Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	**Not-for-Profit Private Sector Financial Reporting Framework**	**Meeting:**	M188
Topic:	**Tier 3 – Financial Instruments: Measurement**	**Agenda Item:** **Date:**	12.2.2 6 June 2022
Contact(s):	Evelyn Ling eling@aasb.gov.au Fridrich Housa fhousa@aasb.gov.au	**Project Priority:** **Decision-Making:** **Project Status:**	High High Initial deliberations

Objective of this paper

1 The objective of this agenda paper is for the Board to **decide** its preliminary views on Tier 3 reporting requirements for a not-for-profit (NFP) private sector entity's financial instruments for inclusion as part of a discussion paper (DP)[1] for the following topics:

(a) measurement of interest income and interest expense – effective interest method (paragraphs 4 – 10);

(b) impairment of financial assets (paragraphs 11 – 22); and

(c) estimating fair value (paragraphs 23 – 26).

2 In analysing these topics and making the staff recommendations, staff had regard to the current requirements in Australian Accounting Standards, approaches taken by selected other jurisdictions,[2] feedback from Australian stakeholders, findings from academic research and other literature, and the findings from staff review of a sample of financial statements. Staff have noted relevant aspects of its environment findings as part of its analysis of each topic considered.[3]

Summary of staff recommendations

3 Staff recommend that the Tier 3 reporting requirements for financial instruments should:

(a) require interest income and interest expense to be recognised as amounts are earnt or incurred, calculated by applying the contractual interest rate to the amount on which interest is earnt;

[1] For succinctness, in general, references to 'AASB 9' in this paper are to the suite of Tier 1 financial instrument-related standards, rather than to AASB *9 Financial Instruments* in particular.

[2] The selected other jurisdictions/pronouncements considered were the *IFRS for SMEs*, United Kingdom FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, United Kingdom FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, Hong Kong *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard* (HK SME-FRF & FRS), New Zealand *Public Benefit Entity Simple Format Reporting – Accrual (Not-For-Profit)* (NZ Tier 3 reporting requirements) and CPA Canada Handbook Section 3856 *Financial Instruments*. Staff did not consider the applicable USA requirements given their expected complexity.

[3] For further reference, Agenda Paper 5.2.1 of the AASB May 2022 meeting included summaries of the staff research in this regard. A copy of this agenda paper is included as supplementary material to this agenda item – refer Agenda Paper 12.2.1.1.

(b) require for a financial instrument not measured at fair value, any initial premium or discount to be amortised on a straight-line basis over the life of the instrument (unless another systematic basis or shorter period is more reflective of the period to which the premiums or discounts relate);

(c) for both debt and equity instruments, require an impairment loss to be recognised when it is probable that the amount invested will not be collectible (whether in part, or in full), measured at the anticipated uncollectible amount; and

(d) adopt the same fair value definition as in AASB 13 but develop a simpler expression of the fair value hierarchy that mirrors AASB 13 principles; and be informed by the IASB's expected fair value measurement amendments to the *IFRS for SMEs* as to the basis and extent of guidance to be included as part of a Tier 3 Standard.

Measurement of interest income and interest expense (Proposed simplification 5)

Current requirements and staff research/outreach findings

4 AASB 9 defines the effective interest rate as the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. It may differ from the contractual interest rate as it takes into consideration any fees that are an integral part of the effective interest rate (e.g. origination fees), points paid or received, transaction costs[4] and other premiums or discounts on acquisition of the financial instrument.

5 AASB 9 requires interest to be recognised and measured using the effective interest method. The effective interest method requires interest to be calculated by:

(a) applying the effective interest rate to the gross carrying amount of a financial asset;

(b) applying the effective interest rate to the amortised cost of a credit-impaired financial asset; or

(c) applying the credit-adjusted effective interest rate to the amortised cost of a purchased or originated credit-impaired financial assets.

6 Staff note the following:

(a) some jurisdictions require use of the effective interest method to calculate interest (*IFRS for SMEs*, UK FRS 102) while others do not (e.g. Hong Kong, NZ, UK FRS 105);

(b) a feedback theme from AASB ITC 47 *Request for Comment on IASB Request for Information on Post-implementation Review of IFRS 9 Financial Instruments – Classification and Measurement* was that in straightforward cases, amortised cost and the effective interest rate method are easy to apply and provide users with useful information. However, staff also received (limited) feedback from NFP Project Advisory Panel members that understanding and applying the effective interest method can be challenging for some smaller NFP private sector preparers.

Proposed simplifications and staff analysis[5]

7 Table 1 in Agenda Paper 12.2.1 noted that staff consider simplification of the measurement of interest income and interest expense to be necessary having regard to the complexity of understanding and applying the effective interest method. As a simplification of explanation

[4] At its May 2022 meeting, the Board decided to require transaction costs to be expensed as incurred. Consequently, for Tier 3 purposes, such costs would not form part of the effective interest rate.

[5] Staff have updated its analysis following the AASB May 2022 meeting.

and interpretation, rather than requiring interest to be calculated using the effective interest method, staff propose that the Tier 3 reporting requirements should:

(a) require interest income and interest expense to be recognised as amounts are earnt or incurred, calculated by applying the contractual interest rate to the amount on which interest is earnt; and

(b) for a financial instrument not measured at fair value, separately require the amortisation of any initial premium or discount on a straight-line basis over the life of the instrument (unless another systematic basis or shorter period is more reflective of the period to which the premiums or discounts relate).

Staff consider these simplifications to be consistent with the Tier 3 principles agreed by the Board at its August 2021 meeting.

8 In accordance with the Board's agreed approach to simplification as set out in the flowchart included in Appendix A to Agenda Paper 12.1, staff analysed reasons for the proposed accounting versus the effective interest method:

Table 1: Arguments for and against the proposed interest measurement simplification

Arguments in support of the proposed interest measurement simplification	**Arguments in support of requiring interest be measured using the effective interest method, per AASB 9**
• consistent with the Board decision at its May 2022 meeting for some financial assets and financial liabilities to be subsequently measured at cost, and for transaction costs related to the acquisition or assumption of the financial instrument to be expensed as incurred • accounting is simple to understand and apply as interest measurement matches the contractual interest rate • consistent with the Tier 3 requirement to measure lease payments and lease income on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern of the user's benefit • for a smaller entity that may not typically hold financial instruments that incurred fees, premiums or discounts, the benefits of more faithfully representative interest income/ interest expense do not appear to justify the costs involved in identifying fees and premiums/discounts that are an integral part of the effective interest rate, calculating an effective interest rate, and monitoring changes in the effective interest rate over the life of the financial instrument • application of the effective interest method to impaired financial assets is unnecessarily complex for smaller entities, who may not commonly have financial instruments impacted by such AASB 9 criteria	• maintains consistency with Tier 1 measurement • acknowledges and more faithfully represents the true "interest" implicit in the terms of the financial instrument • smaller NFP private sector entities might not commonly access financial instruments that have a premium or discount on issue, or incur origination and other fees. Consequently, similar to how requiring a financial asset or financial liability to be initially measured at its transaction price rather than fair value may be an unnecessary simplification, the simplification may likewise be 'unnecessary' because the effective interest rate is the same as the contractual interest rate. Guidance could be developed to provide clarity for preparers in this regard • the proposed simplification justifies what staff think is the current practice, rather than improving accounting practices by smaller entities

Arguments in support of the proposed interest measurement simplification	Arguments in support of requiring interest be measured using the effective interest method, per AASB 9
• recognising interest based on the contractual rate and when it is earnt or incurred is consistent with the approach taken by NZ Tier 3 reporting requirements; facilitating trans-Tasman harmonisation	

Staff recommendations

9 Staff recommend requiring interest to be recognised and measured by reference to the contractual interest rate, and for any initial premium or discount to be amortised on a straight-line basis over the life of the instrument. Staff think these are simplifications that the Board could take to reduce an element of preparer cost without any significant loss of useful information to users of the Tier 3 financial statements or material misrepresentation of the financial statements over the life of the related financial instrument. The materiality of any difference between the effective interest method and the result under the proposed simplification is unlikely to result in consolidation issues should the Tier 3 entity financial results be consolidated into Tier 1/Tier 2 consolidated financial statements.

10 In addition, while staff do not have any evidence in this regard from the preliminary outreach activity, staff think it is likely that the practice of many Tier 3 entities is already consistent with such policy, and as such, the simplification better leverages the information that management uses to make decisions and limits transition costs.

Question for Board members

Q1 Do Board members agree, for the purposes of the Discussion Paper, that:

(a) interest income and interest expense should be recognised as amounts are earnt or incurred, calculated by applying the contractual interest rate to the amount on which interest is earnt; and

(b) for a financial instrument not measured at fair value, any initial premium or discount should be amortised on a straight-line basis over the life of the instrument, unless another systematic basis or shorter period is more reflective of the period to which the premiums or discounts relate?

If not, do Board members prefer requiring an entity to recognise and measure interest using the effective interest method?

Impairment of financial assets (Proposed simplification 6)

Current requirements and staff research/outreach findings

11 The AASB 9 impairment model is an expected credit loss model that requires the impairment loss to be calculated using a probability-weighted estimate of credit losses over the expected life of the financial instrument. A credit loss is calculated as the present value of the difference between (a) the contractual cash flows due to an entity under the contract and (b) the cash flows that the entity expects to receive. The AASB 9 impairment model applies only to financial assets held at amortised cost, as under AASB 9, equity instruments are always measured at fair value.[6]

[6] Note, AASB 13 *Fair Value Measurement* envisages that, in some (limited) cases, the fair value of an equity instrument may be its cost.

12 The estimate of the expected losses depends on the type of financial asset held (e.g. trade receivables versus other debt instruments) and the extent of change in the credit riskiness of the financial asset.

13 Staff note the following:

(a) the various selected other jurisdictions require financial assets to be written down where impaired. The impairment loss is measured differently for different types of financial assets (e.g. receivables versus shares);

(b) the review of the sample set of financial statements indicated that some entities recognise impairment of their trade receivables;

(c) staff received (limited) feedback from NFP Project Advisory Panel members that understanding and applying AASB 9 impairment requirements can be challenging for some smaller NFP private sector preparers; and

(d) the IASB is expected to propose, as part of its project reviewing the *IFRS for SMEs*, requiring an expected loss model for impairment of financial assets other than trade receivables.

Proposed simplification and staff analysis[7]

14 Staff consider that all financial assets that are not measured at fair value should be assessed for impairment at each reporting date, similar to AASB 9. However, as noted in Table 1 in Agenda Paper 12.2.1, staff consider simplification of the impairment provisions of AASB 9 to be necessary having regard to the complexity of understanding and applying the effective interest method. As a simplification of the impairment recognition and measurement criteria, staff propose the following options for the impairment of financial assets that are debt instruments:

(a) **Option A:** Require an impairment loss to be recognised when it is probable that the amount owed will not be collectible (whether in part, or in full), measured at the anticipated uncollectible amount; and

(b) **Option B:** Require an impairment loss to be recognised and measured using the probability-weighted AASB 9 lifetime expected credit loss impairment model. (This option proposes extending the AASB 9 simplified approach for trade receivables to all debt instruments held by the entity, and allow for the use of a provision matrix.)

Staff consider these simplifications to be consistent with the Tier 3 principles agreed by the Board at its August 2021 meeting.

15 Staff intend for Option A to reflect two primary differences from Option B:

(a) to represent an incurred loss model (as per the former AASB 139 impairment requirements, and as reflected by the existing *IFRS for SMEs*); and

(b) to provide flexibility for the impairment amount to be determined by reference to either a probability-weighted estimate or a ‘most likely outcome’ scenario.

16 In accordance with the Board’s agreed approach to simplification as set out in the flowchart included in Appendix A to Agenda Paper 12.1, staff have analysed reasons for supporting one Option over the other:

[7] Staff have updated its analysis following the AASB May 2022 meeting.

Table 2: Staff analysis of the comparative advantages of Option A and Option B

Arguments in support of Option A over Option B *(Require an impairment loss to be recognised when it is probable that the amount owed will not be collectible, measured at the anticipated uncollectible amount)*	**Arguments in support of Option B over Option A** *(Require an impairment loss to be recognised for all lifetime expected credit losses)*
• the resulting impairment loss is more understandable and explainable to users of the financial statements compared to the AASB simplified approach, as the impairment loss is directly 'relatable' to individual credit status • for smaller NFP and their common transactions, it is less complex to understand and apply, and requires less management judgement, compared to Option B, as it recognises that entities may have less sophisticated credit risk management systems. Consequently, it is less costly to implement and audit compared to Option B. • Option A could be expected to better leverages the information that management is likely to use to make decisions • Appears consistent with the requirements specified by UK FRS 105, Hong Kong and New Zealand • More consistent with the Board's decisions on recognition of impairment of non-financial assets, which could be at a time later than under AASB 136.	• provides users with more timely credit loss information as it is more forward-looking • maintains better consistency with Tier 1 recognition and measurement criteria and the Conceptual Framework. Option B is more 'neutral' compared to Option A • may give management better insight into its financial management practices • when operationalised by smaller NFP private sector entities, it is possible that the resulting impairment loss is the same amount as Option A

Staff recommendation

17 Staff recommend Option A for the reasons identified in Table 2. Staff think that an expected lifetime credit loss model to determining impairment is challenging for smaller NFP private sector entities to understand and is unlikely to have widespread impact given the types of assets commonly held by smaller NFP private sector entities. Also, staff suspect that Option B is unlikely to be operationalised in the spirit of the AASB 9 requirement by these entities. Staff further consider that it may be challenging to audit the management judgements informing probability weightings or the estimation of expected future cash flows for smaller entities. Consequently, staff are concerned that Option B, while a simplification of AASB 9, may not present a sufficiently proportionate response for smaller entities as the benefits of applying this option do not appear to exceed its costs.

18 However, staff note that the primary financial assets held by a smaller NFP private sector entity subject to a significant change in credit risk are its trade receivables. The Board might determine the earlier recognition of impairment provides users with better information, and that complexity can be managed that emphasising that impairment may be calculated through use of a provision matrix.

Question for Board members

Q2 Do Board members agree, for the purposes of the Discussion Paper, that an impairment loss on a debt instrument should be recognised when it is probable that the amount owed will not be collectible (whether in part, or in full), measured at the anticipated uncollectible amount (Option A)?

If not, do Board members prefer requiring an impairment loss to be recognised for all lifetime expected credit losses?

Impairment of equity instruments measured at cost

19 At its May 2022 meeting, the Board decided that financial assets other than investments should be measured at cost. These financial assets may include equity instruments. Further, in Table 2 of Agenda Paper 12.2.1, staff proposed that an entity's interests in subsidiaries, associates and joint ventures be measured at cost in the entity's separate financial statements. Consequently, in addition to specifying how an impairment loss should be determined for debt instruments, the Tier 3 reporting requirements also need to specify when and how an impairment loss should be determined for an entity's equity interests in another entity.

20 Staff **recommend**, as a simplification to assist preparers in understanding Tier 3 reporting requirements, to adopt the same impairment requirements as that proposed in Option A in paragraph 14(a) above. That is, Tier 3 reporting requirements should require that an impairment loss on an equity instrument be recognised when it is probable that the amount invested will not be collectible (whether in part, or in full), measured at the anticipated uncollectible amount.

21 This has the advantage of having a single set of impairment requirements for financial assets, and is broadly consistent with the Board's decisions regarding impairment of non-financial assets.[8] It recognises that a financial asset is not necessarily impaired at reporting date even if its fair value is lower than its carrying amount on that date, which staff think is consistent with the approach taken by NZ Tier 3 reporting requirements; facilitating trans-Tasman harmonisation.

22 The Board could develop some indicators in its Tier 3 pronouncement to provide an entity with guidance to assessing whether the financial asset is impaired.

Question for Board members

Q3 Do Board members agree, for the purposes of the Discussion Paper, that an impairment loss on an equity instrument should be recognised when it is probable that the amount owed will not be collectible (whether in part, or in full), measured at the anticipated uncollectible amount?

If not, how do Board members prefer requiring an impairment loss to be recognised for equity instruments measured at cost?

Estimating fair value (Proposed simplification 10)

Current requirements and staff research/outreach findings

23 AASB 13 *Fair Value Measurement* sets out a consistent framework and guidance for measuring the fair value of both financial and non-financial assets and liabilities, and equity. It requires the fair value to be determined by reference to a 'fair value hierarchy' and estimated having

[8] At its April 2022 meeting, the Board decided that impairment would be assessed for a non-financial asset only if the asset were physically damaged or if the asset's service potential might have been adversely affected by a change in the entity's strategy or changes in external demand for the entity's services.

regard to the price the entity can sell the asset, or transfer the liability at, to market participants. For non-financial assets, the asset's fair value has regard to the highest and best use of the asset.

24 Staff note the following:

(a) from the sample of financial statements reviewed, only investment financial assets and property, plant and equipment were measured at a recurring fair value;

(b) the feedback from the preliminary outreach activity suggests that determining fair value of financial instruments is not necessarily of concern of stakeholders, if unlisted equity instruments can continue to be measured at cost as a proxy for fair value (where appropriate);

(c) many other jurisdictions do not provide much guidance on determining fair value as part of the reference document. The definition of fair value varies between jurisdictions. For example, the fair value definition in the Hong Kong FRS & FRF is more explicitly an exit price compared to the definition used in the NZ Tier 3 reporting requirements (and other jurisdictions);[9]

(d) as part of its second comprehensive review of the *IFRS for SMEs* project, the IASB is expected to propose amendments to align the definition of fair value in the Standard with that of IFRS 13 *Fair Value Measurement* and to incorporate IFRS 13 principles of the fair value hierarchy, and add illustrative examples.[10]

Proposed simplification, staff analysis and recommendation[11]

25 Staff think it is important for the definition of "fair value" to be the same as that specified by AASB 13. This retains consistency in specification of the measurement basis between Tier 3 reporting requirements and Tier 1 and Tier 2 reporting requirements, and avoids potential interpretation and re-training costs.[12] Similarly, staff think the fair value hierarchy for establishing a fair value (firstly, by reference to listed prices, and finally, by reference to a valuation model using observable inputs to the extent possible) should form part of the Tier 3 reporting requirements to provide a framework for preparers. This assists in enhancing comparability between the financial statements of Tier 3 entities.

26 However, overall, staff think AASB 13 can be simplified for understandability and interpretation when considering the assets and liabilities that might be typically held by a smaller NFP private sector entity, and the types of fair value measurement required. Consequently, for Tier 3 reporting requirements, staff **recommend** that the Board:

(a) adopt the same fair value definition as in AASB 13 but develop a simpler expression of the fair value hierarchy that mirrors AASB 13 principles; and

(b) be informed by the IASB's fair value measurement amendments to the *IFRS for SMEs* as to the basis and extent of guidance to be included as part of a Tier 3 Standard. These

[9] NZ Tier 3 reporting requirements define fair value as "the amount for an arm's length transaction if it takes place between two willing parties in the market".

[10] An IASB Exposure Draft is expected to be issued in Q3 2022.

[11] At its August 2021 meeting, staff proposed developing requirements for fair value measurement in a future Tier 3 pronouncement having regard to the requirements specified by NZ Tier 3 reporting requirements. Staff note that fair value is defined differently in the NZ Tier 3 reporting requirements to that of AASB 13 and that the NZ guidance is limited. Following further outreach and analysis, staff have reconsidered the original proposal.

[12] Staff note that this action is also consistent with the Board decision to continue to require, as an accounting policy option, investment property and property, plant and equipment to be measured by reference to its fair value rather than another specified current value measurement basis.

amendments are expected to provide a suitable base for the Board's future deliberations as they are current, and will be based on the IFRS-equivalent of AASB 13.

Question for Board members

Q4 Do Board members agree, for the purposes of the Discussion Paper, to adopt the same fair value definition as in AASB 13 but develop a simpler expression of the fair value hierarchy that mirrors AASB 13 principles?

Q5 Do Board members agree that the expected IASB's fair value measurement amendments to the *IFRS for SMEs* provide a suitable base for informing the basis and extent of fair value guidance to be included as part of a future Tier 3 pronouncement?