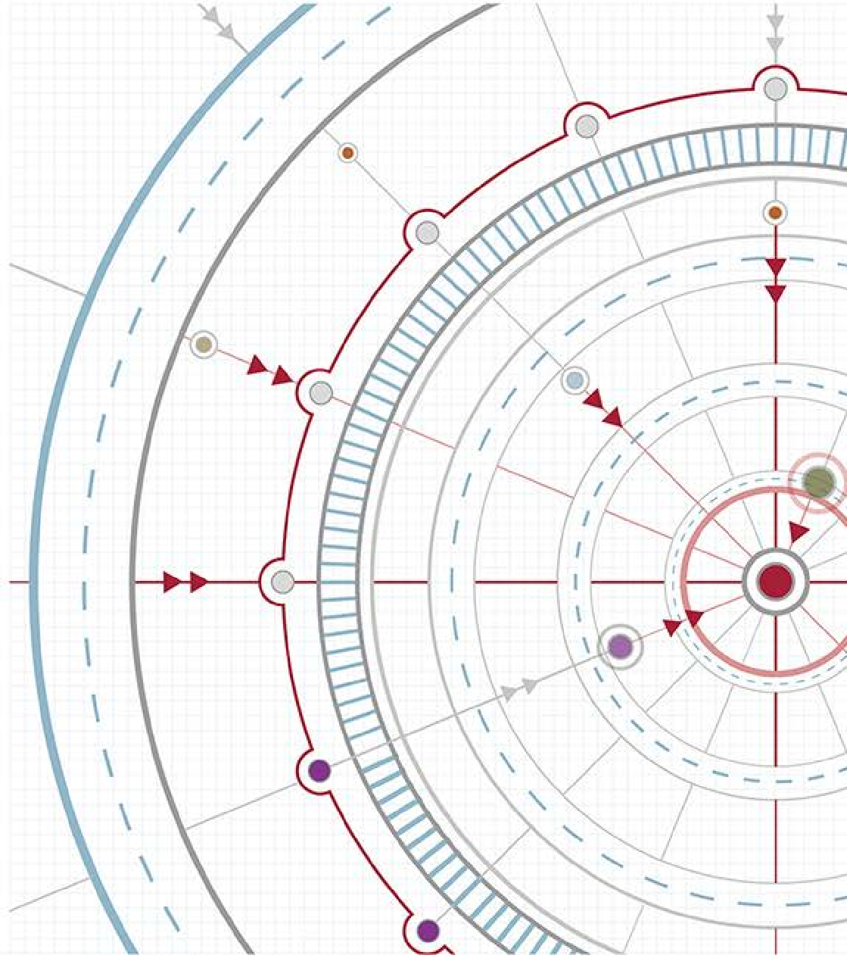

Agenda Decision—‘Curing of a credit-impaired financial asset’

IFRS 9 *Financial Instruments*

Angie Ah Kun, IASB Technical Staff
Elizabeth Figgie, IASB Technical Staff

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board or the IFRS Foundation.

Why are we doing this webcast?

Question	**How does an entity present amounts in the statement of profit or loss if a credit-impaired financial asset is subsequently cured?**
Conclusion	**IFRS Standards provide an adequate basis to address this matter**
Recommendation	**The staff should prepare educational material related to the Committee's conclusion**

During this webcast, we will cover:

- the question submitted and the Committee's conclusion;
- the relevant requirements in IFRS 9;
- the application of those requirements to a simplified fact pattern; and
- possible bookkeeping entries over the life of the asset.*

*IFRS 9 does not prescribe specific bookkeeping; the journal entries presented are for illustrative purposes only.

Question submitted

Question submitted to the Committee

How does an entity present amounts in the statement of profit or loss when a credit-impaired financial asset is subsequently cured (eg it is paid in full)?

Difference when an asset becomes credit impaired = **Interest on gross carrying amount** − **Interest revenue recognised**

Following the curing of the financial asset, where is this difference presented?

→ **Interest revenue?**

or

→ **Reversal of impairment loss?**

Committee's conclusion

In the statement of profit or loss, an entity is required to present the difference described in the submission as a reversal of impairment losses following the curing of a credit-impaired financial asset.

[Appendix A, paragraphs 5.4.1 & 5.5.8]

✓ **Reversal of impairment loss**

✗ **Interest revenue**

Stakeholders asked us to explain the accounting over the financial asset's life to help them understand the Committee's conclusion.

IFRS 9 Recap

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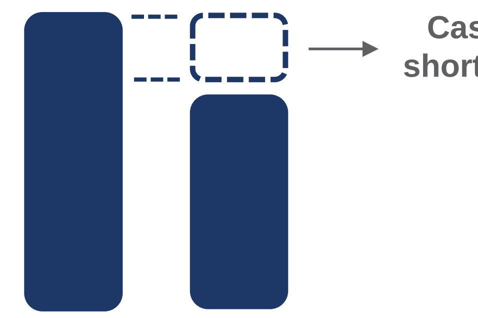
Defined terms

Gross Carrying Amount (GCA) eg CU84 − **Expected Credit Losses (ECL) eg CU66** = **Amortised cost (AC) eg CU18**

The amortised cost of a financial asset, before adjusting for any loss allowance. For example:

Loan	CU100
Interest revenue	CU10
Principal repayments	CU(26)
GCA	**CU84**

Credit loss =
PV of (contractual cash flows due – cash flows expected to be received)

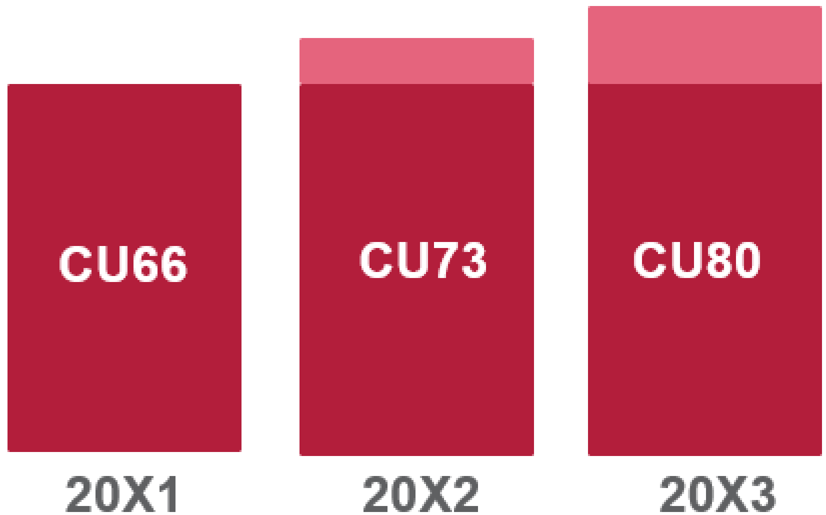


The amount measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, **adjusted for any loss allowance.**

Time value of money

- Measurement of expected credit losses reflects the time value of money.
- Credit losses are discounted at the original effective interest rate (EIR).
- The ECL balance (loss allowance) is a discounted amount.

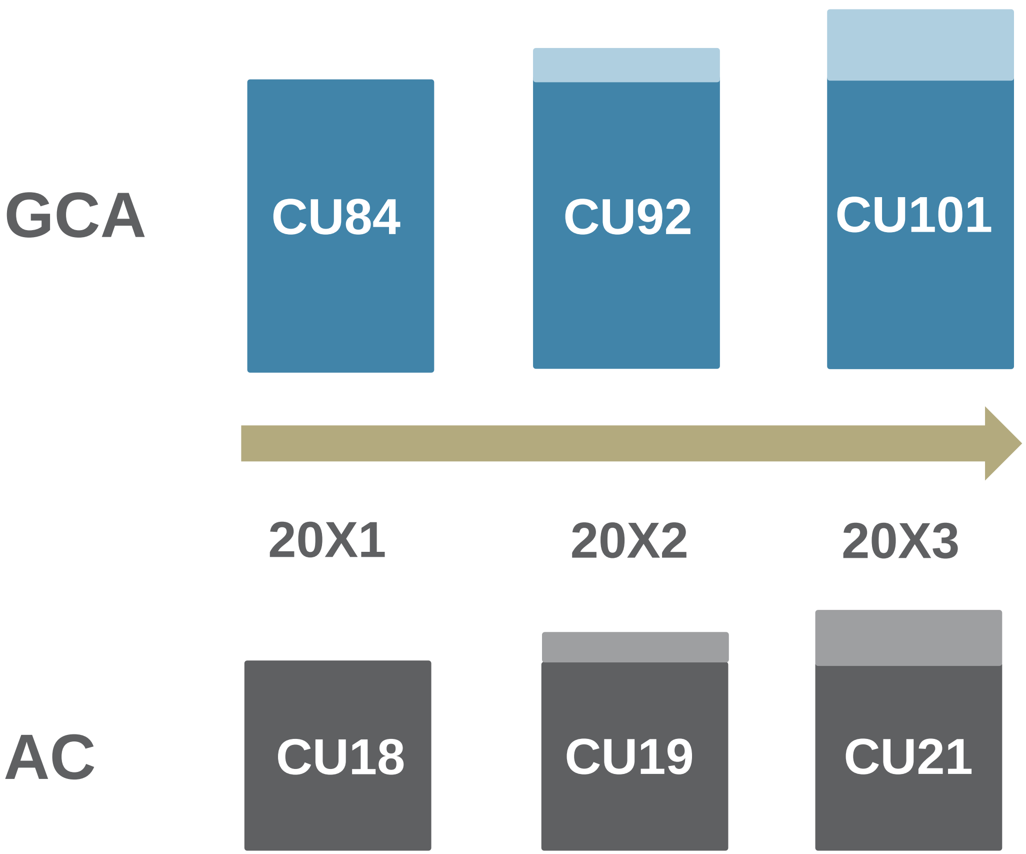
Assumptions	
EIR	10%
ECL in 20X1	CU 66
Expected cash shortfalls remain constant	



Each year the ECL balance increases to reflect the effect of time value of money; ie the ECL balance is a discounted amount and therefore changes in this balance over time include the unwinding of the discount.

Time value of money (cont.)

Similarly, assuming no principal repayments and no change in the amount or timing of expected cash shortfalls…



IFRS 9 is clear that the GCA, the loss allowance and amortised cost are discounted amounts and therefore the changes in these amounts during a reporting period include the effect of unwinding of the discount.

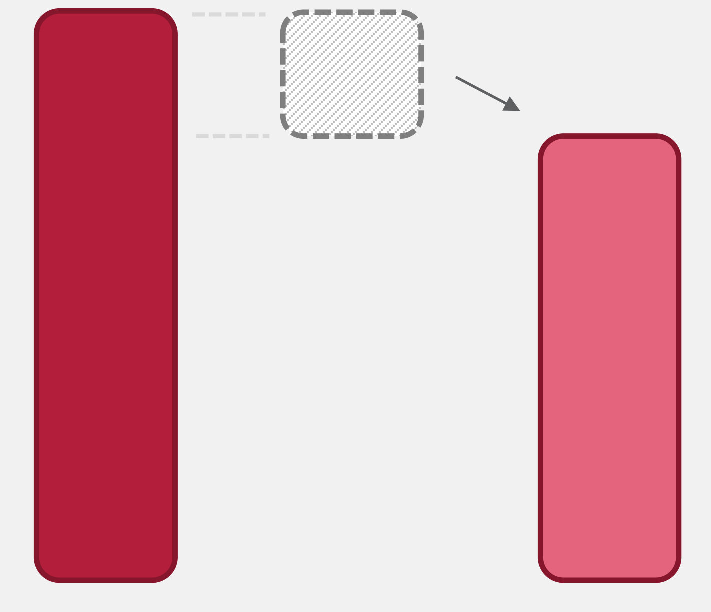
Overview of impairment model

Change in credit risk since initial recognition

Expected credit losses recognised

12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Stage 1—No significant increase in credit risk since initial recognition	**Stage 2**—Significant increase in credit risk since initial recognition, but not yet credit-impaired	**Stage 3**—Credit-impaired or incurred loss has occurred

Interest revenue



Gross Carrying Amount (GCA) - Expected Credit Losses (ECL) = Amortised cost

When a financial asset becomes **credit impaired**, interest revenue is calculated based on the amortised cost.

[paragraph 5.4.1(b)]

Example

Example

On 1/1/20X1 an entity originates a loan measured at amortised cost with the following terms:

Terms	Values
Principal amount	CU100
Effective interest rate	10%
Term to maturity	5 years
Annual instalments	CU26
Lifetime ECL balance at 31/12/20X1	CU66

Assumptions:

- The entity measures ECL for the first time at the first reporting date after initial recognition (31/12/20X1)
- At 31/12/20X1 the credit risk on the loan has increased significantly since initial recognition (ie the loan is in Stage 2)
- At 31/12/20X2 the loan is credit-impaired (ie it is in Stage 3)
- There is no change in the expected shortfalls in contractual cash flows between 31/12/20X1 and 31/12/20X3 even though the loan has deteriorated to Stage 3
- At 1/1/20X4 the entity receives the contractual amount due in full
- Amounts have been rounded to the nearest whole currency unit

Year 1—Journal entries

Date			
1/1/20X1	Dr Loan (GCA)	100	
	Cr Cash		100
	Originate loan		
31/12/20X1	Dr Loan (GCA)	10	
	Cr Interest revenue		10
	Accrual of interest		
	Dr Cash	26	
	Cr Loan (GCA)		26
	Receipt of instalment		

Applying paragraph 5.4.1 of IFRS 9, interest revenue is recognised by applying the EIR to the GCA.

Date			
31/12/20X1	Dr Impairment loss	66	
	Cr ECL allowance		66
	Recognise lifetime expected credit losses		

Applying paragraph 5.5.8 of IFRS 9, this change in the loss allowance is recognised as an impairment loss.

Year 1 (20X1)

	1/1/20X1	31/12/20X1
	Origination	**Stage 2**
Statement of financial position		
GCA	100	84
ECL		(66)
Amortised Cost	100	18
Statement of profit or loss		
Interest revenue		10
Impairment loss		(66)

Year 2—Journal entries

Date			
31/12/20X2	Dr Loan (GCA)	CU 8	
	Cr Interest revenue		CU 8
	Accrual of interest		
31/12/20X2	Dr Impairment loss	CU 7	
	Cr ECL allowance		CU 7
	Unwinding of discount on ECL		

During Year 2, interest revenue continues to be calculated by applying the EIR to the GCA. At the end of Year 2, the asset is in Stage 3 and therefore the entity changes the interest revenue calculation at the beginning of the next reporting period (paragraphs 5.4.1(b) and BC5.74 of IFRS 9).

Applying paragraph 5.5.8 of IFRS 9, this change in the loss allowance is recognised as an impairment loss.

Year 2 (20X2)

	1/1/20X1	31/12/20X1	31/12/20X2
	Origination	**Stage 2**	**Stage 3***
Statement of financial position			
GCA	100	84	92
ECL		(66)	(73)
Amortised Cost	100	18	19
Statement of profit or loss			
Interest revenue		10	8
Impairment loss		66	7

*At 31/12/20X2 the financial asset is credit-impaired (in Stage 3) and therefore the entity changes the interest revenue calculation at the beginning of the **next** reporting period.

Year 3—Journal entries

When an asset becomes credit-impaired, an entity calculates interest revenue by applying the EIR to the amortised cost of the financial asset.

[paragraph 5.4.1(b)]

…presenting interest revenue on the basis of the GCA of the financial asset, that reflects the contractual return, would no longer faithfully represent the economic return…

[paragraph BC5.74]

Date			
31/12/20X3	Dr Loan (GCA)	CU 2	
	Cr Interest revenue		CU 2
	Accrual of interest		

Present value calculations

- The GCA and ECL allowance are discounted amounts so their calculations need to reflect the effect of the unwinding of the discount*
- In Year 3 (20X3), the GCA needs to increase by CU9 and the ECL allowance needs to increase by CU7, based on the EIR determined at initial recognition of 10%, in order to reflect the passage of time
- As a result, after the journal entry on slide 18 to recognise interest revenue of CU2, the GCA and ECL balances need to increase by an additional CU7

How would the entity record this amount?

*The appropriateness of adjusting both the GCA and loss allowance for the unwinding of the discount was confirmed when the Transition Resource Group for Impairment of Financial Instruments (ITG) discussed the measurement of the loss allowance for credit-impaired financial assets in December 2015 (Agenda Paper 9).

Year 3 – Bookkeeping

Alternative 1

Date			
31/12/20X3	Dr Loan (GCA)	CU 7	
	Cr ECL allowance		CU 7
	Unwinding of discount on GCA and ECL		

- These balances are now at the amounts required by IFRS 9
- No additional adjustments to those amounts are required

Alternative 2

Date			
31/12/20X3	Dr Impairment loss	CU 7	
	Cr ECL allowance		CU 7
	Unwinding of discount on ECL		
	Dr Loan (GCA)	CU 7	
	Cr Impairment loss		CU 7
	Unwinding of discount on GCA		

- The net effect is the same because the entries to impairment expense offset each other
- The credit entry cannot be recognised in interest revenue because it would be inconsistent with the requirement in paragraph 5.4.1(b) of IFRS 9

IFRS 9 does not prescribe specific bookkeeping entries.

Year 3 (20X3)

	1/1/20X1	31/12/20X1	31/12/20X2	31/12/20X3
	Origination	**Stage 2**	**Stage 3***	**Stage 3**
Statement of financial position				
GCA	100	84	92	101
ECL		(66)	(73)	(80)
Amortised Cost	100	18	19	21
Statement of profit or loss				
Interest revenue		10	8	2
Impairment loss		66	7	0
Difference between applying EIR to GCA and interest revenue recognised		0	0	7

*At 31/12/20X2 the financial asset is credit-impaired (Loan in Stage 3) and therefore the entity changes the interest revenue calculation at the beginning of the next reporting period.

Year 4 – Journal entries

Date			
1/1/20X4	Dr Cash	101	
	Cr Loan (GCA)		101
	Receipt of full contractual amount due		
1/1/20X4	Dr ECL allowance	80	
	Cr Impairment loss		80
	Reversal of ECL upon curing		

- Applying paragraph 5.5.8 of IFRS 9 the entity recognises in profit or loss, as a reversal of expected credit losses, the adjustment required to bring the loss allowance to zero when the asset is paid in full
- The amount of this adjustment includes the effect of the unwinding of the discount on the loss allowance during the period the financial asset was credit-impaired (CU7 in Year 3)

Year 4

	1/1/20X1	31/12/20X1	31/12/20X2	31/12/20X3	1/1/20X4
	Origination	**Stage 2**	**Stage 3***	**Stage 3**	**Repaid in Full**
Statement of financial position					
GCA	100	84	92	101	0
ECL		(66)	(73)	(80)	0
Amortised cost	100	18	19	21	0
Statement of profit or loss					
Interest revenue		10	8	2	0
Impairment loss		66	7	0	(80)
Difference between applying EIR to GCA and interest revenue recognised		0	0	7	0

Reversal of impairment losses may exceed the impairment losses recognised in profit or loss over the life of the asset.

*At 31/12/20X2 the financial asset is credit-impaired (Loan in Stage 3) and therefore the entity changes the interest revenue calculation at the beginning of the next reporting period.

IFRS

Key observations and takeaways

Key takeaways

1. The GCA, amortised cost and the loss allowance are discounted amounts. Changes in these amounts during a reporting period include the effect of the unwinding of the discount.

2. Any amount of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount required by IFRS 9 is recognised in profit or loss, as an impairment gain or loss. In the example in this webcast, the asset is ultimately paid in full so the loss allowance must be adjusted to zero.

3. The impairment approach in IFRS 9 has recognition and measurement consequences when a financial asset becomes credit-impaired. Specific to this matter, interest revenue is calculated differently for a financial asset that becomes credit-impaired and this affects the accounting for impairment losses.

Key takeaways (cont.)

4. Cumulative interest revenue recognised when a credit-impaired financial asset is ultimately cured is not the same as it would have been if the financial asset had not been credit-impaired. The expected credit loss impairment model in IFRS 9 focuses on an entity's expectations about cash shortfalls and <u>changes</u> in those expectations over time.

5. IFRS 9 includes specific requirements for interest revenue recognition. The effective interest method recognises interest revenue <u>over time</u> at the relevant EIR. The difference described in the submission does not reflect an additional amount of interest revenue.

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