



30 June 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear David

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

The Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide comments on Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (ED/2009/12).

The AOSSG currently has 24 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Hong Kong, India, Indonesia, Iran, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Nepal, New Zealand, Oman, Pakistan, Saudi Arabia, Singapore, Sri Lanka, Thailand, Turkey and Uzbekistan.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Other views that are consistent or otherwise with the overall AOSSG comments are also provided within this submission. Individual member standard setters 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's Financial Instruments Working Group. The AOSSG has not received any substantive contrary views from our constituents.

The AOSSG acknowledges that the global financial crisis has highlighted that users of general purpose financial statements require more forward-looking information to be incorporated into loan-loss provisioning, and that this featured in the letter from G-20 leaders to the IASB and the recommendations of the Financial Crisis Advisory Group. Accordingly, the AOSSG is supportive of the IASB's efforts to improve on the approach to impairment in IAS 39 *Financial Instruments: Recognition and Measurement* for financial assets measured



at amortised cost. However, AOSSG members have a number of significant concerns with the IASB's proposals on both conceptual and practical grounds.

The AOSSG considers that the proposed expected loss model is not consistent with an amortised cost measurement attribute and lacks a conceptual basis. In particular, the AOSSG considers that the proposed model is unsuitable as the basis for measuring assets at amortised cost because it is not based on the occurrence of transactions or other events. Furthermore, the AOSSG considers that the proposed impairment model is inconsistent with an amortised cost measure because it mixes asset measurement and revenue recognition and in some circumstances captures amounts that do not relate to changes in credit risk.

Furthermore, the AOSSG is concerned about the consistency of the proposed model with other requirements and projects. In particular, the AOSSG notes that the model takes an aggressive approach to the recognition of losses (and gains) relating to a financial asset when compared to the recognition of expenses when accounting for liabilities. The latter is driven by the existence of an obligation. The former is now to be based only on expectations. This inconsistency would become most evident whenever an asset and liability are recognised through a single transaction. To achieve consistency, liabilities would need to be derecognised simply because it is expected that a receivable might not be realised. However, to do so would be contrary to the treatment of provisions under IFRSs.

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

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

The AOSSG notes that the IASB has released a Request for comment on the FASB Exposure Draft, which is due for comment by 30 September 2010. The AOSSG considers that the different timing of the IASB and FASB proposals will require duplication of effort by the IASB and its constituents in striving for converged outcomes on financial instruments. The AOSSG urges the IASB and FASB to better coordinate their efforts and make best use of



limited standard setting resources and the limited time available to constituents to comment on proposals.

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.

The AOSSG views, as summarised above, and other views, are explained in more detail in Appendix A. Appendix B provides direct responses to the questions in ED/2009/12 with cross-references to AOSSG views in Appendix A.

If the proposals in ED/2009/12 were to proceed, we believe that consideration should be given to providing more guidance to assist preparers and auditors to implement the requirements given the level of sophistication, data availability and expertise in emerging markets such as those in many AOSSG jurisdictions. The AOSSG also reminds the IASB to consider those emerging markets in the process of adopting IFRSs, and particularly those that might be adopting IAS 39 and IFRS 9 separately.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'M. Faiz Azmi', is written over a light blue horizontal line.

Mohammad Faiz Azmi
Chairman of the AOSSG

A handwritten signature in black ink, appearing to read 'K.M. Stevenson', is written over a light blue horizontal line.

Kevin M. Stevenson
Leader of the AOSSG Financial Instruments
Working Group

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1 Measurement model – the absence of a conceptual basis

(Broadly relates to Questions 1, 2, 3 and 4 in ED/2009/12)

- 1.1 The subject of ED/2009/12 is impairment of financial assets measured at amortised cost. ED/2009/12 proposes changing the definition of ‘amortised cost’ in IFRS 9 to refer to “A cost-based measurement of a financial instrument that uses amortisation to allocate interest revenue or interest expense”. As further explained in ED/2009/12:

BC4 The exposure draft proposes requirements for the impairment of financial assets but also for amortised cost measurement as a whole.

In addition, at paragraph BC15, the IASB rejects a fair value approach to impairment on the basis that it is inconsistent with a cost measurement basis.

AOSSG comments

- 1.2 AOSSG members consider that any model that purports to be cost-based should adhere to cost measurement principles. However, AOSSG members are concerned that:
- (a) on the one hand, the IASB has not been consistent with its conclusion in paragraph BC15 because the proposed initial and subsequent measurement of financial assets is not cost; and
 - (b) on the other hand, because of its reasoning in paragraph BC15, the IASB may be excluding possible impairment models from its consideration, such as the model underlying IAS 36 *Impairment of Assets*.
- 1.3 AOSSG members note that IAS 36 applies to assets measured at cost (including assets measured at revalued cost) and applies clear measurement principles involving the use of current value information. IAS 36 defines ‘recoverable amount’ in terms of the lower of fair value and value in use, and value in use is defined in terms of the present value of future cash flows expected to be derived from the asset.
- 1.4 AOSSG members consider that the IASB should explore an IAS 36-style approach to the impairment of financial assets measured at amortised cost before concluding its

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deliberations, particularly since the IAS 36 approach appears to have proved to provide a robust impairment model for non-financial assets during the recent credit crisis.

- 1.5 Under an IAS 36-style approach, the initial measurement of financial assets measured at amortised cost would be based on the contractual rate embedded in the asset. This is in contrast with ED/2009/12 that proposes applying a credit-loss-adjusted effective interest rate for the purposes of initial measurement. The proposed methodology introduces elements that move away from the cost-based initial measurement by incorporating credit loss expectations in the amortised cost measurement. Central to the definition of a financial instrument is the notion of a ‘contract’, and in an exchange transaction the contractual interest rate(s) at inception represents the market view at the date of the transaction. Having each entity determine a rate or rates at inception at other than the market rate(s) is a departure from a transaction-based cost model.
- 1.6 Under an IAS 36-style approach, impairment would be measured using current value information. That is, subsequent to initial measurement at cost, an assessment could be made as to whether the ‘recoverable amount’ of the financial asset has fallen below the lower of its fair value and value in use, with value in use being determined by reference to an assessment of the expected future cash flows discounted at the relevant prevailing market rate.
- 1.7 Another view is that, given the focus is on determining the basis for amortised cost measurement, consistent with the cost basis of measurement, and given the FCAG’s recommendation to explore models that use more forward-looking information, the IASB could usefully examine the notion of incurred but not reported (IBNR) losses. The notion of IBNR is widely used in accounting for insurance contracts, with insurers providing for claims liabilities that relate to events they know have occurred from general information about the claims environment, rather than from being advised of the occurrence of specific events. AOSSG members consider that the basis for recognising losses using the IBNR notion would be consistent with the principles of the incurred loss model, that is, there is the occurrence of a ‘loss event’, and historical

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evidence and observable data indicate that there are implications from the loss event that will affect future cash flows.

- 1.8 AOSSG members observe similarities between an IBNR approach and the FASB ED proposal for an entity to consider all available information relating to past events and existing conditions and their implications for the collectability of cash flows. The FASB's proposal to remove the 'probable' threshold before which an impairment could be recognised is also consistent with an IBNR approach that draws on a broad range of information to identify when obligating events have taken place. That is, an entity would employ probability in a measurement context and recognise impairment losses once the available information is sufficient to alter the entity's view on the measurement of expected cash flows. This may be well before the entity would be able to accumulate sufficient evidence to justify that a particular loss meets the criterion of 'probable' in a recognition sense.
- 1.9 Although set in the context of determining that part of the 'qualifying portion of a change in fair value' that must be included in net income, the FASB's proposals appear to be consistent with a cost approach to measuring an asset subject to an impairment test because the focus is on past transactions and events. Accordingly, AOSSG members would support the IASB considering the FASB's proposed approach in determining impairment losses for financial assets at amortised cost. AOSSG members also concur with the FASB's proposed approach to distinguishing (a) information that provides the basis for determining that particular events have already occurred and which gives rise to impairments (or reversals of impairments) from (b) forecast information, which goes beyond a cost model and the IBNR approach.

Other views

- 1.10 Some AOSSG members support the IASB's logic in paragraph BC31 on the basis that it is consistent with the credit risk management principles applied by some entities. However, those AOSSG members are concerned about the significant operational issues with the proposed model in ED/2009/12. Accordingly, on the basis that the costs

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of implementing the ED/2009/12 proposals would be significant compared with the likely benefits, even these AOSSG members have considerable reservations about adopting the IASB proposed impairment model.

2 Issues concerning ‘interest’ and credit risk

(Broadly relates to Questions 3 and 4 in ED/2009/12)

2.1 IFRS 9 includes a definition of ‘interest’ in IFRS 9 to help identify ‘contractual cash flows that are solely payments of principal and interest’ for the purposes of classifying financial assets at amortised cost. IFRS 9 describes interest as follows:

4.3 For the purpose of this Standard, interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.

2.2 Accordingly, interest is effectively ‘deemed’ to comprise only two components – time value of money and compensation for bearing credit risk. However, interest can be considered to comprise a wider number of factors. The OECD¹, for example, regards interest as being a function of:

- (a) the amount, purpose and period of the transaction;
- (b) the credit-worthiness of the borrower;
- (c) the collateral offered and/or other guarantees/guarantors available;
- (d) the competition for the transaction; and
- (e) government policy.

Others specifically identify ‘liquidity risk’ as an element of interest rates.²

1 <http://stats.oecd.org/mei/default.asp?lang=e&subject=15>

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

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AOSSG comments

- 2.3 AOSSG members consider that using the effective interest rate calculation as a means of accounting for credit losses based on an over-simplified definition of interest can lead to some material component of the losses recognised under the proposed impairment model being due to factors other than credit risk.
- 2.4 AOSSG members note that the impacts of shifts in the yield curve on variable rate instruments would be recognised as credit losses (or gains) under the ED/2009/12 proposals. This is because the proposed model prescribes a ‘catch-up approach’ when there are subsequent changes to expectations about credit losses. The proposed impairment model is unable to distinguish catch-up adjustments that relate to the deterioration of the credit quality of assets (impairment) from adjustments that relate to other factors that might cause a shift in the relevant yield curve. This is because catch up adjustments are made for any shift in the yield curve, which may occur for reasons other than changes in credit risk, such as a change in liquidity risk and other impacts of changed market expectations.³ This issue is particularly significant in environments where variable rate loans are common such as in many AOSSG jurisdictions.
- 2.5 Accordingly, AOSSG members believe that the IASB has not achieved its aim of avoiding problems associated with recognising as credit losses amounts that arise from non-credit related factors in the existing IAS 39. AOSSG members note that the IASB comments:

BC19 ... The Board noted that this mixed approach (to measurement) in IAS 39 has created significant complexity, created application problems, and resulted in anomalous revenue recognition in periods subsequent to the impairment date to adjust for the effects of non-credit related factors.

³ Australian Treasurer, *Review of the Commonwealth Government Securities Market*, October 2002

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- 2.6 Since the proposed model is unable to adequately distinguish the impacts of credit losses from other impacts, AOSSG members believe that it lacks transparency.

Other views

- 2.7 Some AOSSG members support incorporating the impact of an initial assessment of credit losses into the determination of the effective interest rate. However, most of those members consider that, at least in some circumstances, the catch up adjustment should also be made through the effective interest rate calculation. This view is further explained in section 5 of this Appendix.

3 Concerns about incorporating expected credit losses into effective interest rates/revenue recognition

(Broadly relates to Questions 3 and 4 in ED/2009/12)

- 3.1 ED/2009/12 proposes that interest revenue be adjusted for initial credit losses on the basis that the holder of financial assets would otherwise be overstating revenue [paragraph BC11(a)]. The IASB also concludes that the proposed impairment model would reflect lending decisions more faithfully than the existing model [paragraph BC31]. The implication is that the proposed model better reflects the manner in which banks and similar financial institutions make lending decisions and, in turn, this would help users to analyse business models and performance.
- 3.2 Based on discussions with a range of AOSSG constituents, it is apparent that some large loans are specifically priced using cash flow analysis and that some entities undertake cash flow analysis for particular classes (or portfolios) of loans. However, because of the many factors that drive interest rates and the competitive markets in which lenders operate, many (and probably most) loans are not priced in a manner consistent with the proposed impairment model or in the simplified way that the description of ‘interest’ in IFRS 9 implies.
- 3.3 Lenders in many AOSSG jurisdictions have indicated that they do not manage credit risk as a function of revenue recognition, and feedback from analysts in AOSSG

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jurisdictions suggests that users are interested in knowing how a banking business is managed. This is consistent with the view that a ‘through the eyes of management’ approach can be helpful to users⁴. AOSSG members note that the approach taken by in the FASB ED to determine effective interest rates is to use the rate that equates the contractual cash flows with the initial cash outflows⁵, and excludes initial expected credit losses. In this case, the FASB proposals are more consistent with the business models of most entities in AOSSG jurisdictions in determining impairment amounts. The FASB acknowledges concerns about separating impairment amounts between initial and subsequent assessments and this is one of the reasons it decided not to pursue an expected loss model [paragraph BC175 of FASB ED].

3.4 In relation to revenue recognition, most lenders in AOSSG jurisdictions and users of their financial statements focus on the margin between the lending rates and the cost of funding—sometimes called the ‘net interest margin’. (IASB notes the significance of this in paragraph BC49, but only as a matter of presentation). AOSSG members also observe that most financial institutions and non-financial institutions in AOSSG jurisdictions present results to users in a format that clearly distinguishes ‘gross operating income’ from ‘impairment expense’. Users have advised that this format of presentation is important as it provides a clear message about what is contractually received/receivable and the total of recognised credit losses (impairment) and generally reflects the way in which entities are managed. Users have also commented that, because the expected loss model deals with initial expectations of impairment losses separately from subsequent impairment losses/gains, it obscures the overall picture of the level of impairments.

3.5 AOSSG members note that the FASB also proposes a net interest income recognition approach in that, “the amount of interest income to be recognised in net income ... shall be determined by applying the financial asset’s effective interest rate to the amortised

⁴ For example IFRS 8 *Operating Segments* adopts a ‘through the eyes of management’ approach

⁵ Paragraph 66 of FASB ED

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cost balance net of any allowance for credit losses” [paragraph 76 of the FASB ED]. However, in contrast to the IASB proposals, the FASB proposals do not include an initial adjustment to the effective interest rate for expected credit losses.

- 3.6 In concept, if the net interest margin were to be assessed using the IASB’s proposed impairment model, the same ‘impairment’ model would need to be applied to the wholesale cost of funding. That is, ‘own credit risk’ would need to be factored into the calculation of interest expense for the sake of comparing like with like. However, AOSSG members note that ED/2009/12 explicitly states, without any supporting justification or acknowledgement of the asymmetry involved, that “For financial liabilities estimates of expected cash flows do not reflect the entity’s own non-performance risk.” (paragraph B3).

AOSSG comments

- 3.7 AOSSG members consider that the proposed impairment model is relatively complicated compared with the existing IFRS models of impairment (in IAS 36 and IAS 39) because it integrates revenue recognition and impairment. Furthermore, AOSSG members consider that ED/2009/12 is effectively elevating the effective interest rate method to the status of a measurement basis, which it is not.
- 3.8 AOSSG members do not believe that the IASB and FASB proposed models, in the context of revenue recognition, better reflect the manner in which banks and similar financial institutions in AOSSG jurisdictions make lending decisions and doubts that the IASB’s proposed impairment model would better meet the needs of users of their financial statements.
- 3.9 In general, AOSSG members consider that the IASB should exclude initial expected losses from the calculation of effective interest rates and that the effective interest rates should be based on contractual cash flows so that the model more closely aligns with entities’ business models and so that:

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- (a) the net interest margin clearly shows the difference between the contractual rates at which an entity lends versus the cost of its funding; and
- (b) all credit losses are treated in the same way so that the aggregate impact of such losses is readily apparent.

4 Impact on non-financial institutions

(Broadly relates to Questions 3, 4, 11 and 12 in ED/2009/12)

- 4.1 AOSSG members note that the IASB's proposed impairment model is oriented to financial institutions whose main business is lending. Many other types of entities, such as those with long-term trade receivables, will be impacted by the proposals and the focus of these entities is on generating revenue from selling goods and services, not generating interest revenue. Credit provided to customers by non-financial institutions is generally incidental to the sale of goods and services.
- 4.2 Accordingly, the proposed model, which deals with impairment through a revenue recognition methodology, is unlikely to be suitable for non-financial institutions in a number of respects. For example, it is unlikely to produce information that is relevant to users of their financial statements who would be more focused on the information that drives these entities' business models. The risk of impairment of financial assets such as an entity's trade receivables is likely to be a business risk that is managed by the entity as a completely separate function from the management of the entity's core activities that produce revenue. Similarly, financial statement users in AOSSG jurisdictions have indicated to AOSSG members that they would separately analyse the revenue generating functions and credit risk aspects of the businesses of non-financial institutions.

AOSSG comments

- 4.3 AOSSG members consider that the proposed model, even taking into consideration the 'practical expedients' noted at paragraphs B15 to B17, would add a layer of complexity to the preparation of financial statements that is not warranted for entities whose main

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business activities are not lending. AOSSG members are not aware of any evidence to suggest that the accounting policies applied to recognise impairment of financial assets such as trade receivables were a source of concern arising during the credit crisis.

- 4.4 AOSSG members appreciate that ‘transaction neutrality’ is an important notion that underpins the development of most IFRSs, such that the accounting treatment of similar transactions involving financial assets should be treated similarly no matter which entity undertakes them. AOSSG members support this notion and generally take the view that the inappropriateness of the proposed impairment model for financial assets such as trade receivables is a further reason for not supporting the IASB’s proposed impairment model for application to any financial assets.
- 4.5 AOSSG members also consider the following matters to be relevant should the IASB proceed with its proposals in ED/2009/12, and encourage the IASB to consider these matters for inclusion in the final standard as guidance.
- (a) Non-financial institutions mostly use ageing of debtors, sales representative information, and information from credit rating agencies to estimate their credit losses.
 - (b) Under IAS 18, revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity, that is, revenue is not recognised when an inflow is not probable. However, ED/2009/12 proposes that trade receivables would be measured at their invoice amount from the sale of goods less the initial estimate of undiscounted expected credit losses [paragraph B16]. For this purpose, AOSSG members think the meaning of ‘probable’ in IAS 18 is different from the meaning of ‘probability-adjusted’ under the expected loss model. For example, if there is a 20% chance that the invoiced amount may not be collectable, the receivable is deemed to be ‘probable’ and recognised in full (as there is more than a 50% chance of recovering the amount), however, the probability-weighted number under the proposed model is 80% of the invoiced

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amount. AOSSG members urge the IASB to clarify the application of the notion of probability-weighting to trade receivables.

- (c) For those assets held by non-financial institutions, some AOSSG members consider that an indicator or trigger event approach for recognising impairment should be retained in order to help avoid the costs of the proposed model exceeding any benefits it may provide. For example, one ‘trigger’ approach would be to undertake a qualitative (high or low risk of default as indicated by loss history) assessment on medium to long-term receivables, other than loans, before deciding whether it is necessary to apply the proposed model.

5 Practical concerns about separating initial and subsequent impairment

(Broadly relates to Questions 3 and 4 in ED/2009/12)

The impact of separating initial and subsequent impairment assessments

- 5.1 A concern about the separation of initial and subsequent impairment assessments is that it may effectively force entities to adopt a ‘closed portfolio’ approach to impairment assessment. That is, under the proposed impairment model, entities would not find it feasible to add new loans to a portfolio for which the initial cash flow expectations have already been made and embedded in the effective interest rate calculation. There seems to be no facility under the proposed impairment model for entities to re-calculate the effective interest rate for initial expected cash flows associated with new loans. If new loans were added to an existing portfolio, any initial impairment losses on those new loans would presumably be included with subsequent impairment losses on the existing loans in the portfolio, which seems to violate the notion underlying ED/2009/12 that initial and subsequent impairments are treated differently.
- 5.2 Banks and other financial institutions in AOSSG jurisdictions generally manage loans on an ‘open portfolio’ basis. Accordingly, the proposed impairment model would be inconsistent with the manner in which most banks and other financial institutions in AOSSG jurisdictions manage their businesses and would cause them to incur

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significant costs in creating or changing information systems. If the proposed impairment model were to be required, many entities may choose to continue to manage their businesses on an open portfolio basis (and report different information in their segment disclosures compared with their whole-of-entity financial statements) and need to incur the ongoing expense associated with maintaining two information systems.

- 5.3 AOSSG members note that the Expert Advisory Panel has acknowledged the significant operational issues associated with applying the expected loss model in the context of open portfolios⁶.
- 5.4 AOSSG members also note that the European Banking Federation has commented that initial and subsequent impairments should be treated consistently. However, the European Banking Federation recommends seeking consistency in the treatment of initial and subsequent impairments by adjusting the effective interest rate for subsequent impairments, which members of the AOSSG generally do not support.

The use of the catch-up approach

- 5.5 ED/2009/12 prescribes a ‘catch-up approach’ when there are subsequent changes to expectations about credit losses. AOSSG members appreciate the IASB’s efforts in communicating why the approach might be considered appropriate in concept through staff explanation and an example posted on the IASB website.

AOSSG comments

- 5.6 AOSSG members consider that the IASB’s proposed impairment model would give rise to practical problems associated with the manner in which financial institutions currently manage their business—using an open portfolio approach.
- 5.7 AOSSG members also consider that the IASB’s proposed approach effectively requires information to be analysed on the basis of the ‘vintage’ of each loan or portfolio of

⁶ IASB Update on Expert Advisory Panel (EAP) discussions, 26 May 2010

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loans, which is inconsistent with the perspective of financial institutions in AOSSG jurisdictions and the users of their financial statements, and could prove costly to implement.

- 5.8 As commented earlier, AOSSG members generally agree with the proposal to employ the catch-up approach, and consider it would be consistent with that approach to employ a type of incurred loss model to account for initial expected credit losses. Accordingly, those members of the AOSSG disagree with the suggestion that the effective interest rate should also be adjusted for subsequent losses (the European Banking Federation view) as a means of achieving consistency with the treatment of initial expected credit losses. Those AOSSG members consider that adjusting the effective interest rate for subsequent losses would delay the appropriate recognition of credit losses relating to past transactions or events and would be a further corruption of the revenue recognition model.

Other views

- 5.9 Some AOSSG members support an approach whereby the effective interest rate is adjusted for changes to the initial expectations about future cash flows (credit losses), consistent with the recommendations of the European Banking Federation. However, those members generally consider that the catch-up adjustment, which immediately reflects the impact of changed expectations in profit or loss, should still be applied to ‘non-performing loans’
- 5.10 Those AOSSG members in support of subsequent adjustments to the effective interest rate also acknowledge that this approach might pose practical issues with the recalculation of effective interest rates and, in some cases, might result in a negative effective interest rate.
- 5.11 Those members supporting a differential approach to performing loans and non-performing loans also note that, if the distinction has recognition and measurement implications, the IASB may need to give further consideration to the robustness of the

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proposed definition of ‘non-performing’ in Appendix A of ED/2009/12. A further complication is that the definition of ‘non-performing’ is often a jurisdictional matter and its meaning may vary from one country to the next.

6 Estimates of future cash flows

(Broadly relates to Questions 3 and 4 in ED/2009/12)

- 6.1 The IASB’s proposed impairment model requires an entity to estimate expected cash flows over the remaining life of a financial asset, using current cash flow information at each measurement date [paragraphs 4 and B8]. The estimates used for the cash flow inputs are expected values, which are estimates of amounts and timing of cash flows based on probability-weighted possible outcomes [paragraph 8].

AOSSG comments

- 6.2 It is unclear from the proposed requirement of ‘using current cash flow information at each measurement date’, whether an entity estimates future cash flows based on information prevailing at reporting date or on expectations of future changes beyond the reporting date extrapolated from currently available information. That is, under the proposed impairment model it is not clear whether the entity can or must consider trends based on the information available today to make projections about future conditions over the life of loans. For example, would a bank consider the possible impacts of the closing of a factory when it is estimated that this event will affect factory employees who have borrowed from the bank and will probably lead to lower levels of economic activity that will in turn affect suppliers to the factory who have borrowed from the bank?
- 6.3 Based on discussions with constituents in AOSSG jurisdictions, there are varying interpretations of using ‘current cash flow information’ to estimate future cash flows. In the case of the example of a closing factory, one view is that there is no observable data in relation to default payments, and therefore impairment losses should not be recognised. A second view is that, based on historical evidence, the closing of the

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factory is the observable evidence that future cash flows on loans to the factory employees and suppliers will be affected. A third view, is similar to the second view, except that historical evidence shows that the closing of the factory also leads to lower levels of general economic activity. AOSSG members consider that the second and third views are consistent with the notion of the incurred but not reported (IBNR) approach to impairment. AOSSG members suggest that, if the proposals proceed, the IASB should provide clarification about the scope of current cash flow information that should be considered.

6.4 AOSSG members note the FASB ED proposes that:

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

AOSSG members consider that the FASB proposals would be helpful in the context of the IASB's proposed expected impairment loss model in identifying relevant cash flows for both initial and subsequent impairment assessments. AOSSG members also

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consider that the FASB guidance (in paragraph 42 of FASB ED) would also be helpful in the context of an incurred loss model based on the notion of IBNR.

- 6.5 The projection of expected cash flows, including credit losses, based on a probability-weighted basis would require entities to foresee the pattern of expected credit losses over the life of a loan or loan portfolio. This would involve preparing multiple scenarios on expected cash flows that might be generated by the financial assets (both at initial recognition and subsequent measurement). AOSSG members note that, in practice, this may involve considerable cost and effort as data is often not readily available, even in the case of larger, more sophisticated, financial institutions with established risk management systems.

7 AOSSG preferred position

(Broadly relates to Questions 1, 2, 3 and 4 in ED/2009/12)

- 7.1 The impetus for the proposed impairment model in ED/2009/12 was criticism of the incurred loss model for having a number of weaknesses. One criticism is that the recognition of impairment losses has been delayed [paragraph BC11]. The proposed impairment model also responds to the recommendations of the FCAG to explore alternatives to the incurred loss model that use more forward-looking information for loan loss provisioning [paragraph IN3].

AOSSG comments

- 7.2 In general, AOSSG members believe that the most logical and direct response to criticism of the IASB's proposed impairment model is a solution that focuses on the balance sheet, rather than a model that involves recognising losses via a revenue recognition methodology. Instead of providing for losses earlier than when 'actual losses' have occurred, the proposed impairment model initially focuses on spreading those losses over the period of revenue recognition. It subsequently shifts focus to the balance sheet with expected losses subsequent to initial recognition being dealt with directly as balance sheet adjustments.

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- 7.3 In many ways the IASB's project on financial asset impairment seems to carry preconceptions about the label 'incurred loss model', and that any model with that name has weaknesses that cannot be rectified. It could equally have been said that the weaknesses identified are weaknesses of the existing 'probable threshold' incurred loss model or weaknesses in the manner in which it has been applied. The AOSSG would prefer that the IASB deal with the FCAG's recommendation by exploring amendments to the existing incurred loss model that would expand and clarify the range of events that could be taken to have occurred and which give rise to incurred losses. Such an expansion could be along the lines of the IBNR loss notion outlined in Section 1.
- 7.4 In the context of the credit crisis of 2007/2008 it is probably fair to say that, although many banks found themselves under-provisioned, a number did not. AOSSG members believe it is evident, from having observed the recent debates at the IASB and among national standard setters about the level of adequacy of loss provisioning and the timing of recognition of impairment losses by banks in various jurisdictions applying IAS 39, that there is diversity in practice [a weakness noted in paragraph BC11(d)]. That said, in general, AOSSG members believe that the proposed requirement to project expected cash flows is likely to involve significant subjectivity that will also give rise to a similar or possibly greater level of diversity.
- 7.5 Accordingly, AOSSG members consider it may be premature to conclude that the incurred loss model should be abandoned, and are not convinced that a completely new impairment model based on expected losses would resolve the issue of some entities having under-provisioned for losses. AOSSG members recommend that the existing incurred loss model should be revised or clarified to achieve earlier loss recognition and greater consistency in terms of the timing of loss recognition.
- 7.6 AOSSG members also note that the FASB proposals include modifying the existing incurred loss model by removing the existing probable threshold requirement for recognising impairments on loans. Accordingly, credit impairments would be recognised earlier on the basis of an entity's expectations, using past events and

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existing conditions about the collectability of cash flows, rather than using probability as a recognition threshold.

7.7 Should the IASB proceed with its proposals to implement an expected loss impairment model, AOSSG members suggest aspects of other existing impairment models, currently employed in some AOSSG jurisdictions, that the IASB should consider.

- (i) Some financial institutions include a combination of general provisions (mainly based on the historical loss data for performing loans) and specific provisions (based on the incurred loss model principles for non-performing loans). AOSSG members recommend that the IASB provide clarity as to whether such mixed impairment models would be acceptable approximations of the proposed impairment model.
- (ii) The methodology of internal-ratings based (IRB) financial institutions in providing for loan losses under Basel II might give rise to outcomes similar to those under the IASB's proposed impairment model. While AOSSG members note that there are some significant differences between the impairment methodologies of Basel II and the IASB proposed model⁷, AOSSG members suggest that the IASB, whenever possible, consider leveraging off aspects of the Basel II methodology to the extent that it also meets the aims of loss provisioning for financial reporting purposes. Other AOSSG members are concerned about employing approaches used by prudential regulators on the basis that the objectives of regulators and standard setters are different. This is acknowledged by the IASB in paragraphs BC22 to BC24.

Other views

7.8 In general, AOSSG members consider that the issue of pro-cyclicality is a matter best addressed by prudential regulators and should not be a determining factor in identifying

⁷ For example, Basel II requires expected losses for 12 months using a through-the-cycle approach, and estimations that are based on historical data.

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appropriate financial reporting requirements. However, some AOSSG members are troubled that, since one of the motivations for considering an expected loss model was to address concerns about pro-cyclicality, the proposals have failed in this respect. Those AOSSG members consider that the proposed impairment model would do little to address the issue of pro-cyclicality because the impact of unexpected events such as another major credit crisis would be mainly reflected in catch up adjustments.

8 Cost beneficial disclosures

(Broadly relates to Questions 5, 6 and 7 in ED/2009/12)

- 8.1 ED/2009/12 outlines the objective of disclosure for financial instruments measured at amortised cost as ‘providing information that enables users of the financial statements to evaluate the financial effect of interest revenue and expense and the quality of financial assets including credit risk’.
- 8.2 AOSSG members note that the IASB has focused on user needs in considering the proposed disclosures for amortised cost assets and, overall, are supportive of the proposed disclosures. However, AOSSG members are concerned that, in formulating its proposed disclosures, the IASB has not given sufficient consideration to limiting the volume of information to that which would be useful to users and to difficulties of providing information that has not historically been captured by entities in their information systems.

AOSSG comments

- 8.3 While, in general, AOSSG members do not believe in proposing differential reporting, some AOSSG members have indicated that some of the proposed disclosures would be particularly burdensome to non-financial institutions where financial assets measured at amortised cost are not significant to their balance sheets. Accordingly, those AOSSG members propose exempting non-financial institutions from the disclosure requirements unless they have ongoing material disclosures.

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8.3 AOSSG members are supportive of the following proposed disclosures due to the usefulness of information, irrespective of the impairment model used for financial reporting purposes:

- (a) a reconciliation of the allowance account showing changes during the period, including direct write-offs;
- (b) estimates and changes in estimates; and
- (c) a reconciliation of changes in non-performing financial assets, and a qualitative analysis of the interaction between changes in non-performing financial assets and changes in the allowance account.

8.4 In addition, AOSSG members have highlighted difficulties that entities would experience in collecting information needed for some of the proposed disclosures, and have questioned the usefulness of the information to users. Based on cost-benefit considerations, AOSSG members do not support the following proposed disclosure requirements in their current form.

- (i) Cumulative loss development – AOSSG members note that the loss development disclosure in ED/2009/12 is similar to the claims development disclosure required under IFRS 4 *Insurance Contracts* paragraph 39(c)(iii) [paragraph BC59 of ED/2009/12]. AOSSG members acknowledge that there are benefits to providing such information, for example, in showing an entity's history in estimating credit losses. AOSSG members note that the claims development disclosure in IFRS 4 is not required in respect of insurance contracts for which uncertainty about the amount and timing of claims payments is typically resolved within one year, such as life insurance contracts [IFRS 4, paragraph BC220]. A result of the 'relief', is that the IASB has effectively exempted most insurance contracts with a contract period of more than one year from being the subject of claims development disclosures. Typically, only the one-year contracts have a large payment 'tail', such as casualty contracts. Because the insurance contracts to which the claims

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development disclosure requirement in IFRS 4 applies generally have one-year contract terms, tracking the claims experience on the basis of yearly cohorts is relatively straightforward. Accordingly, AOSSG members are concerned that in making its decision to propose a similar disclosure requirement in ED/2009/12, the IASB has not given sufficient consideration to the increased difficulties of providing information on loss development experience for loan assets that generally have contractual (and actual) terms of two or more years. Accordingly, the IASB should reconsider proposing this disclosure requirement on the basis that the cost to provide this information might significantly outweigh its benefits. Alternatively, AOSSG members consider that it may be appropriate to only require information on historical loss rates⁸ if such information is regularly reviewed by the chief operating decision maker to make decisions about allocation of resources and performance assessments [consistent with the ‘through the eyes of management’ principle under IFRS 8 *Operating Segments* paragraph 5(b)].

- (ii) General disclosures about stress testing – AOSSG members appreciate it is proposed that disclosures on stress testing (paragraph 20) would not be compulsory, and only entities that prepare stress testing information for internal risk management purposes would be required to make disclosures. However, AOSSG members are concerned that this information may not be particularly relevant for financial reporting purposes, considering there is no clarity as to what constitutes ‘stress testing’ in ED/2009/12. AOSSG constituents have noted that a wide variety of stress testing is performed by some banks for regulatory, product development and other purposes. Furthermore, AOSSG members have been informed that, some of the stress testing information would only be meaningful if voluminous detail were provided. In order to provide some limits and consistency around the disclosure of stress testing information, AOSSG members

⁸ Commonwealth Bank Australia, *Full year results: Analyst presentation*, pages 100-101, August 2009.

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suggest that, if it is to be required, such information should be limited to that which is regularly reviewed by the entity's chief operating decision maker.

- (iii) Vintage information – AOSSG members understand that, in some AOSSG jurisdictions, financial statement users and managements generally do not use vintage information when making estimates of, or analysing, credit losses. This is because loan assets, particularly housing loans, are generally managed and analysed on an open portfolio basis under which loans of various vintages are aggregated. Accordingly, vintage information would not reflect the basis on which management's expectations are formulated, and would therefore appear inconsistent with the proposed expected loss model. AOSSG members also note that the proposed disclosure of vintage information relates to nominal amounts, which may be of limited use to users since the amounts would not reflect the extent to which an allowance for credit losses against these nominal amounts has been made. AOSSG members suggest that disclosures based on management's expectations about the 'expected life' of assets would be more meaningful information to users. If the IASB persists with the proposed 'vintage' disclosure requirement, it should consider:

- * limiting the requirement to those cases where it directly relates to the credit risk profiles of the loans concerned, and not to all types of amortised cost assets; and
- * making it prospective on transition because, for example, many banks in AOSSG jurisdictions generally do not presently capture information about financial assets on the basis of vintage..

9 Other issues

(Broadly relates to Questions 3 and 4 in ED/2009/12)

Consistency in applying the effective interest rate method between ED/2009/12 and the Derecognition project

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9.1 AOSSG members understand that, under the Derecognition project, the IASB has tentatively decided that a financial liability is derecognised when the contract has been substantially modified. AOSSG members also note that the IASB has tentatively decided that derecognition accounting by the borrower and lender should be symmetrical, in that, both the asset (held by the lender) and liability (held by the borrower) are derecognised when either of them meets the substantial modification criteria.

AOSSG comments

9.2 For consistency of interpretation and application, AOSSG members consider that paragraph B14 of ED/2009/12 would have to be amended or clarified to indicate that the effective interest rate before the modification of terms would continue to be used to calculate amortised cost and impairment only if the contract is not substantially modified. If the contract giving rise to the financial liability were substantially modified, both the original liability of the issuer and asset of the holder would be derecognised, and a new liability and asset under the substantially modified contract would presumably be recognised using a new effective interest rate. AOSSG members suggest that the IASB consider the proposals of ED/2009/12 together with developments in the Derecognition project.

Costs of implementing the proposed model

9.3 By undertaking cash flow projections and assessing the credit risk of each client or each portfolio of clients that share similar characteristics under the proposed impairment model, the IASB comments that it believes the proposed approach would reflect lending decisions more faithfully than existing arrangements [paragraph BC31]. However, the IASB also acknowledges that the proposed approach will pose significant operational challenges [paragraph BC29].

9.4 The reasoning outlined in the Basis for Conclusions to ED 2009/12 seems to be underpinned by presumptions that:

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- (a) the simplified description of ‘interest’ in IFRS 9 sufficiently reflects the real composition of interest rates negotiated between lenders and borrowers; and
- (b) the proposed impairment model, based on expected cash flows, reflects the manner in which lenders price loans, or is a rational basis on which lenders should price loans.

AOSSG comments

- 9.5 The significance of these presumptions is they imply that, even if the proposed impairment model would be costly to implement, it would be of benefit to those entities applying it because it is (or should be) the basis on which they operate their businesses. AOSSG members consider that this is unlikely to be the case for most lenders in AOSSG jurisdictions. Although the primary benefits of concern to standard setters are those that might accrue to users of the financial statements (and AOSSG members question whether the proposals offer any such benefits elsewhere in this submission), the significance of the costs to entities of implementing the proposed impairment model might be such that the outcome of any cost-benefit test would turn on whether the implementing entities would gain any benefit from using the model.
- 9.6 The comments received from constituents in AOSSG jurisdictions suggest that many banks and other financial institutions do not use a model such as the proposed impairment model in pricing their loans. Smaller financial institutions in particular are often ‘price takers’ and the level of analysis that they need to undertake in operating their businesses would not involve the types of cash flow estimates contemplated in the proposed impairment model. Even larger, more sophisticated, financial institutions have noted that they consider the analysis of impairment and revenue recognition to be two separate functions and that the proposed impairment model does not correspond to the manner in which they operate their businesses.
- 9.7 To put the possible costs of implementing the IASB’s proposed impairment model in context, AOSSG members have been informed that, on average, the costs that each of

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



Appendix B

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

AOSSG specific comments

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

IASB ED Question 1

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

IASB ED Question 2

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

While some AOSSG members consider that there is a clear proposed objective of amortised cost measurement, some AOSSG members have also commented that the objective is unclear and inconsistent with the amortised cost measurement category.

Refer to Section 1 of Appendix A for an explanation of the AOSSG view.

IASB ED Question 3

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

The AOSSG believes that any principle-based standard should be accompanied by application guidance, particularly when it introduces significant change to existing accounting practices. Furthermore, the AOSSG considers that the standard should be accompanied by examples that help constituents in migrating from their existing impairment models and to promote consistency in the application of the Standard. The AOSSG notes that the FASB has provided illustrative examples in its Exposure Draft in addition to application

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guidance and the AOSSG observes that those examples have helped members to understand the proposed requirements.

Accordingly, if the IASB proceeds with its proposals, some members of the AOSSG consider that the efforts already made by the IASB in providing the following examples and explanations should be provided in the final Standard as guidance:

- (a) IASB staff examples on short-term receivables, fixed-rate loans and floating rate loans, and their respective accounting entries;
- (b) IASB explanation on proposing the catch-up approach for recognising subsequent changes in expectations; and
- (c) relevant IASB frequently asked questions on webcasts.

IASB ED Question 4

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

Some AOSSG members do not agree with the measurement principles set out in ED/2009/12 on conceptual grounds. All AOSSG members do not agree with the measurement principles on practical grounds.

Refer to Sections 2, 3, 4, 5, 6 and 9 of Appendix A for an explanation of the AOSSG's views on the measurement principles.

Refer to and Section 7 and paragraphs 1.4 to 1.9, 2.7, 3.9, 4.5, 5.8 to 5.11, 6.2 to 6.5, 9.2 of Appendix A for AOSSG's recommendations.

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IASB ED Question 5

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

The AOSSG agrees with the proposed objective of presentation and disclosure in ED/2009/12 and believes that it is appropriate for financial instruments measured at amortised cost.

IASB ED Question 6

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

There is a mixed view among AOSSG members regarding the proposed presentation requirements. On the one hand, some AOSSG members support the proposed requirements because they might reflect lending decisions more faithfully in some AOSSG jurisdictions. On the other hand, some AOSSG members disagree with the requirements on the basis that the proposals are not consistent with most entities' business models in managing credit risk, net interest margin and pricing of their loans. Furthermore, users have commented that they do not support the proposed requirements because the overall picture of net income margins and the level of impairments would be obscured.

Refer to paragraphs 3.1 to 3.9 for an explanation of the AOSSG's views.

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IASB ED Question 7

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

Overall, the AOSSG is generally supportive of the proposed disclosures. However, some members of the AOSSG have reservations about specific proposed disclosures.

Refer to paragraphs 8.3 to 8.4 for an explanation of the AOSSG's views and alternative disclosures the AOSSG would prefer.

IASB ED Question 8

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

Different AOSSG members are at different stages of IFRS adoption – from those that adopted IFRSs in 2005 to those that are planning to adopt IFRSs. In the event that the IASB progresses its proposals, the AOSSG believes that there should be a lead-time of at least three or four years between the date of issue and the mandatory effective date, with early adoption permitted, in order to accommodate a smooth transition to IFRSs in as many jurisdictions as feasible. For example, some members that plan to adopt IFRSs in the next few years may wish to apply IFRS 9 on first-time adoption of IFRSs rather than apply IAS 39 before migrating to IFRS 9.

Some AOSSG members also considered that it is not ideal for the final standard to be adopted in phases, and suggested that the mandatory adoption dates for all phases to be consistent for a smooth implementation and transition of the Standard. Those members noted that the existing IFRS 9 (issued November 2009), that is the revision on classification and measurement of financial assets, prescribes a mandatory application date by 1 January 2013,

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and suggests that the IASB consider revising its mandatory application date to accommodate the remaining phases of IFRS 9.

IASB ED Question 9

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

If the IASB pursues its proposals, the AOSSG notes the IASB's rejection of both fully retrospective and fully prospective applications of the proposed impairment model for the reasons outlined in paragraphs BC69-70. However, the AOSSG considers that the proposed transition approach seems to approximate a fully retrospective application and would involve entities in considerable effort in calculating approximations of credit loss-adjusted effective interest rates.

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

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

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IASB ED Question 10

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

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

IASB ED Question 11

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

Generally, the WG agrees that the proposed guidance on practical expedients is appropriate.

Refer to paragraphs 4.3 to 4.4 for specific AOSSG views.

IASB ED Question 12

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

Refer to paragraphs 4.3 to 4.5 and 7.7 for AOSSG views on additional guidance on practical expedients.