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Australian Accounting Standards Board

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Sir David Tweedie
Chairman
International Accounting Standards Board
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UNITED KINGDOM

Dear David

AASB comments on IASB Request for Information ('Expected Loss Model') – *Impairment of Financial Assets: Expected Cash Flow Approach*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Request for Information ('Expected Loss Model') – *Impairment of Financial Assets: Expected Cash Flow Approach* ("Request for Information").

The AASB notes that the Request for Information is specifically seeking comments on the feasibility of implementing an expected cash flow approach and that the AASB has limited expertise on this aspect of the topic. Accordingly, in contrast to the AASB's usual submissions to the IASB, there is a greater focus in this submission on conveying Australian constituents' views on the matters raised. In preparing this submission, the AASB has been particularly keen to seek the views of constituents who would not normally comment directly to the IASB. In formulating its own views, the AASB has considered the views of Australian constituents.

The AASB acknowledges that the global financial crisis has highlighted that users of general purpose financial statements require a broad range of credit information to be incorporated into loan-loss provisioning, and this was reflected in the letter from G-20 leaders to the IASB. Accordingly, the AASB is supportive of the IASB's efforts to improve the impairment methodology of financial assets measured at amortised cost in IAS 39 *Financial Instruments: Recognition and Measurement* by exploring the expected loss model.

The AASB notes, however, that there is no commonly shared understanding about the notion of 'expected loss' and the factors that should be included in the assessment of future expected losses and when the future cash flows should be re-estimated. There is also a lack of clarity about the presentation of expected losses in the statement of comprehensive income – as interest income or as doubtful debt expense – given that interest income is recognised on the basis of expected cash flows, including expected losses, upon initial recognition of an instrument. In addition, the AASB believes that, unless the IASB clearly identifies a measurement attribute for the expected cash flow approach, there will be divergence in practice. The AASB also considers that, in progressing an expected loss model, the IASB needs to address a number of application issues.

Australian constituents have expressed significant concerns about the expected one-off and ongoing costs of implementing the model. Other concerns expressed by constituents relate to application issues involving variable-rate instruments and collective-provisioning that already exist in the current impairment methodology that may need to be resolved separately before implementing the expected cash flow approach.

The IASB has stated that, once the FASB Impairment project proposals are issued, it will issue that document for consideration and comment by its constituency prior to finalising an IASB pronouncement. The AASB notes that this would mean that the topic will presumably need to be reassessed in the near future and require duplication of effort and work by the IASB and its constituency as part of the convergence exercise. The AASB encourages the IASB to work closely with the FASB on this project to better coordinate the efforts of the two Boards.

If you have any queries regarding any matters in this submission, please contact Christina Ng (cng@aasb.gov.au) or me.

Yours sincerely

K.M. Stevenson

Kevin M. Stevenson
Chairman

IASB Request for Information ('Expected Loss Model') - *Impairment of Financial Assets: Expected Cash Flow Approach*

AASB specific comments

The AASB provides the following responses to the IASB's Request for Information.

Question 1

Is the approach defined clearly? If not, what additional guidance is needed, and why?

It is not clear to the AASB how the expected cash flow approach should be applied, and the notion of 'expected loss' requires clarification.

In current practice, there are many different views about how a credit loss should be estimated and the factors/inputs that an entity could incorporate into an assessment of an 'expected loss'. Some constituents have argued that the model should require entities to identify 'loss events' or impairment triggers under the expected cash flow approach, before determining that there is a change in expected cash flows. Other concerns include how an entity could access reliable information that would form a sound and unbiased basis for making estimates of future cash flows. Accordingly, the AASB recommends that the IASB provide some principle-based application guidance or illustrative examples that may clarify the notion of 'expected loss'.

Furthermore, it appears that the expected cash flow approach would require expected losses to be recognised through a lower interest income and not as a doubtful debt expense. Some constituents have expressed concerns about whether this would provide useful and relevant information if expected losses are not recognised as doubtful debt expense and presented as part of interest income. The AASB suggests that the IASB should clarify in its exposure draft where in the profit or loss expected losses should be presented and how an entity would disaggregate expected losses from interest income.

The AASB notes that the examples provided in the IASB's May 2009 Agenda Paper 5A illustrate the expected cash flow approach on a long-term loan. The AASB also acknowledges the IASB staff efforts in providing examples illustrating possible ways of applying an expected cash flow approach to variable rate instruments. However, constituents have raised some concerns about how the expected cash flow approach would apply to short-term loans and receivables, for example trade receivables. The AASB considers that some illustrative examples showing how the approach might apply to 'simple' financial instruments would be helpful.

In the context of periodic reporting, it is not clear what is meant by "a continuous re-estimate of (all) expected cash flows". For example, would this preclude making a re-estimation of cash flows only at the end of each reporting period with the benefit of all the information available at period end?

The AASB also considers that the IASB needs to clearly identify its measurement objective for an expected cash flow approach. The incurred loss model can be viewed as having an historical cost measurement attribute, consistent with measuring loans and receivables at amortised cost. However, the AASB believes that there is potentially a mixture of measurement attributes involved in the expected cash flow approach. When expected losses are incorporated into future cash flows, this indicates a fair value measurement attribute. However, it could be argued that, for consistency with the basis of measuring the underlying loan or receivable, it would be appropriate to discount the future cash flows at the original effective interest rate determined at inception of the instrument, which is indicative of an historical cost measurement attribute. The AASB is concerned that, unless the IASB clearly identifies the measurement objective for an expected cash flow approach, there will be divergence in practice and ongoing debate about implementation issues. The Request for Information suggests that the IASB is attempting to attach an impairment model with elements of a fair value measurement attribute to underlying assets that are measured at cost.

Question 2

Is the approach operational (i.e. capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

Question 3

What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

In answering Questions 2 and 3, the AASB has sought the views of Australian constituents who are best-placed to comment on the feasibility of implementing the expected cash flow approach.

Consistent with the IASB staff view on anticipated costs (IASB's May 2009 Agenda Paper 5D), the AASB has been made aware that material system enhancements are likely to be necessary to generate the required information for a cash flow approach in the context of a financial institution. Considerable implementation costs were incurred by Australian banks implementing the Basel II changes which only require information systems to assess expected loss for a 12-month period. If systems need to be extended to accommodate the increased inputs required to formulate expected losses for the remaining life of loans and receivables, further considerable costs would need to be incurred.

Some constituents also expect that more in-house data and analysis, and additional and enhanced staff skills to develop and validate the default rate assumptions may be required. This may be burdensome for entities whose core business is not to maintain debt or fixed-rate interest assets. Other potential costs include expert reports that assess expected losses e.g. costs of credit agency reports, charges for access to information to help estimate future cash flows and staff time involved in validating historical data about past cash flows in order to provide a basis for assessing expected cash flows.

The AASB also understands that increased audit costs are likely to be incurred as a result of the subjectivity involved in assessing expected losses throughout the life of loans and receivables.

For entities that are financial institutions, the requirement to assess expected losses is expected to involve considerable system changes that will be costly and time consuming to implement. It is our understanding that financial institutions in general, are currently applying a thorough provisioning process that includes various models and expertise to assess expected losses. However, the current restriction in IAS 39 in recognising future losses or losses with no objective evidence has been preventing management from providing for those losses in their financial reports. As a result, the AASB believes that the IASB should consider revisiting the current requirements and widen the scope for recognising impairment losses instead of implementing a new expected loss model.

For entities that are not financial institutions, it is common practice to assess debt provisioning based on the ageing of debtors. Historical trends on payments are applied to determine the likelihood of recoverability of debtors. Would this form of debt provisioning meet the requirements of the expected loss model if the expected loss assessment is done at inception of the debt? The AASB believes that this is a possible adaptation of the expected loss model, and that the IASB should clarify in its exposure draft whether such an approach would be acceptable.

Question 4

How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

Some constituents believe that, regardless of which impairment model is used, application issues with variable rate instruments arise due to the nature of the instruments and that this is an existing application issue that should be dealt with separately.

There is considerable support among Australian constituents for Approach B, i.e. the use of a catch-up adjustment, for the impairment of variable rate instruments as this is consistent with the existing application of IAS 39.

The AASB suggests that the IASB conduct an education session via webcast and provide illustrative examples or application guidance in its exposure draft to help explain the alternative ways in which an entity may apply the expected cash flow approach to variable rate instruments.

Question 5

How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

(a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?

(b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?

The AASB believes that both approaches would often produce materially the same results. Furthermore, there may be challenges in separately accounting for specific assets with losses subsequent to collective-provisioning to avoid double-counting of expected losses.

The AASB considers that the IASB should consider a more principle-based approach in its exposure draft, and propose that entities choose between a collective-provisioning approach or individual assessment approach on the basis of the approach that produces the more reliable and relevant results in the circumstances.

Question 6

What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

For entities that are not financial institutions, an expected loss model may be difficult to apply to trade receivables. To address this concern, consideration should be given to clarifying existing methods of debt provisioning that already meet the requirements of an expected loss model (refer Questions 2 and 3).

Another approach would be to address the concerns of entities that are not financial institutions by retaining the incurred loss model and permitting its use, when the impact would not be expected to be materially different from applying the expected loss model.

Other issue

The note disclosure about significant judgements and estimates regarding financial instruments may need to be more extensive to explain the basis of inputs/assumptions used in determining expected losses. This may result in an already complex disclosure becoming more difficult to understand, and arguably would diminish the overall usefulness of this information to users.