



Project	Financial Instruments: Impairment
Topic	Interest income recognition and definition of amortised cost

Introduction and purpose of paper

1. The purpose of this paper is to discuss whether the definition of amortised cost to which an effective interest rate (EIR) is applied for determining interest income should include a reduction attributable to a credit impairment allowance. The definition of amortised cost is one piece of three interrelated pieces for determining the amount of interest income to be reported in the financial statements for financial assets.
2. The total amount of interest income recognised on financial assets will not be based solely on the boards' decisions on the issues presented in this paper. The boards would also need to consider whether a discounted or undiscounted cash flow technique is used when measuring the amount of credit impairment, where to recognise the interest amount on impairment amounts in the income statement if expected losses are discounted and whether the ceasing accrual of interest on loans that are not performing (nonaccrual) would be required. These issues are discussed in FASB Memos 84 and 85 / IASB agenda papers 4B and 4C.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

3. This paper is organised as follows:
 - (a) Current and proposed amortised cost definitions in US GAAP and current definition in IAS 39, *Financial Instruments: Recognition and Measurement*
 - (b) Proposals in the FASB's and IASB's original Exposure Drafts and constituents' feedback related to the recognition of interest income, effective interest rates, and amortised cost
 - (c) Redeliberations to date
 - (d) Alternatives for defining amortised cost for the boards' consideration.

Amortised Cost Definitions

4. Current US GAAP includes three different definitions of amortised cost in the Master Glossary. This is a result of this term being defined differently in FASB Staff Position FAS115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, and FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. The FASB's Exposure Draft would have revised the definition to have a uniform definition of amortised cost in US GAAP. The Exposure Draft proposed that amortised cost be defined and calculated as follows:

A cost-based measure of a financial asset or financial liability that adjusts the initial cash inflow or outflow (or the noncash equivalent) for factors such as amortization or other allocations. Amortized cost is calculated as the initial cash outflow or cash inflow (or the noncash equivalent) of a financial asset or financial liability adjusted over time as follows:

- a. Decreased by principal repayments
- b. Increased or decreased by the cumulative accretion or amortization of any original issue discount or premium and cumulative amortization of any transaction fees or costs not recognized in net income in the period of acquisition or incurrence

- c. Increased or decreased by foreign exchange adjustments
 - d. Decreased by write-offs of the principal amount.
5. IAS 39 defines *amortised cost* as:

[T]he amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest rate method of any difference between the initial amount and the maturity amount and minus and reduction (directly or through the use of an allowance account) for impairment or uncollectibility.
6. IAS 39 includes a deduction for impairment losses within amortised cost and applies interest to this amount because impairment is required to be calculated as the present value of all shortfalls in cash flows discounted at the EIR.¹
7. The significant difference between the two approaches is that the current FASB approach does not subtract and the IASB approach does subtract an allowance for credit impairment in calculating the amortised cost amount. This means that if interest income were to be calculated by multiplying amortised cost in its purest definitional forms above by the ‘contractual’ EIR (that is, EIR calculated ignoring credit losses) interest income would not be recognised on principal not expected to be collected using the IASB definition and interest income would be recognised on principal not expected to be collected using the FASB definition. However, the proposals in the FASB and IASB’s original Exposure Drafts did not calculate interest income by multiplying amortised cost in its purest definitional forms above by the contractual effective interest rate (ignoring losses) as each Board had a different objective in mind as to what interest income should represent.

FASB Exposure Draft Proposed Approach

8. The proposed guidance in the FASB’s Exposure Draft for determining the amount of interest income to be recognised in a given reporting period would have required

¹ In effect, interest income comprises interest at the EIR on the carrying amount gross of impairment losses net of interest accrued on the impairment losses as they are unwound over time.

applying the contractual EIR (determined based on contractual cash flows and ignoring credit loss expectations) of a loan (or pool of loans) to the loan's amortised cost balance less the associated allowance for credit losses. Consequently, interest income recognised would be reduced to reflect the effect of estimated credit losses. Estimated credit losses in the FASB's Exposure Draft represent the contractual amounts due to an entity that the entity does not expect to collect and the collectability assessment would be required to be updated at each reporting date. For assets evaluated for impairment on a collective (pooled) basis, the Exposure Draft did not propose requiring that a discounted cash flow approach be used to measure expected losses. However, for assets evaluated on an individual basis, the Exposure Draft proposed requiring that an entity measure the amount of impairment on the asset on the basis of a present value technique, except in circumstances in which the entity elects the allowed practical expedient for collateral dependent assets. The practical expedient would result in recognising impairment only when the fair value of the collateral is less than the amortised cost of the financial asset.

9. The FASB received feedback through comment letters, field visits, and extensive outreach with all constituent groups, particularly users of financial statements. This feedback is summarised in detail in FASB Memorandum 66. In summary, constituents, particularly users, overwhelmingly opposed the proposed guidance. A critical concern cited was the effect of the proposed change on an entity's reported net interest margin. The net interest margin is a key metric by which management and users evaluate financial institutions. Moreover, users almost universally asserted that they prefer to analyse credit losses separate from net interest margin because it allows them to incorporate their own expectations of credit quality of loans in their projections.
10. Preparers also expressed significant concerns about the operationality of the proposed guidance. Their concerns were primarily based on the fact that in the financial sector most financial institutions manage interest accruals and credit impairments using separate operating systems. These constituents cited that integrating these two distinct systems was operationally not feasible.

IASB Exposure Draft Proposed Approach

11. In order to provide clarity of the overall premise of amortised cost measurement, the IASB's original Exposure Draft proposed an objective for amortised cost measurement being:

[T]o provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument.
12. The IASB's Exposure Draft proposed that the EIR used to calculate the interest income recognised in earnings reflects an entity's initial estimate of expected credit losses to occur over the tenure of a loan. The Exposure Draft proposed that the amortised cost of a financial asset at any time would be determined as the present value of the expected future cash flows at the measurement date discounted at the EIR that was determined at initial recognition. Implicitly, this meant that expected credit losses were determined as the shortfall in all contractual cash flows (both principal and interest) discounted at the original EIR and this was included (as an implicit deduction) in the carrying amount of the financial asset.
13. Consistent with this balance sheet measurement, the Exposure Draft proposed that the interest recognised on a financial asset would be calculated by applying the originally determined EIR (including the initial estimate of expected credit losses) to the carrying amount of the loan.
14. It was proposed that any changes in the expected amount of the credit losses would be recognised as impairment losses (and not adjustments to the initially calculated EIR) in the period that the change occurred. Keeping the EIR constant was viewed by the IASB as being consistent with an amortised cost measurement. IASB agenda papers 4A of the IASB's 3 August 2010 meeting and 1C of the IASB's 24 August 2010 meeting outline the IASB's reasoning for these decisions as 'the Board believed that the pricing of a financial asset inherently includes some estimate for

initial [expected loss]. Therefore, allocating the [expected loss] over the life of the portfolio more accurately reflects the effective return of the instrument.’

15. Feedback received by the IASB related to the proposed approach for interest income recognition in its Exposure Draft is detailed in IASB agenda paper 1A for the IASB-only 24 August 2010 meeting. The main concern raised by respondents in respect of this approach was that determining an EIR that included consideration of initial credit loss estimates was operationally burdensome. In particular, it was noted that accounting systems are used to determine EIRs whereas credit risk systems measure expected losses and these systems are not integrated. It also was noted that for open portfolios it would be challenging to determine which expected losses were initial estimates and which were changes in estimates relating to financial assets that had been held before the reporting periods.
16. While the EIR reflected initial loss estimates, the IASB’s original Exposure Draft did propose that interest be presented in the income statement both before and after consideration of such losses. The following extract is representative of users’ feedback to the IASB and notes that users ‘would rather the financial statements be as granular as possible, and show the gross interest amount, the expected losses on a separate line (some prefer to show it within revenue and others prefer it shown in expense), and the resulting net amount.’

Redeliberations to Date

17. At its 13 September 2010 meeting, the IASB decided to use a 'decoupled' effective interest approach. That is, they agreed that the effect of expected credit losses expected at the inception of a loan would not be integrated in the calculation of the EIR. Therefore, the EIR would continue to be calculated as it currently is under IAS 39. Impairment would be separately recognised and accounted for in the financial statements. In the IASB-only deliberations before the issue of the Supplementary Document, the IASB considered a time-proportional approach for the 'good book' as a way to approximate the effect of the originally proposed integrated EIR by reflecting the effect of impairment over the life of a loan portfolio.
18. In FASB Memos 84 and 85 / IASB agenda papers 4B and 4C, the boards will be asked separately to consider whether expected losses should be determined as undiscounted principal amounts or discounted principal and interest amounts (in that case, how the interest unwind should be accounted for) and whether nonaccrual guidance should be required. Therefore, these papers will potentially affect the overall interest ultimately recognised in the income statement.

Alternatives and Staff Recommendation

19. The following alternatives are being provided for the boards to determine whether they believe that the definition of amortised cost to which an EIR is applied should include or exclude a reduction for a credit impairment allowance.

Alternative 1—A reduction for a credit impairment allowance would not be included when calculating amortised cost.

Alternative 2—A reduction for a credit impairment allowance would be included when calculating amortised cost.

20. The staff recommends Alternative 1. As stated earlier in this paper, the significant difference between the FASB's current and proposed approaches and the IASB's current approach is that the FASB's approach would not subtract and the IASB's approach would subtract an allowance for credit impairment in calculating the amortised cost amount.
21. Based on the feedback received on each of the Board's proposals for determining interest income and decisions to decouple impairment from yields, the need to subtract an allowance for credit impairment in calculating the amortised cost amount is not as critical and, in fact, not subtracting an allowance for credit impairment is consistent with a 'decoupled' approach whereby interest recognition and impairment are separately considered. This gives the boards greater flexibility in determining how best to calculate expected losses, the discounts rates to be used for discounting (if relevant), and the relevance of nonaccrual guidance. In addition, the feedback received from constituents, particularly users, stressed the need for an interest income recognition model that allows them to continue to analyse net interest margin and credit losses separately. As stated earlier, FASB Memos 84 and 85 / IASB agenda papers 4B and 4C further consider the overall presentation of interest income and credit impairment.

Question for the Board

Which alternative do the boards support?