:

- fixed rate financial assets;
- variable/floating rate financial assets;
- transitional guidance, such as how the transitional effective interest rate adjustment calculation should work;
- fixed and variable financial liabilities;
- calculation of probability weighted expected cash flows;
- how the allowance account might work in practice; and
- assessment for non-performing financial assets – due to being open to subjectivity, some guidance on collectability may be appropriate.

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

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

HoTARAC considers that the expected loss approach would overcome some of the weaknesses of the incurred loss model particularly by eliminating the need for a loss trigger, however, HoTARAC holds a number of conceptual and practical concerns with the proposed approach.

Conceptual issues:

- There are conceptual difficulties with the proposed expected loss approach, particularly when compared with the approach to measuring assets in other Accounting Standards. The proposed Standard may be the only Standard that will require entities to anticipate future activities when measuring assets. Such a fundamental issue requires consideration at the conceptual framework level and is not appropriate at the level of an individual Standard.

  Further, the development of current Standards includes asset measurement principles which are inconsistent with this approach. For example, in IASB DP/2009/1 *Leases* the International Accounting Standards Board tentatively decided to adopt an amortised cost-based approach to subsequent measurement of right of use assets based on contractual cash flows rather than expected cash flows.

- The measurement of financial liabilities has not been adequately considered in the ED. The ED proposes that the estimated cash flows of financial liabilities do not reflect the entity's own performance risk (AG B3). Essentially, the ED proposes a different measurement approach for financial liabilities and financial assets measured at amortised cost. This may lead to a reduction in comparability between such financial assets and liabilities as the issuer and holder of these financial instruments would be required to account for them differently.

- HoTARAC also considers entities may need additional guidance on the measurement of financial liabilities.

- HoTARAC considers that the IASB should work with regulators in addressing some of the issues encountered in the Global Financial Crisis.

Practical issues

- Significant reservations are held regarding how an entity could obtain access to reliable information to estimate future cash flows as that information may be held by external parties, or historical data may be difficult to obtain or not exist. Reliability concerns will be compounded for non-financial institutions where valuation may be required for individual financial assets and the issue of probability weighted expected cash flows becomes more problematic, without the availability of historical data. The expected cash flows approach puts more onus on entities to ascertain information that may not be readily available to them.

- The prediction of cash flows that are dependent on another entity's circumstances is too subjective and relies heavily on management's assumptions and judgement. HoTARAC supports alternative view AV2 as it does not believe that the results of applying the model will be auditable and thus will not be verifiable due to the subjectivity involved in estimates. It is also unclear to what extent management is bound to consider internal and external evidence and what relative precedence is required to be given to each. As a result, HoTARAC is not convinced that the proposed model necessarily results in better information than the current model. Some HoTARAC members also argue that, by smoothing profit based on expected losses, the proposed model may reduce the quality of information currently provided by applying the incurred loss approach, through not reflecting the world as it is.

- Another example of the subjectivity and limitations of the expected cash flow approach concerns the reversal of impairment losses. While some entities may consider this to be a reversal of the initial impairment, another entity may treat this as a change in accounting estimate and account for it in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

- As noted in BC36 the proposals will allow entities to recognise an impairment gain from a favourable change in credit loss expectation even if no impairment loss has been previously recognised. While HoTARAC recognises that this gain aims to reflect an improvement in the credit quality of the financial asset, HoTARAC is concerned about the possible manipulation of expected loss estimates at initial recognition to recognise future revenue, ie manipulating the expected cash flows and subsequently recognising an impairment gain. This being said, HoTARAC does note that the extent of the gain is limited to the difference between the initial carrying amount and the present value of the full contractual cash flows discounted using the effective interest rate.

- A minority of HoTARAC members also believe that it is unclear from the Exposure Draft what information is to be used as the basis for determining estimates of expected credit losses. For example, Paragraphs IN7, B9, B16 and BC29 do not indicate that predictions of future conditions are expected; rather, historical and current information is referred to. Clearly there is less subjectivity dealing with historical information and current conditions. However, Paragraph BC23 implies that the allowance for losses should be predictive of future credit losses, which may suggest that estimates of credit losses should, at least partially, be based on extrapolations into the future. Also, a user's presumption may be that such estimates are based on predictions of future circumstances. These HoTARAC members consider more clarification should be incorporated into the application guidance about whether predictions of future circumstances are expected.

HoTARAC commends the IASB for acknowledging the cost and implementation issues, previously raised, by providing a longer lead time for implementation.

It is HoTARAC's view that the incurred loss approach would be preferable to the expected loss approach.

One proposal to improve the incurred loss approach could be by requiring the review of estimates at each measurement date as proposed in the ED rather than the delayed trigger method. However, HoTARAC is concerned about the practical application of remeasuring all the financial instruments at each measurement date. If the above approach is adopted, the IASB would need to consider the implications of this.

Another suggestion would be to change the criteria for recognising a provision for impairment and leaving the amortised cost calculation as it currently is.

HoTARAC supports the IASB's conclusion that the alternative impairment approaches, ie fair value approach and through-the-cycle approaches, discussed in BC15 to BC24 are inappropriate.

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

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

HoTARAC considers the objective of presentation and disclosure as set out in the ED to be clear.

However, HoTARAC does not believe the objective of presentation and disclosure as set out in the Exposure Draft is appropriate. HoTARAC believes the objective of presentation and disclosure should be linked to the objective of amortised cost, which should be sufficiently broad to cover all financial instruments measured at amortised cost, including short-term trade receivables.

Further, HoTARAC is concerned about the difficulties in distinguishing between expected credit losses and interest revenue, given expected credit losses are offset against revenue. It may not be possible to separately assess the financial effect of the interest revenue and the quality of the financial assets.

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

The majority of HoTARAC members broadly agree with the proposed presentation requirements, subject to the following concerns.

It appears that the proposed presentation requires two amortised cost calculations – one based on contractual cash flows and another based on the expected cash flows (including future credit losses). This will increase the burden on financial statement preparers as well as requiring accounting systems to have dual capability.

The presentation requirements seem overly onerous for non-financial institutions that do not hold financial instruments carried at amortised cost, other than non-complex ones such as short-term trade receivables. HoTARAC questions the usefulness and relevance of this information given the entity would not calculate an effective interest rate or recognise interest revenue. HoTARAC believes the IASB needs to reconsider the presentation and disclosure requirements for non-financial entities which only hold such instruments; and provide additional guidance and clarification where necessary, possibly through the practical expedients (also see Question 12).

A minority of HoTARAC members do not agree with the proposed presentation requirements, particularly the proposed additional line items in the Statement of Comprehensive Income. There is a concern that such detail would be inappropriate on the face of this Statement, giving disproportionate attention to financial asset impairment and leading to cumbersome presentation. An alternative would be to present this detail in the Notes to the statements.

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

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

In general, HoTARAC is concerned about the complexity and volume of disclosures and the prescriptive nature of the requirements and considers the proposed disclosures to be onerous for non-financial institutions. Instead, HoTARAC supports a broader more flexible, principles-based approach that reflects how risks are managed. The objective should be to ensure that only relevant information is disclosed for financial and non-financial institutions.

The majority of HoTARAC members support the reconciliation of changes in the allowance account as it provides transparency and useful information regarding the composition of the account. However, HoTARAC questions the usefulness of this information for non-financial institutions which only hold short-term trade receivables. A minority of HoTARAC members do not support the reconciliation of changes in the allowance account, due to the issue of unbundling the expected credit losses from the amortised cost calculation.

HoTARAC also supports the requirement to include qualitative disclosures of estimates and changes in estimates that are required to determine amortised cost for financial instruments other than trade receivables. As reflected in BC57-59, this would be necessary if the IASB's expected loss approach is retained, as it addresses some of the concerns regarding the subjectivity of management estimates under the expected loss model by attributing significant changes in estimates to particular causes.

HoTARAC does not support the disclosure of stress testing and origination and maturity (vintage) information and finds this information particularly irrelevant for non-financial institutions. While HoTARAC members are aware that only entities which prepare stress testing information for internal risk management purposes will be required to disclose this, HoTARAC is concerned that this information is excessive given the other disclosures which are proposed. In addition, HoTARAC is also concerned that this information would be difficult to audit and may lead to a reduction in the comparability of such information in financial reports.

While HoTARAC members agree that the origination and maturity information may be useful and appropriate for financial institutions, this would not be as relevant for non-financial institutions and may impose an additional disclosure burden without commensurate benefit to users. In addition, the proposals need to accommodate financial assets that have no maturity dates, which may be allowed by public sector lenders.

Further, HoTARAC is concerned that the definition and discussion regarding non-performing assets and write-offs is too prescriptive. That is, the nature of financial assets differ, as do practices across countries, such that specifying a number of days past due, may be inappropriate. Similarly, HoTARAC members are not sure that it is necessary for enforcement activities to have ceased before being able to consider an item as uncollectible, for example it could be assumed uncollectible after 12 months for reporting purposes.

HoTARAC questions how this will link with IFRS 7 *Financial Instruments: Disclosures*. An alternative would be for the IASB to consider such disclosures as part of IFRS 7 rather than a Recognition and Measurement Standard.

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

Given the extent and complexity of the proposals, HoTARAC agrees with the IASB's proposed lead-time of three years, as opposed to the usual 6-18 month effective date.

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

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

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

(a) HoTARAC agrees with the proposed transition requirements, and considers it to be the most appropriate approach compared to the alternatives put forward by the Board. However, HoTARAC considers an illustrative example of the transitional effective interest rate adjustment would be beneficial.

(b) While the customised transition approach appears simpler and less onerous, HoTARAC does not support this approach due to its negative effect on equity and interest revenue after transition. This approach uses the original effective interest rate determined in accordance with IAS 39 (not including credit loss expectations) to be applied to expected cash flows (including credit loss expectations). As set out in the Basis for Conclusions, this will result in lower cash flows discounted at a higher discount rate which will distort interest revenue after transition (BC71).

(c) HoTARAC agrees that comparative information should be restated to reflect the proposed requirements, but only if subject to reasonable practicality requirements.

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

HoTARAC agrees with the proposed disclosure requirements in relation to transition.

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

HoTARAC agrees that the proposed guidance on practical expedients is appropriate. However, HoTARAC considers that the practical expedients should be further developed, particularly for non-financial institutions (which are less likely to have historical loss data and where practical expedients become more important). In this regard, HoTARAC members are concerned that the practical expedients are only available where their impact is immaterial. This would require periodically demonstrating that it is immaterial, which potentially undermines the benefits of the practical expedients and may not be cost effective.

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?

While the practical expedients proposed in relation to short-term receivables are highly desirable, HoTARAC considers the practical expedients for short-term receivables should be extended to presentation and disclosure requirements. For example:

- How would the presentation work where there is no interest revenue? (also see response to Question 6); and
- Some of the proposed disclosure requirements would likely be impractical such as stress testing information, origination and maturity information etc.