



Project **Financial Instruments: Impairment**

Topic **Non-accrual principle**

Introduction and Purpose of this Memorandum

1. **This paper is only relevant if the boards choose to measure expected losses using an undiscounted measure of principal only for some or all financial assets subject to impairment accounting (Alternative A in AP4B/Memo 84).**
2. The purpose of this paper is to provide the boards with information to determine whether the interest income recognition and impairment model being developed for financial assets should incorporate a specific ‘non-accrual’ principle; that is, an explicit requirement for when interest accruals on financial assets must cease. As discussed later in this paper, this issue and the issues discussed in AP 4A/Memo 83 (definition of amortised cost) and AP 4B/Memo 84 (discounting) are interrelated and the staff believes they must be considered together. This paper does not address accounting for impairment of purchases of financial assets into the bad book, which are being addressed separately as part of deliberations on how to recognise and measure impairment on all purchased loans.
3. The remainder of this paper outlines the following:
 - (a) Background-Current IFRSs and US GAAP
 - (b) Interaction with other issues
 - (c) Feedback on relevant sections of the FASB Exposure Draft¹

¹ Note that the original IASB ED did not address the non-accrual status or accounting because current IFRSs and the original proposal would use a discounted measure of all cash flows for impairment.

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.

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- (d) Staff analysis and recommendations.

Background

Current IFRSs and US GAAP

4. Currently, neither IFRSs nor US GAAP have specific requirements for ceasing accrual of interest on financial assets.
5. However, predominant practice for financial institutions in the US is to follow non-accrual guidance included in regulatory reporting instructions for GAAP financial reporting purposes. The principle in the regulatory reporting guidance is that banks shall not accrue interest, amortise deferred net loan fees or costs, or accrete discount on the following types of assets:
 - (a) Assets maintained on a cash basis because of deterioration in the financial condition of the borrower
 - (b) Assets for which payment in full of principal or interest is not expected
 - (c) Assets for which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection².
6. The appendix to this paper provides a full description of the regulatory requirements for non-accrual assets.
7. The FASB staff understands that this definition is also applied in practice by many financial institutions in the U.S. for purposes of determining when an individual asset meets the scope requirement of ASC 310-10-35 (formerly FASB Statement No. 114). ASC 310-10-35 requires, for assets in its scope, that

Using a discounted measure means non-accrual guidance cannot be required. Expected shortfalls in interest are included in the impairment calculation and in the calculation of interest revenue – to also cease interest accrual would double count shortfalls in interest.

² An asset is 'well secured' if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is 'in the process of collection' if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

impairment be measured based on cash flows expected to be collected, discounted at the original rate in the contract, or as a practical expedient, based on the fair value of the collateral for collateral-dependent loans. This guidance applies to assets that are individually considered impaired, but does not define when an asset is impaired, leaving that determination to management. Based on discussions with U.S. Banking Regulators, the staff understands that, in practice determination of when an asset is considered impaired for purposes of meeting the scope requirement of ASC 310-10-35 leverages the non-accrual requirements in regulatory guidance. (Note that this is for assets within the scope of ASC 310-30-35, which excludes large groups of smaller-balance homogeneous loans.)

8. IAS 39 and the original IASB ED require impairment losses to be calculated based on discounted future cash flows (principal and interest). Given IAS 39 requires all cash flows (principal and interest) to be taken into account for calculating the impairment loss, IAS 39:AG93 does not allow for non-accrual of interest following an impairment as it is unnecessary. Following an impairment, IAS 39 requires interest revenue to be recognised using the contractual EIR (ie the rate that was used for discounting the future cash flows for the purpose of measuring the impairment loss) applied to the carrying amount (which is net of the impairment amount).

Interaction with other issues

Interaction with amortised cost definition

9. AP 4A/Memo 83 discusses the definition of amortised cost and addresses whether for purposes of recognising interest income the effective interest rate for financial assets should be applied to amortised cost gross or net of the allowance. If the boards decide that amortised cost should be net of the allowance, the effects of impairment are directly included in the recognition of interest income. In this case, the practice of not accruing interest on a loan is not needed if the impairment amount incorporates expectations of shortfalls in all cash flows.

10. Currently, the definition of amortised cost in IFRSs, and the original IASB ED, would require a reduction for impairment or uncollectibility. As a result, interest income recognised on financial assets subject to impairment is reduced for the effects of incurred losses under current IFRSs (and also expected losses under the original IASB ED).
11. The staff have recommended in agenda papers AP 4A/Memo 83 (definition of amortised cost) that consistent with a decoupled approach, interest be calculated based on a carrying amount that is not reduced by impairment balances. This means that it is through the calculation of the impairment amount, the unwind of any discount on that impairment amount and non-accrual guidance that the impact of any anticipated shortfalls in interest are reflected in the income statement and/or the change in the yield on an asset can be reflected.

Interaction with discounted/undiscounted issue

12. As discussed in AP 4B/Memo 84, the staff believe that non-accrual guidance is not necessary if impairment losses are measured based on discounted amounts of principal and interest not expected to be collected. The full effect of interest shortfalls are in that case recognised in the income statement through the recognition of the impairment amount and the ‘unwind’ of the interest on that amount.
13. AP 4B/Memo 84 also notes that non-accrual guidance needs to be addressed if the boards decide that impairment should be measured on the basis of undiscounted principal amounts for all financial assets or only a subset of financial assets (ie those for which impairment is determined on a pooled basis using a loss rate technique). Such a principle would be necessary to ensure that interest is not accrued when deemed not collectible having been omitted from the impairment calculation.

FASB Exposure Draft and feedback received

14. The following outlines the key components of the FASB's impairment and interest income recognition model and its impact on current non-accrual practices in the FASB Exposure Draft³:

- (a) An entity shall recognise a credit impairment when it is not expected to collect all contractual amounts due for originated financial assets.
- (b) Both the amount and timing of cash flows expected to be collected must be considered in assessing and measuring the amount of credit impairment.
- (c) For financial assets evaluated on a pool basis, the amount of impairment recognised in net income for a pool is determined as the difference between the existing allowance for the pool and the allowance determined by applying an appropriate historical loss rate (adjusted for existing economic conditions) to the current principal balance of the pool at the reporting date.
- (d) For financial assets evaluated on an individual basis, impairment would be measured on the basis of present value of cash flows expected to be collected. Entities may elect a practical expedient on the basis of the fair value of the collateral if the asset is a collateral-dependent financial asset. (This is consistent with current U.S. GAAP.)
- (e) The amount of interest income to be recognised in net income is determined by applying the effective interest rate to the amortised cost balance net of the allowance for credit losses.
- (f) Accrual of interest would be ceased only if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative (that is, if total cash flows expected to be collected are less than the original principal amount).

³ As mentioned above, the original IASB ED did not address non-accrual guidance, because it was not necessary with the model proposed. Therefore, the original IASB ED did not request feedback on non-accrual guidance.

- (g) An asset (or part of an asset) would be written off in the period the entity has no reasonable expectation of recovery.

15. The following excerpts from the basis for conclusions of the FASB ED that explains the FASB's rationale for the interest income recognition decisions:

BC201. The Board is concerned that the existing interest income recognition method for loans (other than loans acquired with evidence of deterioration in credit quality) is based on the initial investment without deducting the allowance for credit impairments, which allows an entity to continue to recognize interest income on principal that is not expected to be collected. Some Board members believe that in recent years entities have relaxed their underwriting standards and lent to borrowers with lower credit ratings at higher interest rates so that higher interest income could be reflected in net income in earlier years even though the entities expected to have losses in the future on some portion of the loans. Board members also are concerned that because there is limited guidance on when an entity should cease accruing interest on a loan, entities may delay putting a loan on non-accrual status and accrue interest on loans even when a borrower has failed to make contractual interest payments.

BC202. The Board believes that it is inappropriate for an entity to accrue interest on an amount that it does not expect to collect. Therefore, the Board decided that interest income should be calculated on the basis of the amortized cost less any allowance for credit impairments of the financial asset... The Board notes that users of financial statements place significant value on the reported net interest margin. The Board believes that net interest margin should reflect the interest an entity expects to receive on the basis of current assessments of credit impairments. The proposed impairment model would result in the yield (or net interest margin) of a financial asset changing as a result of changes in the credit impairments.

BC203. The Board considered an alternative approach that would permit an entity to calculate interest income by multiplying amortized cost by the effective interest rate and would provide guidance on when an entity should cease accruing interest on financial assets (that is, when a financial asset should be placed on nonaccrual status). However, the Board believes that general nonaccrual guidance could not be developed to fit all situations. The Board believes that interest income could be too high if nonaccrual policies allow entities to continue to accrue interest on nonperforming loans or on performing loans for which cash shortfalls are expected. For example, an entity may have received all contractual interest payments on a loan that requires interest-only payments for a period of time but may not expect to receive all principal amounts due. The Board believes that the entire estimated shortfall should not be reflected as a credit impairment; rather, a portion of the expected loss should be reflected through a lower effective interest rate. Additionally, the Board believes that accruing interest on the basis of the effective rate multiplied by amortized cost without deducting the allowance for credit impairments would result in an upwardly biased number because any

pool of financial assets with a single credit impairment would have an actual yield net of credit impairments at less than the effective rate. Because no individual asset would be identified as impaired when financial assets are evaluated in a pool, it would not be possible to place a financial asset on nonaccrual to prevent interest income from being overstated.

Feedback received on original FASB ED

16. Constituents opposed the proposed methodology for the calculation of interest income which commingles credit losses and interest income through the reduction of amortised cost by the allowance for credit losses. In conjunction with opposing the interest income recognition model proposed in the FASB ED, most constituents, including users, also opposed the proposed changes to ‘non-accrual’ accounting. These constituents believe that the current accounting and disclosures for nonperforming assets and ceasing accrual of interest are well understood by users and is information they utilise in their analysis of a bank’s credit quality. This includes the additional information provided via disclosures about nonperforming assets and assets for which interest accrual has ceased.
17. Constituents were concerned that the proposed definition of non-accrual (ie ceasing accrual of interest when the overall yield is negative) would result in a difference between financial reporting and regulatory reporting. Many preparers asserted that the regulatory definition of non-accrual assets used for regulatory reporting would be suitable for use in GAAP financial reporting. Preparers also noted that it would be operationally difficult to apply the proposed guidance to small-balance, homogenous pooled loans for which no individual cash flow analysis is otherwise performed.

Staff analysis and recommendations

18. As mentioned in paragraph 1, this paper is only relevant if the boards decided to use an undiscounted measure of principal amounts for expected losses.
19. Whether non-accrual guidance is necessary depends on the measurement method that is selected for impairment losses. Therefore:
 - (a) If the boards decide that impairment losses should be measured as discounted amounts of principal and interest cash flows not expected

to be collected, with the unwinding of the discount recognised in earnings, then expected losses related to interest are captured within the impairment calculation and non-accrual guidance may not be needed.

- (b) If the boards decide that impairment should be measured on the basis of undiscounted principal amounts then non-accrual guidance would be necessary. In this case, expected losses related to interest are not explicitly captured in the measurement of impairment losses.

APPENDIX

Nonaccrual requirements for regulatory reporting

Source: FFIEC 031 and 041 Call Report Instructions Glossary

Nonaccrual Status: This entry covers, for purposes of these reports, the criteria for placing assets in nonaccrual status (presented in the general rule below) and related exceptions, the reversal of previously accrued but uncollected interest, the treatment of cash payments received on nonaccrual assets and the criteria for cash basis income recognition, the restoration of a nonaccrual asset to accrual status, and the treatment of multiple extensions of credit to one borrower.

General rule – Banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.

An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

For purposes of applying the third test for nonaccrual status listed above, the date on which an asset reaches nonaccrual status is determined by its contractual terms. If the principal or interest on an asset becomes due and unpaid for 90 days or more on a date that falls between report dates, the asset should be placed in nonaccrual status as of the date it becomes 90 days past due and it should remain in nonaccrual status until it meets the criteria for restoration to accrual status described below.

Any state statute, regulation, or rule that imposes more stringent standards for nonaccrual of interest takes precedence over this instruction.

Exceptions to the general rule – In the following situations, an asset need not be placed in nonaccrual status:

- (1) **The criteria for accrual of income under the interest method specified in ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer"), are met for a purchased impaired loan or debt security accounted for in accordance with that Subtopic, regardless of whether the loan or debt security had been maintained in nonaccrual status by its seller. For further information, see the Glossary entry for "purchased impaired loans and debt securities."**

- (2) The criteria for amortization (i.e., accretion of discount) specified in former AICPA Practice Bulletin No. 6, "Amortization of Discounts on Certain Acquired Loans," are met with respect to a loan or other debt instrument accounted for in accordance with that Practice Bulletin that was acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party (such as another institution or the receiver of a failed institution), including those that the seller had maintained in nonaccrual status.**
- (3) The asset upon which principal or interest is due and unpaid for 90 days or more is a consumer loan (as defined for Schedule RC-C, part I, item 6, "Loans to individuals for household, family, and other personal expenditures") or a loan secured by a 1-to-4 family residential property (as defined for Schedule RC-C, part I, item 1.c, Loans "Secured by 1-4 family residential properties"). Nevertheless, such loans should be subject to other alternative methods of evaluation to assure that the bank's net income is not materially overstated.**

However, to the extent that the bank has elected to carry such a loan in nonaccrual status on its books, the loan must be reported as nonaccrual in Schedule RC-N.

Treatment of previously accrued interest – The reversal of previously accrued but uncollected interest applicable to any asset placed in nonaccrual status should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes a reversal of all previously accrued but uncollected interest applicable to assets placed in a nonaccrual status against appropriate income and balance sheet accounts.

For example, one acceptable method of accounting for such uncollected interest on a loan placed in nonaccrual status is (1) to reverse all of the unpaid interest by crediting the "accrued interest receivable" account on the balance sheet, (2) to reverse the uncollected interest that has been accrued during the calendar year-to-date by debiting the appropriate "interest and fee income on loans" account on the income statement, and (3) to reverse any uncollected interest that had been accrued during previous calendar years by debiting the "allowance for loan and lease losses" account on the balance sheet. The use of this method presumes that bank management's additions to the allowance through charges to the "provision for loan and lease losses" on the income statement have been based on an evaluation of the collectability of the loan and lease portfolios and the "accrued interest receivable" account.

Treatment of cash payments and criteria for the cash basis recognition of income – When doubt exists as to the collectability of the remaining recorded investment in an asset in nonaccrual status, any payments received must be applied to reduce the recorded investment in the asset to the extent necessary to eliminate such doubt. Placing an asset in nonaccrual status does not, in and of itself, require a charge-off, in whole or in part, of the asset's recorded investment. However, any identified losses must be charged off.

While an asset is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis as long as the remaining recorded investment in the asset (i.e., after charge-off of identified losses, if any) is deemed to be fully collectible. A bank's determination as to the ultimate collectability

of the asset's remaining recorded investment must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's historical repayment performance and other relevant factors.

When recognition of interest income on a cash basis is appropriate, it should be handled in accordance with generally accepted accounting principles. One acceptable accounting practice involves allocating contractual interest payments among interest income, reduction of the recorded investment in the asset, and recovery of prior charge-offs. If this method is used, the amount of income that is recognized would be equal to that which would have been accrued on the asset's remaining recorded investment at the contractual rate. A bank may also choose to account for the contractual interest in its entirety either as income, reduction of the recorded investment in the asset, or recovery of prior charge-offs, depending on the condition of the asset, consistent with its accounting policies for other financial reporting purposes.

Restoration to accrual status – As a general rule, a nonaccrual asset may be restored to accrual status when (1) none of its principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest, or (2) when it otherwise becomes well secured and in the process of collection. If any interest payments received while the asset was in nonaccrual status were applied to reduce the recorded investment in the asset, as discussed in the preceding section of this entry, the application of these payments to the asset's recorded investment should not be reversed (and interest income should not be credited) when the asset is returned to accrual status.

For purposes of meeting the first test, the bank must have received repayment of the past due principal and interest unless, as discussed below, (1) the asset has been formally restructured and qualifies for accrual status, (2) the asset is a purchased impaired loan or debt security accounted for in accordance with ASC Subtopic 310-30 and it meets the criteria for accrual of income under the interest method specified therein, (3) the asset has been acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party, is accounted for in accordance with former AICPA Practice Bulletin No. 6, and meets the criteria for amortization (i.e., accretion of discount) specified therein, or (4) the borrower has resumed paying the full amount of the scheduled contractual interest and principal payments on a loan that is past due and in nonaccrual status, even though the loan has not been brought fully current, and the following two criteria are met. These criteria are, first, that all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period and, second, that there is a sustained period of repayment performance (generally a minimum of six months) by the borrower in accordance with the contractual terms involving payments of cash or cash equivalents. A loan that meets these two criteria may be restored to accrual status but must continue to be disclosed as past due in Schedule RC-N until it has been brought fully current or until it later must be placed in nonaccrual status.

An asset in nonaccrual status that is subject to the cost recovery method required by former AICPA Practice Bulletin No. 6 or ASC Subtopic 325-40, Investments-Other –

Beneficial Interests in Securitized Financial Assets (formerly Emerging Issues Task Force Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets"), should follow that method for reporting purposes. In addition, when a purchased impaired loan or debt security that is accounted for in accordance with ASC Subtopic 310-30 has been placed on nonaccrual status, the cost recovery method should be used, when appropriate.

A loan or other debt instrument that has been formally restructured so as to be reasonably assured of repayment (of principal and interest) and of performance according to its modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the asset are supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured asset must remain in nonaccrual status. The evaluation must include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan or other debt instrument is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. (In returning the asset to accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be taken into account.) Such a restructuring must improve the collectability of the loan or other debt instrument in accordance with a reasonable repayment schedule and does not relieve the bank from the responsibility to promptly charge off all identified losses.

A formal restructuring may involve a multiple note structure in which, for example, a troubled loan is restructured into two notes. The first or "A" note represents the portion of the original loan principal amount that is expected to be fully collected along with contractual interest. The second or "B" note represents the portion of the original loan that has been charged off and, because it is not reflected as an asset and is unlikely to be collected, could be viewed as a contingent receivable. The "A" note may be returned to accrual status provided the conditions in the preceding paragraph are met and: (1) there is economic substance to the restructuring and it qualifies as a troubled debt restructuring under generally accepted accounting principles, (2) the portion of the original loan represented by the "B" note has been charged off before or at the time of the restructuring, and (3) the "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.

Until the restructured asset is restored to accrual status, if ever, cash payments received must be treated in accordance with the criteria stated above in the preceding section of this entry. In addition, after a formal restructuring, if a restructured asset that has been returned to accrual status later meets the criteria for placement in nonaccrual status as a result of past due status based on its modified terms or for any other reasons, the asset must be placed in nonaccrual status.

For further information on formally restructured assets, see the Glossary entry for "troubled debt restructurings."

Treatment of multiple extensions of credit to one borrower – As a general principle, nonaccrual status for an asset should be determined based on an assessment of the individual asset's collectability and payment ability and performance. Thus, when one

loan to a borrower is placed in nonaccrual status, a bank does not automatically have to place all other extensions of credit to that borrower in nonaccrual status. When a bank has multiple loans or other extensions of credit outstanding to a single borrower, and one loan meets the criteria for nonaccrual status, the bank should evaluate its other extensions of credit to that borrower to determine whether one or more of these other assets should also be placed in nonaccrual status.