asian-oceanian standard-setters group

10 July 2013

Hans Hoogervorst
Chairman
International Accounting Standards Board
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Dear Hans

AOSSG comments on IASB ED/2013/3
Financial Instruments: Expected Credit Losses

The Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide comments on the IASB ED/2013/3 *Financial Instruments: Expected Credit Losses*. In formulating its views, the AOSSG sought the views of its constituents within each jurisdiction.

The AOSSG currently has 26 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Dubai, Hong Kong, India, Indonesia, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Saudi Arabia, Singapore, Sri Lanka, Syria, Thailand, Uzbekistan and Vietnam.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Each member standard-setter may also choose to make separate submissions that are consistent or otherwise with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that individual member standard setters may hold. This submission has been circulated to all AOSSG members for their comment after having been initially developed through the AOSSG Financial Instruments Working Group.

The AOSSG supports the IASB's ongoing efforts to develop an appropriately balanced impairment model that reflects the underlying economics of transactions and is operational while considering the diverse feedback the Board received on its earlier exposure drafts. The AOSSG also appreciates the efforts that the IASB and FASB initially made to jointly develop one impairment model although that common goal has not been achieved at this stage. AOSSG members consider it is important for both Boards to develop a converged impairment model to minimise any gaps and costs in financial reporting. In any case, the AOSSG continues to support the IASB's and the FASB's decision to require the consideration of more forward-looking information in determining financial asset impairment.

The AOSSG consists of members from a broad spectrum of economic, legal and regulatory environment. When gathering feedback from members, we observed that the proposals in ED/2013/3 would impact entities from our region in various ways depending on their current economic, legal and regulatory backgrounds. Accordingly, AOSSG members are of the view that the IASB should focus on developing an impairment model that is clear in principle, so that the model can be implemented not only to all types of entities, but also to the diverse range of economic, legal and regulatory environments across the various jurisdictions.

Overall, AOSSG members are supportive of the general direction of the proposed model in ED/2013/3 but also have concerns about the model.

AOSSG members note the IASB's aim to balance the appropriateness and cost-effectiveness of its proposed model in ED/2013/3 (paragraph BC61 of ED/2013/3). However, most AOSSG members are particularly concerned that the proposed model lacks a conceptual basis for requiring a loss allowance at an amount equal to 12-month expected credit losses at initial recognition and subsequently on a rolling basis if significant credit deterioration has not occurred. These members consider that this proposed requirement would not reflect the economic link between the pricing of financial instruments and the credit quality at initial recognition. These members have a concern that the lack of principle for the recognition of 12-month expected credit losses would result in diverse application of the proposals, and may not be an improvement on the current IAS 39 *Financial Instruments: Recognition and Measurement* impairment model. An alternative approach and some proposed modifications to the model in ED/2013/3 are provided in our AOSSG submission.

Most AOSSG members support an impairment model that distinguishes between the different credit qualities of financial assets. However, their main operational concern with ED/2013/3 is that it requires credit information on financial assets to be tracked from initial recognition. AOSSG members were informed that entities with existing credit systems generally do not assess credit information in that manner. The current practice of most entities is to assess their borrower/debtor's credit risk at a point in time. Although some larger financial institutions in our region currently employ credit systems that could be modified to enable application of the proposals in ED/2013/3, a significant portion of our constituents, including smaller financial institutions and non-financial institutions, would require new systems to be developed to implement the proposed model in ED/2013/3. Most AOSSG members were informed that entities expect they would need to incur significant costs to develop new, or modified, credit systems and to maintain them continuously to cope with the build-up of credit information.

AOSSG members have mixed views about the proposed operational simplification in ED/2013/3 for trade and lease receivables that permits the recognition of a lifetime expected credit loss upon initial recognition. Some AOSSG members agree that the proposed simplification is a pragmatic approach for these financial assets; otherwise, the costs of applying the full impairment model would outweigh the benefits of the proposed general approach. On the other hand, some AOSSG members disagree with the operational simplification on the basis that it does not faithfully represent the underlying economics of such transactions. Some members have concerns about comparability if, within a particular industry, some entities were to apply the proposed dual-measurement model and some were to apply the single-measurement model.

AOSSG members support the IASB's objective of implementing one impairment model for all financial instruments. As ED/2013/3 would apply to financial assets measured at FVOCI, most members consider the proposed model in ED/2013/3 could benefit from a principle that permits entities not to recognise expected credit losses on such financial assets when there is reasonable and supportable history and current information about the high credit quality of these financial assets, such that both (i) the fair value of the financial asset is greater than (or equal to) the amortised cost and (ii) expected credit losses on such financial assets are insignificant (this is similar to the expedient proposed by the FASB).

Some AOSSG members would prefer the presentation of interest revenue based on a gross approach as they are not convinced there are circumstances when presentation of interest revenue based on a net approach can provide more useful information and believe that the IASB has not provided in paragraph BC99 sufficient rationale for such an interest rate calculation. In the context of discounting, some AOSSG members consider that using any interest rate other than the effective interest rate would be inconsistent with the notion of amortised cost.

The AOSSG has many members who are in the process of adopting IFRS and many members who are considering the timing of specifically IAS 39 and/or IFRS 9 adoption. If the proposals in ED/2013/3 were to proceed, in framing the relevant transitional requirements, the AOSSG urges the IASB to consider those in the process of adopting IFRS, and particularly those that might be adopting IAS 39 and IFRS 9 separately.

The views of our Islamic Finance Working Group members in considering the impact of ED/2013/3 are outlined in Appendix A. Our views in relation to the proposals in ED/2013/3 are explained in more detail in Appendix B. An alternative impairment approach proposed by the Accounting Standards Board of Japan is explained in more detail in Appendix C. Possible modifications to the proposed model in ED/2013/3 recommended by the Australian Accounting Standards Board are explained in more detail in Appendix D.

The AOSSG is keen to play a key role in the development of a global set of high quality financial reporting standards and trusts that the IASB finds our comments helpful in progressing the replacement standard for IAS 39.

If you have any queries regarding any matters in this submission, please contact me.

Yours sincerely,

K.M. Stevenson

Kevin M. Stevenson
AOSSG Chair and Financial Instruments Working Group Leader

Appendix A
Comment letter from the AOSSG Islamic Finance Working Group

10 July 2013

Hans Hoogervorst
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UNITED KINGDOM

Dear Hans

AOSSG Islamic Finance Working Group comments on IASB ED/2013/3
Financial Instruments: Expected Credit Losses

The Islamic Finance Working Group of the Asian-Oceanian Standard Setters Group (AOSSG) is pleased to provide its comments on IASB ED/2013/3 *Financial Instruments: Expected Credit Losses*.

These comments are additional to those in the letter developed by the AOSSG Financial Instruments Working Group dated 10 July 2013, and focus only on issues specific to Islamic finance. The Working Group had sought comment and feedback from other AOSSG members before finalising this letter, and none of those members have expressed significant disagreements.

Shariah acceptance

Persons knowledgeable in Shariah have indicated that the expected loss model would, in general, be acceptable for financial reporting purposes. Nevertheless, there are some practical issues with the proposals that we would like to bring to the IASB's attention. These are described in the following paragraphs.

Main proposals: Difficulties in implementation

Many entities providing Islamic finance are small financial institutions or non-financial institutions such as co-operatives and not-for-profit organisations. These entities may not have systems which are sophisticated enough to capture and monitor the information needed to implement the proposals, e.g. regular monitoring of changes in credit risk.

Disclosures: Onerous and of uncertain value to users

As identified by the AOSSG Financial Instruments Working Group, the proposed disclosure requirements may be costly and onerous for small financial institutions and non-financial institutions. This is especially true for some entities offering Islamic finance. Firstly, they may not have the systems in place to produce the information needed for the disclosures. Secondly, some are already required by regulators to provide other disclosures over-and-above the requirements for conventional financial institutions.

Moreover, the voluminous disclosures proposed may not be as important to users' economic decision-making as other information such as the extent of compliance with specific Shariah principles.

Effects analysis: Impact on Mudarabah / Musharakah profit distribution

Some believe the expected loss model may pose a problem in determining the profit on *Mudarabah* and *Musharakah* customers' accounts. When customers place an amount with a bank under a contract of *Mudarabah* or *Musharakah*, they are deemed to have 'invested' in the financing activities of the bank. Returns on the investment must be based on 'actual' profit from the relevant financing assets, representing specific allowable items of income and deductions, rather than on a pre-determined interest rate.

Historically, impairment losses on the financing assets invested in were based on the incurred loss model and incurred losses were accepted deductions because there was usually an event of default that can be construed to represent 'actual loss'. It is not certain whether impairment based on expected credit losses would be an allowed deduction for *Mudarabah* / *Musharakah* profit distribution – since expected credit loss is based on the probability of default rather than an 'actual' default.

Some stakeholders believe it should be allowed. They note that in some banks general loss provisions are an accepted deduction for profit-sharing purposes, and posit that if such an arbitrary amount was acceptable, then there is an even stronger case for accepting an expected loss based on historical and forward-looking information.

A few are concerned that some banks' Shariah advisors may not allow it. If this is the case, the bank may have to provide a reconciliation between the profit shown in the financial statements and the profit from which returns to customers are computed. This would impose additional costs on the affected bank.

Conclusion

We thank you for this opportunity to share our views. If you have any queries regarding this submission, or require further information on any aspect of Islamic finance, the Working Group would be pleased to offer its assistance.

Yours sincerely,

Mohammad Faiz Azmi

Leader of the AOSSG Islamic Finance Working Group

Appendix B

Detailed comments on ED/2013/3 *Financial Instruments: Expected Credit Losses*

The AOSSG consists of members from a broad spectrum of economic, legal and regulatory environment. When gathering feedback from members, we observed that the proposals in ED/2013/3 would impact entities from our region in various ways depending on their current economic, legal and regulatory backgrounds. Accordingly, AOSSG members are of the view that the IASB should focus on developing an impairment model that is clear in principle, so that the model can be implemented not only to all types of entities, but also to the diverse range of economic, legal and regulatory environments across the various jurisdictions.

The following responses are provided to assist the IASB with its deliberations should it continue to pursue its proposed dual-measurement model as set out in ED/2013/3.

Question 1
(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credits losses only after significant deterioration in credit quality, will reflect: (i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and (ii) the effects of changes in the credit quality subsequent to initial recognition? If not, why not and how do you believe the proposed model should be revised? (b) Do you agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

Responses to Question 1(a)

1. Most AOSSG members do not agree that the proposed dual-measurement model would adequately reflect the economic link between the pricing of financial instruments and the credit quality at initial recognition; and the effects of changes in the credit quality subsequent to initial recognition.

2. In originating and purchasing financial assets, an entity would typically consider the expectation for losses and factor that expectation into the pricing of the instrument. Therefore, the instrument price would reflect the expectation for credit losses of the instrument. However, the IASB's proposed dual measurement model would require initial recognition of '12-month expected credit losses' resulting in amortised cost (or the net carrying amount of the financial instrument) that is less than the instrument's fair value immediately on recognition. Such a loss allowance at initial recognition and on a

rolling basis subsequent to initial recognition if significant deterioration in credit quality has not occurred is arbitrary and would not convey information that is useful.

3. In addition, the recognition of losses at initial recognition appears to result in double counting of expected credit losses that are already factored into the pricing of the instruments. Therefore, these AOSSG members are of the view that recognition of losses at initial recognition does not faithfully represent the economics of the underlying transaction.

4. It is also not clear how the IASB's proposed model would function in the case of financial assets acquired in a business combination. If the financial assets are recognised at fair value on acquisition and subsequently at amortised cost or fair value through other comprehensive income (FVOCI), there would be a 'day two' credit loss recognised. Alternatively, if the proposed model is applied at the acquisition date, goodwill would be increased or an immediate loss recognised. Neither of these accounting outcomes would appear to faithfully represent the transaction.

5. Other AOSSG members do not consider the proposed IASB approach to be ideal but are supportive of the dual-measurement approach as (i) the objective of an initial 12-month expected credit losses would facilitate effective timing of recognition of interest income and credit costs; and (ii) the objective of a subsequent lifetime loss recognition upon a 'significant credit deterioration' would reflect the change in credit quality. Accordingly, these members consider that the proposed approach has the potential for providing relevant information to financial statement users.

Responses to Question 1(b)

6. Most AOSSG members consider that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate (that is, similar to the FASB's proposed approach), also does not faithfully represent the underlying economics of financial instruments for the same rationale provided in paragraphs 2 to 4 above (and consistent with the IASB's view).

7. Other AOSSG members consider that the FASB's proposed approach to be more advantageous for the reasons outlined in paragraph 14 below.

Appendix B
Detailed comments on ED/2013/3 *Financial Instruments: Expected Credit Losses*

Question 2	
(a)	Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?
(b)	Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?
(c)	Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

Responses to Question 2(a)

8. Most AOSSG members do not agree that recognising a loss allowance at an amount equal to 12-month expected credit losses ('stage 1') and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality ('stages 2 and 3') achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation.

12-month expected credit losses

9. AOSSG members appreciate the IASB's intention to 'simplify' the expected credit loss recognition compared with earlier proposals by requiring the recognition of 12-month expected credit losses at initial recognition and on a rolling basis if credit quality has not deteriorated significantly. However, many AOSSG members are of the view that this employs an arbitrary time-horizon and a lack of conceptual basis. Without such a basis, the approach cannot would not convey information that is useful. Some AOSSG members consider that the proposed subsequent rolling 12-month expected credit loss calculation does not consider the varying loss emergence periods experienced by an entity for particular product types, portfolios and markets. For example, some entities in the Asia-Oceania region, such as Australia, Malaysia and New Zealand, commonly use a loss emergence period of between 12 to 24 months, and in some circumstances up to 36 months, in their credit risk systems for some products based on the historical credit risk pattern. If the IASB were to proceed with an impairment model that recognises losses on financial instruments where credit quality has deteriorated significantly ('stage 1'), these AOSSG members consider that the IASB's proposals would better reflect current risk

management systems if the proposals were amended to require 12 months or more as the period for recognising expected credit losses for financial assets in 'stage 1'. The period chosen would depend on the credit characteristics of the financial assets.

10. Other AOSSG members are of the view that the recognition of 12-month expected credit losses for financial instruments that have not deteriorated significantly could be rationalised as a matching process between interest income and credit costs to ensure that the impairment estimate is reasonable.

Lifetime expected credit losses

11. Most AOSSG members have concerns about the complexity of the IASB's proposed model that would require an entity to 'track' the change in credit risk for each financial instrument (or each relevant portfolio of financial instruments) from initial recognition. Most entities in the Asia-Oceania region do not typically track credit risk (i) from initial recognition; and (ii) on an instrument-by-instrument basis or on a particular portfolio where that portfolio is operated on an 'open' basis. Instead, most entities assess credit risk on an overall customer exposure at a point in time. These members were informed that the changes in credit quality of a financial instrument from inception and over its life are currently not recorded within credit systems, and the performance of the instrument relative to its credit quality at inception is not an essential factor in the management of credit risk. Furthermore, credit risk is a function of a customer's ability to pay, and a customer may have multiple contracts with an entity. AOSSG members expect that to track credit risk in the manner proposed in ED/2013/3 would impose a cost burden that is likely to exceed any benefits to users.

Suggested alternatives and modifications

12. One AOSSG member (the Accounting Standards Board of Japan) proposes an alternative impairment approach (details in Appendix C of the AOSSG submission) and another AOSSG member (the Australian Accounting Standards Board) proposes a model that utilises an 'expected but not reported model', which is a further development of the proposed model in ED/2013/3 (details in Appendix D of the AOSSG submission).

Responses to Question 2(b)

13. Despite the comments in the paragraphs directly above, most AOSSG members agree that the approach for accounting for expected credit losses proposed in ED/2013/3 achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor). Other AOSSG members consider that the approach proposed in ED/2013/3, with modifications as set out in Appendix D of the AOSSG

submission, would achieve a better balance between a faithful representation of the underlying economics and the cost of implementation than the earlier proposed approaches.

Responses to Question 2(c)

14. Most AOSSG members do not think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft.

15. However, as mentioned in paragraph 7 above, some of these AOSSG members consider the FASB's proposed approach to be more advantageous as it proposes a single measurement objective that is relatively simpler to implement, easier to comprehend and is more aligned with most entities' credit risk management practices. For example, the FASB's proposed model would not require tracking of credit information from initial recognition of financial instruments.

Question 3	
(a)	Do you agree with the proposed scope of this Exposure Draft? If not, why not?
(b)	Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?

Responses to Question 3(a)

16. Most AOSSG members agree with the proposed scope of the Exposure Draft.

Responses to Question 3(b)

17. AOSSG members note the IASB's rationale that if the measurement objective for a financial asset mandatorily measured at FVOCI in accordance with the IASB ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* is to present in profit or loss amounts equivalent to that which would be presented in profit or loss for the same financial asset if it were measured at amortised cost, the same impairment model should be applied to both measurement categories.

18. However, as previously raised in our submission on ED/2012/4, some AOSSG members are concerned that applying the IASB's proposed impairment model to financial assets that are mandatorily measured at FVOCI would result in an amount being presented in

profit or loss and other comprehensive income (OCI) that are not meaningful and not easily understood by users. These AOSSG members previously recommended in the AOSSG submission on ED/2012/4 that an option to measure these financial assets at FVPL should be provided as they believe the presentation of full fair value changes in profit or loss would provide more meaningful information to users.

19. Some entities in the Asia-Oceania jurisdictions typically invest in highly liquid, high credit quality financial assets that would meet the proposed business model criteria of financial assets measured at FVOCI in ED/2012/4. These entities currently measure these financial assets at FVPL and accordingly, do not have existing credit risk models that can estimate credit losses in the manner that is proposed in ED/2013/3. Furthermore, studies have shown that these types of financial assets have very low credit risk and generally do not default. To build a new credit risk model to estimate credit losses for financial assets that have very low credit risk and generally do not default would be a significant cost burden to these entities. Accordingly, some AOSSG members consider that a principle that permits entities not to recognise expected credit losses on such financial assets when there is reasonable and supportable history and current information about the high credit quality of these financial assets, such that both (i) the fair value of the financial asset is greater than (or equal to) the amortised cost and (ii) expected credit losses on such financial assets are insignificant (this is similar to the expedient proposed by the FASB). Other AOSSG members consider that relief from recognising expected credit losses should be provided for financial assets measured at FVOCI when the credit loss amount is expected to be insignificant, without requiring the fair value of the financial asset necessarily having to be higher than the amortised cost.

20. Some AOSSG members also observe that the IASB's proposed model would require recognition of a day-one loss for financial instruments that are mandatorily measured at FVOCI and at amortised cost, but would not require the recognition of a day-one loss for financial assets that are measured at FVPL. These members have concerns about this inconsistency of measurement and the possible impacts on behaviour.

Question 4
Is measuring the loss allowance (or provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

Responses to Question 4

21. Some AOSSG members have concerns with the operability of the IASB's proposed model. Many entities, including some banks, would not have existing credit systems in the manner that is described in ED/2013/3. These AOSSG members were informed that

even though banks, subject to Basel regulatory reporting, currently calculate and have information relating to 12-month expected loss for the purposes of prudential regulation, considerable adjustments on that 12-month loss information would be required to produce the 12-month expected credit loss calculation and information required by ED/2013/3. Accordingly, some adjustments to existing credit systems, or a new credit system for accounting compliance purpose would be necessary. In addition, a vast majority of entities in Asia-Oceania do not currently have the same (or any) credit systems and information to calculate a 12-month expected credit loss as those banks that do for the purposes of prudential regulation, and accordingly, these entities would have to build new credit systems for the purpose of calculating the credit losses to be recognised. Overall, these members consider that the proposed loss allowance measure at an amount equal to 12-month expected credit losses could be implemented but not without incurring significant costs.

22. The definition of '12-month expected credit losses' is provided in ED/2013/3 as 'the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date'. Paragraph B27 of ED/2013/3 clarifies that 'expected credit losses' are an estimate of the present value of all cash shortfalls over the remaining life of the financial instrument. It is not clear from the proposed definition in ED/2013/3 that 12-month expected credit losses are the expected shortfalls in contractual cash flows *over the life of the financial instrument* that will result if a default occurs in the 12 months after the reporting date. It would be useful if the IASB were to clarify in ED/2013/3 along the lines that the 12-month expected credit losses is the cash shortfalls over the life of the financial instrument associated with the default event that is expected to occur in the next 12 months.

23. The measure of a 12-month expected credit loss also depends on whether a default event is expected. Some AOSSG members were informed that their regulators have a concern that the lack of a definition or guidance on 'default' would result in the application of the 12-month measure inconsistently as an entity can decide what constitutes a default event. These members suggest that the definition and guidance of default consistent with the Basel requirements should be provided. Other AOSSG members consider guidance or examples of a default event should not be provided unless it is made clear that they may only apply in some circumstances, otherwise, they can be interpreted as requirements, which may be inconsistent with an entity's credit risk management practices. These members consider that this issue could be addressed by requiring disclosures that explain the entity's policy on what constitutes a default event and why such a definition is selected (as currently proposed in paragraph 39(a) of ED/2013/3).

Appendix B
Detailed comments on ED/2013/3 *Financial Instruments: Expected Credit Losses*

Question 5	
(a)	Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in the credit risk since initial recognition? If not, why not and what alternative would you prefer?
(b)	Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?
(c)	Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in the expected credit losses (or loss given default ('LGD'))? If not, why not and what would you prefer?
(d)	Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?
(e)	Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

Responses to Question 5(a)

24. Most AOSSG members support the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of an increase in credit risk, however, these members do not support having to track the credit risk since initial recognition (as explained in paragraph 11 above). Many entities do not have established systems in place to capture the necessary information, and accordingly, some financial institutions and non-financial institutions could find the proposed impairment model burdensome. These members were informed that if existing credit systems were modified or new systems were developed to include the assessment of significant credit deterioration *since initial recognition*, the costs to implement such systems can be significant over time as the systems would have to be maintained continuously in a manner that copes with the build-up of credit information. Alternative preferences regarding the assessment of whether lifetime expected credit losses should be recognised have been proposed by two AOSSG members (detailed in appendices C and D of the AOSSG submission).

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Detailed comments on ED/2013/3 *Financial Instruments: Expected Credit Losses*

Responses to Question 5(b)

25. Some AOSSG members expect that SOME diversity would arise as a result of the degree of judgement involved in determining when to recognise lifetime expected credit losses. In addition, these members consider additional guidance is unlikely to significantly reduce this diversity. However, as mentioned in our response to Question 4, as the definition of lifetime expected credit losses includes the notion of a 'default event', the IASB should clarify that an expected default event is not when a cash shortfall occurs, rather it is the expected event (for example, a rise in unemployment and information about job loss) that would result in a future cash shortfall.

26. Some AOSSG members note the definition of write-off proposed by the IASB, "an entity shall directly reduce the carrying amount of a financial asset when the entity has no reasonable expectations of recovery… a write-off constitutes a derecognition event." However, in practice, some entities directly reduce the carrying amount of a financial asset even if some portion of the financial asset can be collected through securitisation as this is a current requirement of the laws or regulations in some jurisdictions. The IASB should consider how best to accommodate such practices.

Responses to Question 5(c)

27. AOSSG members agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in the expected losses (or loss-given-default).

Responses to Question 5(d)

28. AOSSG members have concerns about the proposed operational simplifications.

    (a) Investment grade assets

    Some AOSSG members do not agree with the proposed simplification for financial assets that have low credit risk ('investment grade assets') at the reporting date. Some constituents in the Asia-Oceania region consider that the proposed treatment would not achieve operational relief as intended. Other constituents in the Asia-Oceania region have indicated that it would be more operationally challenging to segregate 'investment grade assets' from non-investment grade assets.

    Some AOSSG members consider this proposed simplification may delay the recognition of lifetime loss depending on how the guidance is interpreted. The proposed definition of 'low credit risk' is if a default is not imminent and any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity of the borrower to meet its contractual cash flow obligations on the financial instrument. These members consider this proposed simplification could be applied inconsistently because it depends on how an entity interprets when a default is imminent. An instrument can be of high credit risk, yet a default may not be imminent. Conversely, an instrument can be of low credit risk, but a default may be imminent. In addition, some entities may regard a credit-rating adjustment of AAA to BBB to be a significant credit deterioration if it no longer meets the entity's 'low credit risk' definition. However, other entities may take a different view.

(b) '30 days past due' rebuttable presumption

Most AOSSG members are of the view that the proposed 30 days past due rebuttable presumption is likely to be rebutted in many cases, and therefore would not appear to be useful and would be burdensome for entities that hold large volumes of financial assets as those entities would have to rebut the presumption on a case-by-case basis. Instead, some AOSSG members consider that (i) there could be more dependence placed on disclosure of the entity's policy for determining significant credit deterioration; and (ii) setting out the objective of the presumption instead of prescribing the threshold in the Standard would be more useful.

29. Some AOSSG members consider that a principle that permits entities not to recognise expected credit losses on such financial assets when there is reasonable and supportable history and current information about the high credit quality of these financial assets, such that both (i) the fair value of the financial asset is greater than (or equal to) the amortised cost and (ii) expected credit losses on such financial assets are insignificant (this is similar to the expedient proposed by the FASB). Other AOSSG members consider that relief from recognising expected credit losses should be provided for financial assets measured at FVOCI when the credit loss amount is expected to be insignificant, without requiring the fair value of the financial asset necessarily having to be higher than the amortised cost.

Responses to Question 5(e)

30. AOSSG members agree that the proposed IASB model should be symmetrical such that it requires the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met. However, some AOSSG members have concerns that, in

practice, entities may more readily move into recognising lifetime expected losses compared with a move back to 12-month expected losses.

Question 6	
(a)	Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?
(b)	Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?
(c)	Do you agree with the proposal that the interest revenue approach shall be symmetrical (ie that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

Responses to Question 6(a)

31. Some AOSSG members would prefer a gross approach as they are not convinced that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) can provide more useful information. These members do not consider the IASB has provided paragraph BC99 sufficient rationale for such an interest rate calculation. Furthermore, these members were informed about the system challenges in performing such a calculation and that the non-accrual approach, similar to the FASB's proposal, is consistent with current practice[1] and regulatory reporting. These members consider that the IASB should be consistent with its current thinking in their revenue joint-project with the FASB when considering the presentation method.

32. In the context of discounting expected credit losses, some AOSSG members are of the view that the interest rate used to calculate interest revenue and the interest rate used as the discount rate to calculate the expected credit losses (and amortised cost) should be the same. In theory, interest revenue should be recognised, as the effect of discounting unwound with the passage of time. Using any interest rate other than the effective interest rate would be inconsistent with the notion of amortised cost, because it effectively permits recognition of the effects of changes in interest rates, which may or may not be related to changes in credit risks.

[1] In general, banks manage impaired loans on a non-accrual basis, that is, they cease recognising interest revenue, and change their credit risk management focus from earning a yield to recovering outstanding contractual cash flows.

Responses to Question 6(b)

33. Consistent with responses to Question 6(a), some AOSSG members do not believe the IASB provided sufficient rationale for the proposal to require presentation of interest revenue on a net basis for financial instruments that have objective evidence of impairment. These members recommend that the IASB consider a presentation requirement that is consistent with its joint-project on revenue with the FASB.

Responses to Question 6(c)

34. Most AOSSG members agree that if both gross and net approaches are adopted the approach should be symmetrical such that the calculation can revert back to a calculation on the gross carrying amount.

Question 7	
(a)	Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
(b)	Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.
(c)	What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

Responses to Question 7(a)

35. AOSSG members are of the view that some of the proposed disclosures could be burdensome and costly especially for smaller financial institutions and non-financial entities to prepare. In particular, AOSSG members note the following disclosures raised concern that the cost to preparers may outweigh any benefit to users:

(a) reconciliation of the gross carrying amount and the associated loss allowance for the different stages of credit quality as proposed in paragraphs 35, 36 and 37 of ED/2013/3. As an alternative, the AOSSG suggests that the gross carrying amounts and associated loss allowance (or provision) of those financial assets should be disclosed as at the opening and closing reporting dates;

(b) the nominal amount of financial assets written off that are still subject to enforcement activity (paragraph 37 of ED/2013/3);

(c) the quantitative and qualitative analyses of significant positive or negative effects on the loss allowance caused by a particular portfolio or geographical area (paragraph 41 of ED/2013/3); and

(d) the gross carrying amount of financial assets and provisions for loan commitments and financial guarantee contracts by credit risk rating grades (by at least three grades even if the entity uses fewer credit grades internally) (paragraph 44 of ED/2013/3).

36. Some AOSSG members have concerns about paragraph 32 of ED/2013/3which proposes to allow entities to incorporate disclosures by cross-reference from the financial statements to some other statement such as a risk report that is available to users of financial statements on the same terms and at the same time as the financial statements. These members consider that disclosures deemed sufficiently important as to be required by an accounting standard should be included within the financial statements themselves. Incorporation of disclosures by cross-reference could also lead to operational issues concerning the audit of such information, if the cross-referenced statement is not already subject to audit in a particular jurisdiction. Some of these members also feel strongly that it is not the role of the IASB to be requiring or permitting where some or all general purpose financial information is located because this is a matter for the standard setters and regulators in each jurisdiction, and is potentially a barrier to the verbatim adoption of IFRS in some jurisdictions.

Responses to Question 7(b)

37. Many entities would not have the requisite systems in place to provide the proposed disclosures, particularly the proposed paragraphs that require reconciliation of the gross carrying amount and the associated loss allowance as mentioned in the paragraph directly above.

Responses to Question 7(c)

38. AOSSG members do not believe there are other disclosures that should be required that would provide more useful information and justify the additional cost.

Question 8
Do you agree with the proposed treatment of financial assets on which contractual cash flows are modified, and do you believe that it provides useful information? If not, why not and what alternative would you prefer?

Responses to Question 8

39. In principle, most AOSSG members agree with the rationale that, for credit loss provisioning purposes, the model should be applied to financial assets that are modified but not derecognised, as if the same financial asset continued to exist.

40. However, some AOSSG members are concerned with the possible implication that a financial asset with a modification relating to a significant change in credit risk, and accordingly, a change in interest rates, would result in the modified financial instrument being derecognised and treated as a new instrument. As a result, in this circumstance, there could be no 'significant deterioration' from initial recognition, and only '12-month expected credit losses' could be recognised. This gives rise to a potential inconsistency with the proposed initial recognition of purchased credit impaired financial instruments, for which no credit loss would initially be recognised. These AOSSG members consider the IASB should provide clarification on how to account for financial assets that have been modified and derecognised because of a change in credit terms.

41. Some AOSSG members are also concerned with the operability of the proposed requirements for non-financial entities, such as telecommunication entities, that routinely modify their 12- or 24-month contracts on handsets, and bundled contracts as requested by customers. It is likely that the proposals, if adopted, could be burdensome for those entities in monitoring modifications and shifting loss recognition between 12-month and lifetime expected losses.

Question 9
(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?
(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

Responses to Question 9(a)

42. Most AOSSG members agree that the model should also apply to loan commitments and financial guarantee contracts.

43. However, some AOSSG members consider that loan commitments greatly differ from loans in that they do not give rise to cash outflows before loans are drawn down. In addition, the credit risk exposures for which loss allowance should be recognised are unclear, because the timing and amount of cash outflows are usually outside the control of the underwriters of loan commitment contracts.

44. Due to the nature of loan commitments, these AOSSG members think that the application of ED/2013/3 would give rise to the following challenges that the IASB should address before finalising the requirements.

(a) It is unclear how to predict the timing and amount of loan commitment drawdowns, and accordingly, the expected credit losses conditional upon the future event that an entity cannot control.

(b) For the reason stated in the previous sub-paragraph, the question may arise whether the contracts or commitments meet the definition of a liability under the IASB's Conceptual Framework. This includes whether there is a past event that warrants recognition of a liability, and whether the loan commitment gives rise to present obligation, the settlement of which is expected to result in outflow from the entity of resources embodying economic benefits (or it is considered as a future commitment).

Responses to Question 9(b)

45. Consistent with prior responses these AOSSG members expect that smaller financial and non-financial institutions could face significant operational challenges in implementing this model due to its complex nature.

Question 10
(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?
(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

Responses to Question 10(a)

46. Some AOSSG members agree with the proposed simplification of the general impairment approach for trade and lease receivables with a significant financing component. While it would be more conceptually sound to apply the same model to all financial assets, these members consider that the proposed simplifications are a pragmatic approach for these financial assets, otherwise, the costs of applying the full impairment model would outweigh the benefits of the proposed general approach.

47. Consistent with the views in paragraphs 2 and 3 above, most AOSSG members consider that the proposed simplification for trade and lease receivables that permits the recognition of a lifetime expected credit loss upon initial recognition does not faithfully represent the underlying economics of such transactions.

48. In addition, some AOSSG members do not expect that the proposed simplification for trade and lease receivables that include a significant financing component would alleviate

the operational burden since a calculation of expected loss on a lifetime basis would still be required. Unlike larger financial institutions that already have some form of credit risk management systems, many entities with trade and lease receivables (that include a significant financing component), including smaller financial institutions, would require new systems to be developed in order to capture the relevant information and perform the calculations. In particular, leasing entities (as compared to banks) in some jurisdictions, including Japan, have infrequent access to their lessees' credit risk information. Therefore, the implementation of the proposed model would be more challenging for entities with lease receivables.

49. Furthermore, some members have a concern that the proposed simplified approach for receivables that include a significant financing component would decrease comparability of financial reporting among entities within the same industry, in that, some entities would apply the proposed dual-measurement model and some would apply the single-measurement model. These AOSSG members believe that the model should be applied consistently with other types of financial asset.

Responses to Question 10(b)

50. Consistent with their views in paragraph 47 above, some AOSSG members also agree with the proposal to amend the measurement on initial recognition of trade receivables that do not have a significant financing component.

51. Consistent with the views in paragraphs 2 and 3 above, most AOSSG members commented that recognition of a lifetime expected loss on initial recognition for trade and lease receivables that do not include a significant financing component does not reflect the underlying economics of the transaction.

Question 11
Do you agree with the proposals for financial assets that are credit-impaired on initial recognition? Why or why not? If not, what approach would you prefer?

Responses to Question 11

52. Some AOSSG members support the proposal in ED/2013/3 relating to financial assets that are credit-impaired on initial recognition. Some of these members note that it is a continuation of the existing requirements in paragraph AG5 of IAS 39 and see no reason to change these requirements.

53. Some AOSSG members consider that the same model should be applied consistently to financial instruments whether originated or purchased. Notwithstanding this view, these AOSSG members consider that the proposal not to recognise expected credit losses at

initial recognition on the purchase of a credit-impaired financial asset is more representative of the underlying economics because the purchase price of the financial asset would have taken into consideration expected credit risk. These members therefore question why this is the case for purchased credit-impaired financial instruments and not for originated financial instruments where the underlying economics are substantially the same.

54. In addition, consistent with the response to Question 8 above, some AOSSG members note the potential inconsistency in initial recognition of financial assets that are purchased credit-impaired, and the apparent requirement to recognise 12-month expected credit losses on financial instruments that were modified and subsequently derecognised (for example, because of a significant change in credit risk and interest rates). These members consider that ED/2013/3 would lead to different accounting treatments in similar credit risk circumstances.

Question 12	
(a)	What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.
(b)	Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?
(c)	Do you agree with the proposed relief from restating comparative information on transition? If not, why?

Responses to Question 12(a)

55. AOSSG members were informed that the lead time needed to implement the proposed requirements would depend on the final form of the model. If the model were to require tracking of credit risk at an instrument level from initial recognition, a longer lead time would be required than if a model that does not require such tracking were introduced. AOSSG members indicated a lead time of at least 24-36 months would be required if the IASB were to proceed with the proposed model in ED/2013/3. In Australia, one bank that participated in the IASB field-testing of ED/2013/3 informed that implementing the proposed model in its current form would require significant system build or modifications. The establishment of systems according to the requirements of ED/2013/3 (including plan, develop, test and implementation of the new system) would cost approximately USD 50 million and would require 24-30 months to complete.

56. Some AOSSG members were informed that insurers in their jurisdictions are likely to hold a significant quantity of financial assets that will be accounted for under IFRS 9 when mandatory; therefore it could be cost effective for insurers in these jurisdictions to implement the proposed changes to insurance contract accounting and financial instruments simultaneously. However, these members do not recommend delaying the effective date of IFRS 9 if the insurance standard were to be deferred. Instead, they consider the IASB should attempt to complete its project on insurance contracts sooner to align with IFRS 9.

Responses to Question 12(b)

57. Some AOSSG members are concerned about the transition requirements to allow a loss allowance equal to lifetime expected losses to be recognised for financial assets for which it is not possible to determine (without undue cost and effort) whether the credit risk has increased significantly since initial recognition. This could result in excessive provisioning which would be released to profit or loss in a subsequent reporting period, artificially inflating profit. These AOSSG members consider that this could be avoided if the proposed model does not require credit risk assessment at initial recognition.

58. Some AOSSG members expressed a concern about the lack of clarity with regards to transition requirements for first-time adopters. Although it is presumed that the IASB will consider the application of IFRS 9 as a whole for first-time adopters when the remaining phases of the financial instruments project are complete, the IASB should seek comments on the proposed timing and requirements of ED/2013/3 for first-time adopters.

Responses to Question 12(c)

59. Some AOSSG members expect that determining comparatives for restatement without the use of hindsight would be challenging in practice. Therefore, these AOSSG members agree with the proposed relief from restating comparatives on transition, however if an entity does restate comparatives this fact should be disclosed. Some AOSSG members also suggest that the IASB provides further guidance for entities that do not wish to provide restated comparatives.

Question 13
Do you agree with the IASB's assessment of the effects of the proposals? Why or why not?

Responses to Question 13

60. As mentioned earlier in this Appendix B, most AOSSG members support the recognition of expected credit losses associated with credit impairment in the financial statements.

61. Some AOSSG members are aware that the IASB is undertaking field testing of the proposed model. In Australia, it may be the case that application of the proposed model would not significantly increase the total amount of loss provisioning recognised by entities. This is because the provisioning for financial assets to which '12-months expected loss' would be recognised on a rolling basis subsequent to inception, may be lower than at present, and the provisioning for financial assets for which lifetime losses would be recognised may be greater (as mentioned in paragraph 9 above some entities in Australia, Malaysia and New Zealand commonly use a loss emergence period of between 12 and 24 months, and in some circumstances up to 36 months, in their credit risk systems for some products based on the historical credit risk). The overall impact may therefore vary by entity.

62. Some AOSSG members agree with the comment in paragraph BC201 that the implementation of the expected credit loss approach will require substantial system changes, time and resources resulting in significant costs for most entities including financial institutions that are already calculating expected credit losses for regulatory purposes. In particular, significant costs would be expected to be incurred in developing systems to track change in credit risk by instrument from initial recognition. It is not clear that the benefit to users of the information that would be provided as a result of ED/2013/3 would outweigh those significant costs.

Appendix C
Alternative impairment approach proposed by the Accounting Standards Board of Japan

General Views on the Proposed Impairment Models by the IASB and the FASB

1. ED/2013/3 *Financial Instruments: Expected Credit Losses* proposes that a loss allowance (or provision) at an amount equal to 12-month expected credit losses should be recognised initially, and lifetime expected credit losses should be recognised after significant deterioration in credit quality. This contrasts with the FASB's proposed approach that recognises all contractual cash flows not expected to be collected as expected credit losses.

2. Development of an improved impairment model is challenging, because there are various matters to consider. Views on an optimal impairment model vary significantly, depending on opinions about which matters should be prioritised. For example, some may be interested in an entity's profitability of credit risk taking operations, while others may be interested in solvency of an entity. Therefore, in developing an improved impairment model, we believe that what is important is to have a clear understanding about what should be accomplished.

3. When considering the priority, we note that the proposed standard is applicable to the business model where entities hold financial assets with the objective of collecting their contractual cash flows, because ED/2013/3 suggests that the proposed standard applies to financial assets measured at amortised cost or FV-OCI.

4. We also note that the *Conceptual Framework for Financial Reporting* (hereafter, the "IASB's Conceptual Framework") explains that users of financial statements need information to help them assess the prospects for future net cash inflows to an entity[2]. In light of this, we believe that emphasis should be placed on the following matters in the development of an improved impairment model for financial assets measured at amortised cost or FV-OCI.

   (1) For the statement of comprehensive income – The relationship between interest income (which includes consideration for bearing credit risks) and credit costs should be properly reflected, while ensuring that necessary expected credit losses that can be reasonably estimated are recognised on a timely basis. For the financial assets

[2] See paragraph OB3 of "The Conceptual Framework for Financial Reporting," Chapter 1 *The Objective of General Purpose Financial Reporting*

measured at amortised cost or OCI, we believe that properly portraying this relationship would enhance the decision-usefulness of information relating to the performance of an entity[3].

(2) For the statement of financial position – A necessary amount of allowance should be recognised for credit costs (this means that allowances should not be understated nor overstated. Therefore, the notion of "sufficiency" is not the sole determinant for the level of allowance.). We note that a reasonable range of estimates should be permitted to achieve faithful representation, because the estimate of credit costs is highly uncertain and cannot be determined accurately in all respects[4].

5. In light of the matters in the previous paragraph, although the FASB's proposed approach may have the advantage in regards to understandability, consistency with the credit risk management practice of entities (as it does not require tracking of credit risks), and relevancy to an entity's solvency analysis, we are of the view that it may fail to reflect the economic reality, as it requires recognition of lifetime expected credit losses for all assets.

6. On the other hand, although it may not be as theoretical as the approach proposed in the IASB's 2009 Exposure Draft (hereafter, the "2009 ED"), we think that the proposed model in ED/2013/3 has a potential of providing relevant information to financial statement users who are interested in profitability of an entity's credit risk taking operations, if the proposed model is sufficiently operational.

7. In our view, the IASB's proposed approach has the advantage in that it separates the measurement objective of expected credit losses into 12-month expected credit losses and lifetime expected credit losses. We believe that setting the measurement objective as 12-month expected credit losses initially would contribute to effective matching between interest income and credit costs while, for those financial assets that have deteriorated in credit quality, it would be necessary to recognise a loss allowance at an amount equal to

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3 See paragraph OB16 of "The Conceptual Framework for Financial Reporting," Chapter 1 of *The Objective of General Purpose Financial Reporting*

4 See paragraph QC15 of "The Conceptual Framework for Financial Reporting," Chapter 3 *Qualitative Characteristics of Useful Financial Information*

lifetime expected credit losses. When the ASBJ staff reached out to financial statement users, equity analysts expressed views that confirmed the ASBJ staff's analysis.

8. However, financial statement preparers have voiced significant concerns over the practical application of the IASB's proposed approach because the IASB's approach requires that the measurement objective changes when the credit risk of the financial asset *increases significantly* following initial recognition (this is often called the "relative approach.") In our understanding, this relative approach effectively requires tracking credit risk on the financial instrument from initial recognition to each reporting date.

Views on an Optimal Impairment Model

9. In light of the matters described in paragraph 4 of this Appendix C, we are generally of the view that the impairment approach proposed in the 2009 ED would be considered as more theoretically appropriate, albeit with some shortcomings (for example, these approaches presume a too simple and unrealistic credit loss recognition pattern.) That approach taken in the 2009 ED is distinctive in that it requires that interest income be recognised on the basis of credit adjusted effective interest rates.

10. However, feedback from stakeholders (both domestically and internationally) has suggested that although such an impairment model could be applied to an individual financial instrument, its application to an open portfolio would be extremely difficult. In other words, although these approaches themselves may be capable of providing relevant information, it would be difficult for an entity to faithfully represent the economic reality, if the existing credit risk management and information systems were not changed substantially. This is because financial institutions holding a large volume of financial assets may not be able to utilise information maintained for their credit risk management purposes; therefore, they would have to rely on alternative data which may not necessarily be precise. As a consequence, the resulting information would not be sufficiently relevant for financial statement users. Some of the reasons are explained below:

    (1) *High volume of debt financial instruments held by financial institutions* – Financial institutions hold a large volume of debt financial instruments and usually manage them on a portfolio basis rather than on an instrument-by-instrument basis. They often have

a strategy to maintain a portfolio's risk profile at the desirable level through purchases and sales of individual instruments. In other words, except for limited major investments, their focus is usually the risk profile of a portfolio as a whole rather than that of individual instruments.

(2) *Consistency with credit management practices in financial institutions* – In most cases, after underwriting loans to borrowers, financial institutions may not raise an interest rate even if the borrowers' credit risk has significantly deteriorated since inception. Therefore, after underwriting, financial institutions usually focus on minimising credit costs rather than maximising credit spreads. Financial institutions thus monitor a static level of borrowers' credit risks periodically rather than changes in the credit risk on a financial instrument. This means that available information capable of capturing changes in credit risks is very limited under their existing information system.

11. We understand that this is the major reason why the IASB decided to explore different approaches including the approach proposed in the Boards' Supplementary Document (SD) *Financial Instruments: Impairment* issued in 2011 (hereafter, "the SD"). However, despite that the IASB's proposed approach in ED/2013/3 has in part alleviated practical challenges (for example, in terms of estimating expected cash flows), we do not believe that it has addressed the problems to that point that it enables financial statement preparers to make faithful representation without undue costs or efforts. In fact, financial statement preparers continue to be concerned about the practical challenges of the approach proposed in ED/2013/3. This is because this relative approach would effectively require tracking of credit risk on the financial instrument from initial recognition to each reporting date.

12. In addition, depending on the extent of increase in credit risks from initial recognition, the proposed approach may require an entity to classify financial assets of the same borrower into different stages; thus requiring recognition of different degrees of credit losses. Although the pricing may differ depending on the timing of initial recognition, we are of the view that this is not reasonable, because the source of the repayments from a borrower is the same.

13. Having regard to the discussion by the Boards to date, we believe that when developing an impairment model, consideration should not just be given to whether the model is capable

of providing relevant information to users, but also to if the model enables financial statement preparers to faithfully represent the economic reality without imposing undue costs or efforts. For these reasons, we believe that further improvement is necessary to the IASB's proposed impairment model.

14. Having considered these matters, we have explored a possible alternative impairment model that would meet the matters described in paragraph 4 of this Appendix C. In the following paragraphs, we will explain a proposed alternative impairment model that we believe is capable of providing relevant information to users but that can also achieves faithful representation while ensuring an appropriate cost-benefit balance.

A Possible Alternative Approach

The ASBJ's Alternative Approach

15. For the reasons stated in previous paragraphs, we have explored an alternative model that (i) encompasses characteristics necessary to provide relevant information to financial statement users in predicting future net cash inflows to the entity (as explained in paragraph 4 of this Appendix C), (ii) enables making faithful representation by financial statement preparers while striking an appropriate cost-benefit balance, and (iii) may be acceptable to the Boards. Based on our deliberations, we recommend the Boards consider the alternative impairment model which includes the following characteristics:

    (1) Classify financial assets into two categories, based on the credit status of borrowers at each reporting date.

    (2) Classify financial assets whose contractual cash flows have been recovered and are expected to be recovered in accordance with the manner originally anticipated as "category-1," and classify the remaining financial assets as "category-2." Considering that category-2 financial assets are the ones whose contractual cash flows have not been recovered as originally anticipated, these financial assets would be monitored and managed on an instrument-by-instrument basis, for example by securing collateralised assets and entering into significant modifications to the contractual terms, so as to maximise the recovery of contractual cash flows.

    (3) For financial assets classified as category-1, recognise the expected credit losses for

financial instruments at an amount equal to the one-year expected credit losses.

(4) For financial assets classified as category-2, recognise the expected credit losses for financial instruments at an amount equal to the lifetime expected credit losses. The expected credit loss of a financial asset shall be calculated at an amount equal to the present value of the recoverable amount deducted from its carrying amount.

Explanation of the ASBJ's Alternative Approach

Classifying Financial Assets into Two Categories

16. Some may hold the view that classification of debt instruments into multiple categories would be almost impossible, because the deterioration in borrowers' credit standings occurs gradually. However, in practice, when the recovery of contractual cash flows is not expected from financial assets as originally anticipated, entities usually segregate these assets from the rest of the assets in their credit risk management process. In such a case, entities might well manage these financial assets not only on the basis of a probability-of-default (PD) statistic but increased attention is often paid to a loss-given default (LGD) statistic. To put it another way, it may be possible to distinguish credit risk management practices into those with particular emphasis on the PD and those with increased attention to LGD.

17. In our view, when establishing a possible impairment model, focusing on this difference in credit risk management processes would contribute to properly portraying interest income and credit costs during reporting periods, while ensuring that necessary expected credit losses that can be reasonably estimated are recognised on a timely basis (see paragraph 4(1) of this Appendix C.) This is the primary reason why we are proposing classification of financial assets into two categories.

18. This approach (requiring classification of financial assets into two categories on the basis of entities' credit risk management) is similar to the approach proposed in the SD which required classification of financial assets into 'good book' and 'bad book.' As part of the feedback process to the SD, stakeholders expressed a particular concern that this approach would be arbitrary, because entities with lax credit risk management practice may have to recognise lesser expected credit losses. In order to address such concern, the ASBJ's

alternative approach does not just rely on entities' credit risk managements, although our proposal and the SD's approach would yield similar conclusion in many cases. Specifically, our proposal refers to the history and expectation as to the recovery of contractual cash flows, in addition to the credit risk management practice.

19. Simultaneously, we propose that the Boards develop robust application guidance which illustrates situations where credit risk management is expected to be undertaken on a more individual basis. For example, the application guidance should state that financial assets whose contractual terms have been substantially modified be classified as category-2, because they are usually managed on an individual basis. In addition, the application guidance should also state that financial assets that meet the criteria relating to objective evidence of impairment as set out in IAS 39 *Financial Instrument: Recognition and Measurement* be classified as category-2. Following this, purchased or originated credit impaired financial assets should be classified as category-2.

20. Furthermore, using the examples in paragraph B20 of ED/2013/3, the application guidance may also include the following examples as indicators in determining if financial assets are classified as category-1 or category-2.

    (1) Whether the external credit rating or the credit spread for the borrower has decreased below a certain level.

    (2) Whether the internal credit rating for the borrower has decreased below a certain level.

    (3) Whether the actual or expected financial position and performance of the borrower are adverse as a result of changes in business conditions or the regulatory environment of the borrower.

    (4) Whether covenants stated under the loan agreement have been breached.

Calculation of Expected Credit Losses for Financial Assets Classified as Category-1

21. For financial assets classified as category-1, it is expected that credit risks are usually monitored and managed on a portfolio basis. Accordingly, for these assets, calculating expected credit losses on a portfolio basis is consistent with the entity's credit risk management. As for the measurement objective, we think that one-year expected credit

losses after the reporting date would be appropriate for the reasons stated in the following paragraphs.

22. As stated in paragraph 4(1) of this Appendix C, we believe that what is important is to properly portray the relationship between interest income and credit costs, while ensuring that necessary credit losses that can be reasonably estimated are recognised on a timely basis. We note that fulfilling the objective is not always easy, because the former point is to ensure matching between income and expense, while the latter point is to address uncertainties in accounting estimates.

23. However, when we have the measurement objective of one-year expected credit losses, the period over which an entity recognises interest income would coincide with the period for which an entity estimates expected credit losses, due to the fact that an accounting period is usually a one-year period. In addition, some existing provisions of IFRSs require an entity to make estimation over a one-year period from the reporting date, in light of estimation uncertainties. For example, when assessing whether the going concern assumption is appropriate, an entity is usually required to assess its ability to continue as a going concern for the twelve months from the end of the reporting period. Accordingly, a one-year period would be considered as a reasonable time-frame in light of ensuring a reasonable estimate of expected credit losses. Furthermore, taking into account the historical data obtained over the last 10 years in Japan, we are of the view that our proposal would generally meet the abovementioned factors.

24. It is presumed that an entity usually calculates expected credit losses on the basis of portfolio balance times loss ratios which are developed on the basis of an entity's historical loss experience, because the historical data is highly verifiable and is more likely to achieve faithful representation. However, considering that historical experience does not necessarily reflect future trends, updating for current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date would be necessary.

25. In many cases, loss ratios could be developed by averaging historical loss experience over several past periods, as updated as necessary, to calculate one-year expected credit losses. However, if credit losses are not expected to occur ratably throughout the contractual

period of the financial assets, the effect on how credit losses would emerge should be taken into account in calculating expected credit losses.

26. In addition, it is not necessary that financial assets in category-1 be aggregated as a single portfolio. Rather, they should be appropriately disaggregated according to their nature and risk profiles. In disaggregating financial assets, internal credit risk ratings of financial institutions might be used. Applicable loss ratios for each portfolio would differ each other, if they were developed based on historical experience and adjusted necessary.

27. For financial assets classified as category-1, discounting expected credit losses to arrive at the present value may not be necessary. This is because the effect of discounting would often be insignificant for financial assets as category-1, and that the effect of discounting may not be calculated precisely because expected credit losses are normally calculated on the basis of the portfolio balance times the loss ratio.

Calculation of Expected Credit Losses for Financial Assets Classified in Category-2

28. By definition, financial assets classified as category-2 are usually managed on an instrument-by-instrument basis. Accordingly, we may well expect that an entity possesses information necessary to reasonably estimate the expected cash flows of financial assets over their remaining periods.

29. Because of that, we believe that it is appropriate to estimate expected cash flows over the remaining life of individual financial assets (which is the remaining life of a contractual period, taking into account expected prepayments) and to discount any expected losses using the effective interest rate. In addition, interest income should be recognised for these assets, as the effects on discounting are unwound with the passage of time; hence, those financial assets would not have a non-accrual status.

30. Separate presentation may be appropriate for credit losses on financial assets classified as category-1 and category-2, because the period of time over which an entity estimates expected credit losses may differ significantly.

Application to non-financial institutions

31. The impairment model for credit losses has a significant impact on financial institutions.

Accordingly, we initially focused on an optimal impairment model for financial institutions when we explored possible alternative approaches. Nevertheless, application to non-financial institutions is equally important, because credit losses also incur in these entities.

32. We note that though the degree of precision in credit risk management by non-financial institutions may be very different from that of financial institutions, the objectives and general approaches to credit risk management would be consistent between financial institutions and non-financial institutions. That means that when an entity does not expect to collect cash flows from financial assets as originally anticipated, both financial and non-financial institutions aim to minimise the incurrence of credit losses with the different levels of credit risk management practice. Thus, it may be possible to presume that financial assets can be classified into at least two categories with different levels of credit risk management, regardless of the types of entities. Accordingly, we believe that the ASBJ's alternative approach would also be generally applicable to non-financial institutions.

33. However, some entities possessing a large volume of trade receivables may not perform credit risk management on an individual basis even for those financial assets classified as category-2 due to the cost-benefit balance. In such a case, an entity may not maintain information necessary to make reasonable estimates of expected cash flows on an individual basis. Where that situation applies, we think that the use of practical expedients (such as a provision matrix method) should be permitted.

Benefit of the ASBJ's Alternative Approach

34. As stated in paragraphs 4 to 7 of this Appendix C, although it may not be perfect, we believe that the ASBJ's alternative approach would address important points in the development of an expected credit loss model (including, proper matching between interest income and credit costs in the statement of comprehensive income, addressing increased uncertainties in the estimate and appropriately reflecting anticipated future losses in the statement of financial position) with consideration for the cost-benefit balance. Furthermore, we believe that the ASBJ's alternative approach has the following benefits.

Appendix C
Alternative impairment approach proposed by the Accounting Standards Board of Japan

Response to the Concerns Expressed in Global Financial Crisis

35. The ASBJ's alternative approach explicitly requires that an entity recognise a certain amount of expected credit losses for financial assets classified as category-1. In other words, an entity must recognise credit losses for financial assets on which there is no objective evidence of impairment. Accordingly, our model would address concerns cited during the financial crisis over lagging recognition of impairment losses.

36. In addition, as with the proposal in ED/2013/3, our proposal requires an entity to estimate credit losses based on the best available information that incorporates reasonably available information, including those about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. This would also contribute to addressing the concerns cited during the financial crisis.

Consistency with the Entity's Credit Risk Management

37. The ASBJ's alternative approach is developed based on the credit risk management that is expected to be undertaken entities (including those of financial institutions). Therefore, we expect that entities could utilise the existing information maintained for their credit risk management purposes to faithfully represent their expected credit losses, without making significant changes to their information systems. In addition, such information is generally considered highly reliable, because the information is often examined and inspected by financial supervisory authorities.

38. Furthermore, our proposal could avoid the risk of having significant inconsistency between financial information based on accounting standards and financial information prepared for supervisory purposes, because the credit risk management processes of financial institutions are often established to meet supervisory requirements. When the ASBJ staff reached out to stakeholders, financial statement users were of the view that it would be confusing if the financial statements prepared on the basis of accounting standards and supervisory requirements result in different level of provisioning. Although general purpose financial reporting prepared in accordance with accounting standards should not

be determined by the information needs of financial supervisors[5], sharing the Boards' decisions and rationales on a timely basis would be helpful to have a common understanding among key stakeholders.

39. Moreover, unlike the approach proposed in ED/2013/3, the ASBJ's alternative approach does not require an entity to assess deterioration of credit risks from the inception of financial assets. Accordingly, our approach addresses the criticism of the IASB's approach that the tracking of changes in credit risks is almost impossible. The ASBJ's alternative approach also addresses the criticism that it is counterintuitive to recognise 12-month expected credit losses for some loans while life-time expected credit losses are required for other loans to the same borrower, when the source of the borrower's cash flow is the same.

40. Lastly, as stated in paragraphs 31 to 33 of this Appendix C, we believe that our approach could also be applicable to non-financial institutions.

Response to the Criticism to the Absolute Approach

41. We are aware that there is a criticism to the absolute approach that segregates financial assets into different categories based on the credit standing of borrowers at each reporting date. For example, some have suggested that subprime loan lenders may have to recognise excessive expected credit losses based on the absolute approach, because that approach may require recognition of life-time expected credit losses at their initial recognition.

42. In this regard, the ASBJ's alternative approach requires that financial assets be classified in category-1 or category-2, based on whether their contractual cash flows have been recovered and are expected to be recovered as originally anticipated (in other words, the classification is made on the basis of how these assets are monitored and managed.)

43. Even in case of subprime lending, lenders usually monitor and manage the credit risk of financial assets at a portfolio level until credit risks of financial assets deteriorate to the point where they do not expect that contractual cash flows will be recovered as anticipated. This means that based on the ASBJ's alternative approach, even for subprime lenders, many loans starts in category-1 at their initial recognition. Accordingly, we believe that the

[5] See paragraph OB9 of "The Conceptual Framework for Financial Reporting," Chapter 1 *The Objective of General Purpose Financial Reporting*.

ASBJ's alternative approach could alleviate the criticism raised of the absolute approach.

Response to the Concerns against Recognition of Day-One Losses

44. Under the presumption that an entity originates or purchases financial assets under arm's length conditions, the transaction price of an individual financial asset should be equal to its fair value. Therefore, the credit loss should not be recognised at initial recognition so as to appropriately reflect the economic reality[6]. Although the ASBJ's alternative approach might fall short of resolving the concern entirely, we think that our approach would significantly alleviate the concern, as it requires an entity to recognise expected credit losses on a portfolio basis. By doing so, we may be able to avoid the explicit question as to whether day-one losses should (or should not) be recognised, because a portfolio consists of financial assets with different inception dates and contractual maturities.

[6] Paragraph 58 of IFRS 13 "Fair Value Measurement"

Appendix D
Recommended modifications to ED/2013/3 by the Australian Accounting Standards Board

The AASB believes the proposals in ED/2013/3 are an important step in the right direction as the AASB supports the development of an impairment model that takes a forward-looking approach to recognising losses based on currently available information. The AASB has a number of significant concerns with the model in ED/2013/3. This Appendix sets out possible modifications to address the AASB's concerns while also achieving the IASB's objectives. The AASB's detailed comments on ED/2013/3 are set out in Appendix B of the AOSSG submission.

Overall, the AASB encourages the IASB to develop a forward-looking impairment model that is more principles-based, rather than a model with rules that unnecessarily cut across an entity's credit risk management practices. This is to facilitate application of the model by entities of all jurisdictions, economies, nature and size. The AASB's suggested modifications to the proposed model in ED/2013/3 utilise a concept of 'expected but not reported losses', which the AASB considers to be in line with the underlying economics of a wide range of businesses and the general credit risk management of entities involved in holding financial debt assets that are not carried at fair value through profit or loss (FVPL).

Overview of the AASB's rationale

If a financial instrument forming part of a portfolio is initially recognised at fair value, the effective interest rate will incorporate expectations of loss. There should be no need for any day one loss to be recognised. If credit risk does not change, nor will any provision for impairment be needed for the portfolio over its life as the performance of the portfolio will be as expected at initial recognition. Though individual instruments may need to be written down, on average the portfolio, as the unit of account, will return the discounted carrying amounts of the total of the instruments in the portfolio. Under and over recoveries will offset when, overall, initial expectations of losses are met.

Allowance for losses will be needed when expectations about losses are not incorporated into the effective interest rate. This could occur because of a lack of information when setting the original credit assessment or when there is a change of circumstance that is unexpected. All such 'corrections' should be made to the carrying amount of the financial assets if the original effective interest rate is to continue to be used.

Many banks currently grade their customers for credit risk and apply loss provisioning to the sub-portfolios for each grade. These internal gradings are mapped to external gradings for regulatory purposes.

This is currently carried out on an incurred but not reported (IBNR) basis for those sub-portfolios and would need to be changed to an expected but not reported (EBNR) basis to achieve the objectives of the IASB ED. The change from IBNR to EBNR can be managed by changing the overlays calculated for each sub-portfolio to estimate the losses within each of them.

Appendix D
Recommended modifications to ED/2013/3 by the Australian Accounting Standards Board

A weakness of the IBNR approach applied by banks is that all loans in a sub-portfolio are subjected to the loss factor for the sub-portfolio, irrespective of whether the loans are 'day one' or 'day two' as the sub-portfolios are managed on an open portfolio basis. This 'simplification' could be conceptually incorrect but practically does mitigate or dilute misclassification on day one and removes the need to track credit ratings by instrument over time. All that is needed at each provisioning point is to know the balance of the sub-portfolio and any changes to the loss factor.

If the economic overlays are designed to cope with the profile of the loans in each sub-portfolio, that is, whether the loans are day one or any other age, the risk of incorrectly provisioning day one loans is offset. The overlay would provide a weighted average loss factor that copes with the mix in loan lives. At the sub-portfolio level, if there were no mispricing at origination, in theory, there would be no day one losses.

Whenever loans are reclassified from their current gradings, a change in provisioning should take place, as each sub-portfolio in each grading has a loss factor. This should reflect the fact that the loans, if written today, would have different terms and conditions because credit risks are different for each grade.

If it is accepted that changes in credit ratings of loans should lead to adjustments to the provision for losses on the portfolio (subject to a cap of not having the portfolio revalued above its historical carrying amount), no distinction is needed between 12-month and life-time losses. (This approach is different from that of the FASB's, which would provide for day one foreseeable life-time losses without any change in credit risk).

A practical problem in following this suggested approach is that the overlays need to be able to cope not only with loans of varying lengths but also re-gradings from other sub-portfolios. A day one loan should not generate a change in a provision. A re-graded loan should cause a change.

The weighting of the loans in the sub-portfolio overlays of itself may not be responsive to disproportionate re-gradings and would need to be revised when re-gradings happens.

As credit risk is a function of the customer's ability to pay, and a customer may have multiple contracts with an entity, it is inappropriate to require credit risk to be tracked for individual instruments. The approach recommended avoids this issue and also removes the need for tracking of individual instruments. Moreover, it is used in practice, albeit on an IBNR basis.

Appendix D
Recommended modifications to ED/2013/3 by the Australian Accounting Standards Board

AASB's recommended possible modifications to ED/2013/3 based on forward-looking information

Overview of proposed modifications

The AASB proposes that the principle for recognising expected but not reported losses is to reflect 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 time of assessment.

The AASB considers that this proposed principle would not require any day-one loss recognition and because an entity would allocate a credit risk grade for each of its borrowers/debtors, 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 A model that is based on this principle would be applicable to all types of financial assets that are not at FVPL with little need for operational simplifications or practical expedients to be included in the accounting standard. This proposed modification is in contrast to the FASB model that requires lifetime expected credit losses to be recognised at initial recognition; an approach the AASB believes cannot be reflective of the underlying economics and does not support.

At initial recognition

Consistent with IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*, at initial recognition, a financial asset should be measured at fair value, and in the case of a financial asset not at FVPL, plus or minus transaction costs that are directly attributable to acquisition or issue of the instrument.

For example, a financial asset would be measured at initial recognition at fair value. Fair value would be determined in accordance with IFRS 13 *Fair Value Measurement*[7]. Generally fair value would be determined as the transaction price agreed between the issuer of the financial instrument and the borrower/debtor.

In many cases the amount recognised would be consistent with the recognition of revenue which, in accordance with the IASB's revised ED/2011/6 *Revenue from Contracts with Customers* and as tentatively agreed by the IASB in its re-deliberations, would be measured at the transaction price, which for contracts with variable consideration would be based on expected value or most likely amount, and adjusted for the time value of money if financing is significant. (Transaction costs are ignored here for simplicity.)

[7] IFRS 13 paragraph 9 defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

Appendix D
Recommended modifications to ED/2013/3 by the Australian Accounting Standards Board

Subsequent measurement

In principle, an entity would assess whether credit risk has changed and recognise those changes in loss allowance based on changes in the borrowers'/debtors' risk gradings. If the entity were to purchase or reissue an asset, or portfolio of assets, and 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 is probable that there has been an insignificant change in credit quality. Conversely, if the entity would not continue to accept the existing pricing (credit terms) in a way that the entity modifies the pricing or credit terms of the asset to reflect the change in credit risk (and in some circumstance, the entity would no longer continue its business relationship with the borrower/debtor), it is probable that there has been a change in credit risk that should be recognised. This approach does not require the entity to track the credit risk of a financial asset, or portfolio, over time. Rather, it bases the assessment of changes in credit risk of a customer on relevant factors (discussed in section 'Assessment of Change of Credit Risk' below) at the time of assessment.

Based on the principle of credit risk assessment above, an entity should recognise a loss allowance as follows:

(1) If there has been a credit change such that if the financial asset were issued or purchased at that point in time the entity would continue to accept the same or similar credit terms for that financial asset, the entity should recognise a loss allowance, or an adjustment to an existing loss allowance that reflects the change in the borrower's/debtor's credit risk grading.

(2) If there has been a credit deterioration such that if the financial asset were issued or purchased at that point in time the entity would no longer accept the same or similar credit terms, and accordingly, would modify the pricing (or credit terms) of the financial asset (and in some circumstance, the entity would no longer continue its business relationship with the borrower/debtor), the entity should recognise lifetime expected losses whether reported or not (EBNR).

(3) If there has been a credit improvement, such that if the financial asset were issued or purchased at the reporting date the entity would no longer continue to accept the same or similar credit terms, and accordingly, would modify the pricing (or credit terms) of the financial asset to be more favourable to its borrower/debtor, the entity should no longer recognise lifetime expected but not reported losses, and adjust the loss allowance to reflect the change in the borrower's/debtor's credit risk grading, to the extent that the adjusted carrying amount does not exceed the financial instrument's historical carrying amount.

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Assessment of change of credit risk

The principle in the assessment of whether a change in credit risk has occurred should be whether an entity would continue to accept the same or similar credit terms, and not modify the pricing if the financial asset were issued or purchased at that point in time. This assessment should be based on information from the entity's internal credit risk management practices corroborated by reliable and supportable external information and forecasts of future events and economic conditions. An entity's credit risk management practices need to be able to facilitate credit risk assessments. Some entities' credit risk models may include a debt provisioning matrix/debt ageing analysis and those models that are used for regulatory reporting purpose.

If an entity's credit risk management practice is to apply probabilities of default to assess changes in credit risks, those probabilities of default should be based on internal historical information adjusted for reliable and supportable external information. The assessment should include consideration of the following factors, where relevant to the entity[8]:

(a) changes in external market indicators of credit risk for a particular borrower/debtor or similar borrower/debtor with the same credit characteristics. Changes in market indicators of credit risk can include, but are not limited to:
   - (i) the credit spread;
   - (ii) the credit default swap prices for the borrower or borrowers of similar credit characteristics;
   - (iii) the length of time and extent to which the fair value of a financial asset has been less than its amortised cost; and
   - (iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments;

(b) an actual or expected changes in the borrowers'/debtors' external credit rating;

(c) changes in internal price indicators of credit risk as a result of a change in credit quality, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date;

(d) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the borrower/debtor;

[8] These factors were proposed in paragraph B20 of IASB ED/2013/3 and have been altered in this Appendix A to reflect that credit risk assessments should be performed at a borrower/debtor level, and not at the instrument level. This is to ensure that all financial assets associated with the one borrower/debtor are assessed for credit impairment (improvement) in the same manner. The AASB notes there may be some repetition in these factors.

(e) an actual or expected internal credit rating downgrade for the borrower/debtor or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies;

(f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a change in a borrower/debtor's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected increase in unemployment rates;

(g) changes in operating results of the borrower/debtor. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in a borrower's/debtor's ability to meet its debt obligations;

(h) [this point has been removed—the AASB considers this factor is not relevant in the context of the AASB's proposed modifications as credit risk is a function of the borrowers'/debtors' ability to pay, and accordingly, a change in a borrowers'/debtors' credit risk, and not the financial instrument];

(i) an actual or expected adverse change in the regulatory, economic, or technological environment of the borrower/debtor that results in a change in the borrower's/debtor's ability to meet its debt obligations, such as a decline in the demand for the borrower's/debtor's sales product because of a shift in technology;

(j) changes in the value of the collateral supporting the obligation and the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's/debtor's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages;

(k) a change in the quality of the guarantee provided by a 100 per cent shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion;

(l) changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected change in the quality of credit enhancement, which are expected to reduce the borrower's/debtor's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security);

(m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument;

(n) changes in the expected performance and behaviour of the borrower/debtor, including changes in the payment status of borrowers/debtors in the group (for example, an increase in the expected number or extent of delayed contractual payments or an increase in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount);

(o) changes in the entity's credit management approach in relation to the financial instrument, ie based on emerging indicators of changes in credit quality of the financial instrument, the entity's credit risk management practice is expected to become more active or focused on managing the instrument, including an instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower/debtor; and

(p) borrower's/debtor's past-due information.

Policy for determining whether a change in credit risk needs to be recognised

An entity should determine and disclose the policy it applies to assess whether credit risk has changed. For example, an entity would recognise lifetime expected but not reported losses when the borrowers' credit risk rating falls below the entity's 'acceptable credit grade' at that point in time. An entity would continue to adjust its loss allowance based on the changes in a borrower's credit risk rating that has not fallen below the entity's acceptable credit terms.