

STAFF PAPER

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IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Disclosure and presentation of interest revenue		
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Introduction

1. In April 2011, the boards decided that interest income for financial assets measured at amortised cost should be determined based on the carrying amount of the asset excluding the amount of the impairment allowance. At that meeting the boards decided to reconsider whether to require disclosure of the effect of the unwinding on the impairment allowance at a later date.

Background

2. In April 2011, the boards discussed interest revenue recognition and the definition of amortised cost. They tentatively decided:
 - (a) that in order to determine interest revenue the effective interest rate would be applied to an amortised cost balance that is not reduced for credit impairment.
 - (b) that the measurement of expected losses should reflect the effect of discounting.
 - (c) to include the unwinding of the discount in the impairment losses line item and, after considering any operational issues, to later consider whether to require disclosure of the effect of the unwinding on the allowance account.

3. As a result of the above, the boards tentatively decided that they did not need to consider the inclusion of a non-accrual principle for an impairment accounting model.

Disclosure of unwind of discount

4. Under the proposed impairment model, an entity will move from an impairment allowance of 12 months expected loss to an allowance of lifetime expected losses for financial assets that have deteriorated in credit quality more than insignificantly since initial recognition. Because of the decoupled approach to measuring expected losses, an entity will be permitted to discount expected losses using a rate between the effective interest rate as determined under IAS 39, and the risk free rate.
5. To determine the unwind of the discount rate, an entity would be required to identify and track the impairment allowance for each asset, including determining the effect of transfers between the 12 month expected loss and lifetime expected loss. In order to quantify the effect of the unwinding of the discount rate, an entity would be required to track the movement of assets between the two measures.
6. During staff outreach performed since April 2011, concerns have been raised by participants regarding the difficulty of determining the effect of unwinding the discount. This is because, as the measurement of the impairment allowance is decoupled from the amortised cost measurement, entities will not be able to track the individual impairment allowance related to the financial assets that move into and out of a portfolio, or between buckets (ie the measurement would be a point in time measure).
7. The staff thinks that computational shortcuts may be used to estimate the effect of transfers in order to approximate the unwind of the discounting of expected credit losses (for example, by assuming the transfers occur at the reporting date). However, while computational shortcuts and approximations may alleviate some of the concerns regarding the practicability of calculating the unwinding of the discount, the cumulative effect may lead to an estimate of the unwinding of

discount that may be artificial and thus not faithfully represent the economics. This view is consistent with concerns expressed to the staff during outreach in developing the disclosure proposals in Agenda Paper 5A.

8. Thus Agenda Paper 5A does not include a recommendation that an entity disclose the amount of the unwind of the discount related to the impairment allowance.

What are the consequences?

9. As a consequence of the above, users will not be able to piece together information to determine the economic yield of impaired financial assets. For some financial assets this would result in accumulating interest in the gross carrying amount and thus increasing interest revenue due to a compounding effect if contractual amounts are not actually paid, offset by increases in the impairment allowance that would not be disaggregated between changes in the estimate of expected cash flows and the unwind of the original estimate.
10. As noted previously, the interest revenue will not faithfully represent the economic yield of the impaired financial asset, and users will not be given enough information to determine that economic yield. The staff notes that as a consequence of the increasing interest revenue, the gross carrying amount will inflate beyond the value of contractual cash flows.
11. The example below illustrates the above by comparing a ‘performing’ to a ‘non-performing’ loan.

Example

Illustration of interest revenue issue

Comparison of two loans: A and B. Both have a carrying value of 1000 at year 1 with an annual interest payment of 10%. Loan A continues to perform, however loan B defaults and does not pay the interest payments at the set dates. The entity expects to receive cash flows of 570 at year 4.

Loan A - performing	Y1	Y2	Y3	Y4
<u>Gross carrying amount</u>				
Opening	1,000	1,000	1,000	1,000
Payments	(100)	(100)	(100)	(1,100)
Interest revenue	100	100	100	100
Closing	1,000	1,000	1,000	0
<u>Impairment allowance</u>				
Opening	-	(20)	(20)	(20)
Changes	(20)	-	-	20
Closing	(20)	(20)	(20)	(0)
Net carrying amount	980	980	980	0

Loan B - non-performing	Y1	Y2	Y3	Y4
<u>Gross carrying amount</u>				
Opening	1,000	1,100	1,210	1,331
Payments	-	-	-	(570)
Interest revenue	100	110	121	133
Write-off	-	-	-	(894)
Closing	1,100	1,210	1,331	-
<u>Impairment allowance</u>				
Opening	-	(672)	(739)	(813)
Changes	(672)	(67)	(74)	(81)
Write-off	-	-	-	894
Closing	(672)	(739)	(813)	-
Net carrying amount	428	471	518	-

12. In the example above, the interest revenue line for Loan B increases because it is calculated on a carrying amount that includes the unpaid interest from prior periods. This results in a gross carrying amount of 1,464 at the end of Y4, when the contractual cash flows are 1,400. The additional 64 represents additional interest calculated using the effective interest method on accumulated unpaid interest.
13. The staff think that, given the above, the IASB may wish to reconsider its tentative decision on the presentation of interest revenue.

Question

Given the above, does the IASB wish to reconsider its tentative decision on the presentation of interest revenue?

If yes, refer to Agenda Paper 5D.