STAFF PAPER

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IASB Meeting

Project	**Financial Instruments: Impairment**		
Paper topic	Interest revenue—Calculation and presentation		
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Introduction

Purpose of this paper

1. The Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* ('the ED') included proposals for the presentation of interest revenue. This paper analyses the responses received on the proposed requirements. It considers whether the interest revenue calculation should change in some circumstances, to what basis the calculation should change, and for what population of assets it should change. It also analyses whether the recognition of interest revenue should be symmetrical, in line with the general model proposed in the ED.

2. This paper does not consider the disclosure requirements related to financial assets in Stage 3 of the proposed model. The complete package of disclosure requirements will be discussed at a future meeting. This paper also does not consider the interest revenue calculation for purchased or originated credit-impaired financial assets, which is covered in Agenda Paper 5D of this meeting.

Paper structure

3. This paper is structured as follows:

   (a) what the ED proposed;

   (b) **Issue A:** whether the interest revenue calculation should change and to what approach; (paragraphs 7 – 26)

   (c) **Issue B:** for what asset population the interest revenue calculation should change (Stage 3 trigger); (paragraphs 27 – 33)

   (d) **Issue C:** whether the interest revenue calculation should be symmetrical; (paragraphs 34 – 37)

   (e) summary of staff recommendations and question to the IASB; and

   (f) Appendix A: Interest revenue presentation alternatives

   Each of the issues listed above is organised into the detailed feedback received, the staff analysis of the feedback and the staff recommendation.

What the ED proposed

4. The ED proposed that:

   (a) An entity shall present interest revenue in the statement of profit or loss and other comprehensive income as a separate line item.

   (b) Interest revenue shall generally be calculated by using the effective interest method on the gross carrying amount of a financial asset. However, for assets that have objective evidence of impairment at the reporting date (and are not purchased or originated credit impaired), interest should be calculated on the net carrying amount (amortised cost) of the asset. This is in alignment with the current requirements of IAS 39 *Financial Instruments: Recognition and Measurement*.

   (c) The interest revenue calculation should be 'symmetrical'. An entity that calculates interest revenue on the amortised cost in one period shall calculate interest revenue on the gross carrying amount in a subsequent period, if there is no longer objective evidence of impairment.

5. The Basis for Conclusions stated the following:

> BC98 The 2009 ED proposed a model in which an entity would have considered initial expectations of credit losses when determining the effective interest rate on financial assets. Consequently, interest revenue would have represented the economic yield, or effective return, on those financial assets. In contrast, the decoupled approach in this Exposure Draft considers the recognition of interest revenue and the recognition of expected credit losses separately. This means that an entity recognises interest on the gross carrying amount without taking expected credit losses into consideration. In addition, users of financial statements stressed the need for an interest revenue recognition model that allows them to continue to analyse net interest margin and credit losses separately. However, the IASB noted that there are some financial assets that have deteriorated in credit quality to such an extent that presenting interest revenue on the basis of the gross carrying amount that reflects the contractual return would no longer faithfully represent the economic return.

6. The ED asked the following question on this topic:

> **Question 16**
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> (a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?
> (b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?
> (c) Do you agree with the proposal that the interest

revenue approach shall be symmetrical (ie that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

Issue A: Whether the interest revenue calculation should change and to what approach

Feedback

7. The vast majority of respondents agreed that the interest revenue calculation should change from a calculation based on the gross carrying amount for some financial assets (proposed in the ED as financial assets that have objective evidence of impairment at the reporting date). These respondents felt that such an approach supports faithful representation, because recognising the entire amount of contractual interest on financial assets for which contractual cash flows may no longer be collected in full would not reflect the economic return. They believed that continuing to calculate interest on the gross carrying amount would result in the overstatement of interest revenue by allowing interest to accrue on the unrecoverable portion of an asset.

8. A large majority of these respondents supported the ED's proposal to change to a calculation of interest on the net carrying amount for these financial assets. However, some preferred a non-accrual approach, while others preferred retaining a gross interest revenue calculation for all financial assets. These views are expanded on below.

Net presentation approach

9. As mentioned above, a large majority of respondents supported moving to an interest revenue calculation based on the net carrying amount of a financial asset. They felt that this would avoid the overstatement of interest revenue and provide more useful information for analysing financial performance and the net interest margin. It was noted that this method would more faithfully represent the amortisation of the interest revenue for assets with objective evidence of impairment, and would contribute to comparability with the treatment for

purchased or originated credit-impaired financial assets, because the interest revenue on these assets is also adjusted due to credit concerns.

10. These respondents also noted that the proposal to present net interest revenue is consistent with the existing requirements in IAS 39. As a result, many consider this proposal to be operational.

11. A recent survey by the CFA Institute among its members revealed that a majority of user respondents favoured a net presentation basis compared to a non-accrual basis for addressing financial assets with 'impaired' performance[1].

Non-accrual approach

12. A minority of respondents advocated a non-accrual approach for Stage 3 assets, instead of the proposed net approach. The primary reason given for this was operational concerns; for example, that it would be difficult to run two different interest revenue models and that entities do not have systems currently in place to accommodate a net approach. Several respondents stated that they support a non-accrual basis, because it was aligned with the current regulatory requirements and credit risk management practices in their jurisdiction.

13. A small number of respondents also thought that it is inappropriate to recognise any interest revenue on assets that have reached a point where an entity no longer expects to receive the contractual cash flows.

Gross (ie no change)

14. A few respondents stated that a non-accrual basis would not be an appropriate approach and preferred not changing the interest revenue calculation at all, but instead retaining a gross interest revenue calculation for all financial assets. The main reason given for this was operational concerns. A small number felt that always recognising gross interest would provide more useful information, because it allows users of financial statements to separately evaluate credit exposure on those assets from the interest revenue to which entity is entitled.

[1] http://www.cfainstitute.org/Survey/credit_loss_survey_report.pdf

Staff analysis

15. During its deliberations in July 2012, the IASB considered whether, and how, the interest revenue calculation should change[2]. An example depicting the three approaches discussed is reproduced in Appendix A of this paper.

Gross interest approach

16. For the reasons set out in the Basis for Conclusions to the ED, the staff remain of the view that a gross interest revenue approach does not faithfully represent the deterioration in credit quality of financial assets. The staff are of the view that the IASB should confirm changing the calculation for some assets (the scope is addressed in Issue B).

17. For the reasons above, the staff analysis does not contain any further discussion on a gross interest approach for financial assets.

Net interest approach

18. The IASB noted in July 2012[2] (and confirmed in paragraph BC98 of the Basis for Conclusions) that there are some financial assets that have deteriorated to such an extent that recognising interest revenue on the basis of the gross carrying amount would not faithfully represent the economic yield. As a result of 'decoupling' interest revenue from expected credit losses, the effective interest rate is not adjusted for credit loss expectations. Applying the contractual effective interest rate to the gross carrying amount for interest revenue purposes therefore ignores credit loss expectations and potentially overstates interest revenue.

19. Furthermore, IAS 39 already requires entities to calculate interest for financial assets with objective evidence of impairment on the net carrying amount (ie on an amount net of the impairment allowance).

20. A large majority of respondents supported a net approach. They believe that a net approach more faithfully represents the economic yield on the expected cash flows, because the amortisation of the gross carrying amount at the effective interest rate is reduced by the amortisation of the impairment allowance. This

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[2] July 2012 Agenda Paper 5D.

more closely reflects the economic yield that was originally accomplished through the application of the credit-adjusted interest rate in the 2009 ED.

21. As noted in the feedback section above, the primary reason given for disagreeing with the net approach (and for supporting the non-accrual approach) was operational concerns. The staff acknowledge that a disadvantage of the net approach is that entities would be required to adjust their interest revenue calculations for a subset of financial assets. However, the IASB considered the additional complexity and stated the following in the Basis for Conclusions:

> BC204 The proposal to change interest revenue recognition from a gross basis to a net basis at a different level of deterioration in credit quality compared to when lifetime expected credit losses are recognised adds a further level of complexity. However, the IASB believes that the financial assets for which there is objective evidence of impairment will be a subset of the financial assets for which lifetime expected credit losses are recognised in accordance with this Exposure Draft. As the objective evidence of impairment listed in this Exposure Draft is similar to the existing criteria in IAS 39, the IASB believes that the application of these concepts should result in a minimal change in practice and will therefore have no significant cost implications.

Non-accrual approach

22. As noted in the feedback section, some respondents preferred a non-accrual approach for some financial assets for operational reasons.

23. The IASB considered and rejected a non-accrual approach in the deliberations preceding the ED, as explained in the Basis for Conclusions:

> BC 102 The IASB considered an approach that would require the presentation of nil interest revenue, similar to a non-accrual approach, for this subset of financial assets. Under this approach, an entity would be required to offset interest revenue on a subset of financial assets with an equal amount of expected credit losses. The advantage of

presenting nil interest revenue is the operational simplicity. The only information that an entity would need to know to apply this approach would be the interest revenue on the subset of financial assets. That is, the proposals would not require an entity to identify the loss allowance related to that subset of financial assets. However, the disadvantage of this alternative is that it would blend together the effect of the unwinding of the present value of expected cash flows with other expected credit losses. In the IASB's view, a nil interest approach applied to a broad set of financial assets will not improve the presentation of interest revenue, because it will not faithfully represent the economic return in a manner that is consistent with the measurement of the gross carrying amount and expected credit losses at a present value.

24. The staff note that amortised cost is a cost-based measurement[3]. Using the effective interest method, the amortised cost is determined as the present value of estimated future cash payments or receipts discounted at the effective interest rate. The interest revenue on the amortised cost of the financial asset is then unwound over the remaining life of the financial asset. A non-accrual approach, by commingling the accrual of interest on the gross carrying amount of the financial asset with credit losses in the impairment loss line item, results in a presentation that the staff think does not reflect the unwinding of the carrying amount.

25. The staff further note that the physical collection of cash, or the lack of doing so, is a separate issue from the unwinding of the amortised cost. To 'cease' the accrual of interest is inconsistent with the present value concept of amortised cost measurement. A non-accrual approach under amortised cost measurement does not, as the term perhaps misleadingly implies, actually stop the accrual of the amortised cost amount (which is generally accomplished through the interest revenue line item). Instead, it affects presentation by relocating the unwinding of the carrying amount from the interest revenue line item and commingling it with

[3] See September 2013 IASB Agenda Paper 6B.

the impairment loss line item. In addition to commingling the amortisation of the gross carrying amount with credit losses in the impairment loss line item, another concern about a non-accrual approach is the understatement of interest revenue.

Staff recommendation

26. The staff remain of the opinion that the net interest approach better reflects the economic yield and a large majority of respondents agreed with the proposals and with the rationale provided. Furthermore, respondents considered the net approach to be operational because it is aligned with the requirements of IAS 39. The staff therefore **recommend confirming** the proposal in the ED that, for some financial assets, the interest revenue calculation should change to a net calculation based on the amortised cost (net of the loss allowance) of the financial asset using the effective interest method and applying the original effective interest rate.

Issue B: For what asset population the interest revenue calculation should change (Stage 3 criterion)

Feedback

27. Nearly all respondents who agreed that the interest revenue calculation should change to a net basis agreed that it should do so when there is objective evidence of impairment at the reporting date. Many of these respondents noted that bringing forward the criterion of objective evidence of impairment from IAS 39 (excluding IBNR) was beneficial from an operational viewpoint, because entities are already applying this concept.

28. A small number of respondents questioned whether bringing forward the criterion of objective evidence of impairment from IAS 39 is appropriate, because it is an incurred loss concept, which seemed inconsistent with a move to an expected credit loss model. They also observed that it was used inconsistently in practice today. A small number felt that there could be difficulty in distinguishing between whether to move assets to Stage 2 or Stage 3, and requested more clarification between the criteria for the two stages. Some of these respondents preferred using ‘default’ as a criterion for when to change the interest revenue

calculation, and felt that 'objective evidence of impairment' substantially meant 'default'.

Staff analysis

29. The IASB's reasoning on using 'objective evidence of impairment' as a transfer criterion for Stage 3 is set out in the ED's Basis for Conclusions as follows:

> BC99 In the IASB's view, the issues about the presentation of interest revenue for financial assets that have objective evidence of impairment are similar to the issues for purchased or originated credit-impaired financial assets on which interest revenue is determined on the amortised cost amount (see paragraphs BC137–BC141). Consequently, if a financial asset has objective evidence of impairment at the reporting date, the proposals in this Exposure Draft would require an entity to calculate and present interest revenue using the effective interest rate on the amortised cost amount (ie the gross carrying amount net of the loss allowance). These requirements will only affect the calculation and presentation of interest revenue and not the measurement of the loss allowance.
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> BC100 The IASB decided to keep the scope of assets on which interest is calculated on the amortised cost amount consistent with paragraphs 59(a)–(e) of IAS 39. Thus, financial assets with objective evidence of impairment will be a subset of financial assets with a loss allowance measured at lifetime expected credit losses. IFRS preparers have already been determining interest on the net amortised cost amount for such assets in accordance with IAS 39. Consequently, this proposal would result in a minimal change in practice.

30. As mentioned above, an advantage of using objective evidence of impairment is that entities already use this criterion for calculating interest on a net carrying amount in IAS 39. This was reflected in the comment letters by many

respondents who noted that bringing forward the guidance from IAS 39 was beneficial from an operational perspective.

31. As mentioned in the feedback section above, a small number of respondents questioned the appropriateness of bringing forward 'incurred loss' guidance. The IASB responded to this concern in the ED's Basis for Conclusions:

> BC101 The IASB acknowledges the concerns of using 'incurred loss' criteria in an expected credit loss model. However, in the IASB's view, it is necessary to retain the faithful representation of interest revenue, while minimising the operational challenges of requiring entities to calculate interest revenue on the amortised cost amount for all assets.

32. The staff note that 'objective evidence of impairment' is defined more broadly and includes more events than only default events. While there may be overlapping situations in which a default event is an indicator of objective evidence of impairment, and the two terms are not mutually exclusive, the staff do not recommend limiting the criterion for the net presentation of interest revenue to financial assets that have defaulted. The staff are concerned that using default as the transfer criterion for Stage 3 may fail to take into account the wider set of events captured by 'objective evidence of impairment' and therefore could increase the size of the group of financial assets on which interest revenue is presented on a basis would not faithfully represent the economic return . Furthermore, it eliminates the operational relief that is provided by retaining the guidance as it is already implemented in IAS 39.

Staff recommendation

33. One of the reasons for initially proposing different interest recognition criteria for some assets was to align them with the concept used for purchased or originated credit-impaired financial assets. For such assets, the IASB had decided that the yield recognised for interest revenue recognition should be adjusted to better represent the economic yield. Using objective evidence of impairment as the Stage 3 transfer criterion is the method that is most consistent with the treatment

of purchased or originated credit-impaired financial assets (refer to Agenda Paper 5D of this meeting). Furthermore, it is operational, because it will result in little change to practice. The staff therefore **recommend confirming** the proposal that the interest revenue calculation should change for financial assets that have objective evidence of impairment at the reporting date (except for those that are purchased or originated credit-impaired).

Issue C: Whether the interest revenue approach should be symmetrical

Feedback

34. Nearly all the respondents who commented on symmetry agreed that the interest revenue approach should be symmetrical (ie that if an asset were no longer in Stage 3, interest revenue would again be calculated on the gross carrying amount). Many of these respondents commented that this approach would ensure that comparability is retained between assets that have reverted from Stage 3 and other assets that do not have objective evidence of impairment. It was noted that it is important from an operational perspective to have a single interest revenue calculation approach for each stage of the model. It was also stated that this would ensure that expectations of interest revenue and economic performance are aligned.

35. A few respondents stated that there was a lack of understanding about when an entity can revert back to a calculation based on the gross carrying amount, and requested that more guidance should be provided. Among these, some suggested that an illustrative example should be added to clarify when a financial asset should revert from Stage 3.

Staff analysis

36. Nearly all respondents agreed that the interest revenue approach should be symmetrical. A symmetrical interest revenue approach ensures that interest revenue is aligned with the faithful representation of the economic return. The

staff are of the view that to be consistent with the general model, the interest revenue approach should be symmetrical.

37. The staff further note that symmetry for the interest revenue approach is consistent with both of the IASB's confirmations in the October 2013 meeting: that the general model should be symmetrical and that the symmetrical treatment of the general model should apply equally to modified financial assets. The staff think that the reasoning behind these confirmations applies to interest revenue symmetry as well.

Staff recommendation

38. The staff **recommend confirming** the proposal that an entity that calculates interest revenue on the amortised cost in one period shall calculate interest revenue on the gross carrying amount in a subsequent period, if there is no longer objective evidence of impairment (ie the calculation of interest revenue should be symmetrical).

Summary of staff recommendations and question to the IASB

39. The feedback, analysis and recommendations on the three issues in this paper are provided in paragraphs 7–38 above.

40. The staff recommendations to confirm the proposals for the calculation and presentation of interest revenue can be summarised as follows:

    (a) the interest revenue calculation should change in some circumstances to a net calculation based on the amortised cost (net carrying amount) of a financial asset using the effective interest method and applying the effective interest rate;

    (b) the interest revenue calculation should change for financial assets (that are not a purchased or originated credit-impaired) that have objective evidence of impairment at the reporting date; and

(c) the interest revenue calculation should be symmetrical (ie interest revenue on the gross carrying amount should resume if there is no longer objective evidence of impairment).

Question to the IASB
Does the IASB agree with the staff recommendation to confirm the proposals for the calculation of interest revenue in the ED? If not, why not and what would the IASB prefer?

Appendix A: Interest revenue presentation alternatives[4]

		Y1	Y2	Y3	Y4
Gross carrying amount					
Opening		1,000	1,100	1,210	1,331
Payments		-	-	-	(570)
Interest	(a)	100	110	121	133
Write-off					(894)
Closing		1,100	1,210	1,331	-
Impairment allowance					
Opening		-	(672)	(739)	(813)
New impairment	(c)	(611)	-	-	-
Unwind of discount	(b)	(61)	(67)	(74)	(81)
Write-off		-	-	-	894
Closing		(672)	(739)	(813)	-
Net carrying amount		428	471	518	-
Presentation alternatives					
Gross interest approach					
Interest revenue	(a)	100	110	121	133
Impairment (loss)	(b) + (c)	(672)	(67)	(74)	(81)
Net interest approach					
Interest revenue	(a) - (b)	39	43	47	52
Impairment (loss)	(c)	(611)	-	-	-
Non-accrual approach					
Interest revenue		-	-	-	-
Impairment (loss)	(a) - (b) - (c)	(572)	43	47	52

[4] Reproduced from the July 2012 Agenda Paper 5D.