

STAFF PAPER

11 December 2015

Project	Transition Resource Group for Impairment of Financial Instruments		
Paper topic	Meaning of ‘current effective interest rate’		
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Introduction

1. This paper addresses an issue raised by a submitter regarding the application of the impairment requirements of IFRS 9 *Financial Instruments* (2014). The issue relates to the appropriate discount rate to use when measuring expected credit losses; specifically, what is meant by the term ‘current effective interest rate’ for a floating-rate financial asset.
2. This paper:
 - (a) sets out the relevant accounting requirements in IFRS 9;
 - (b) summarises the potential implementation issue raised by the submitter; and
 - (c) asks the members of the Transition Resource Group for Impairment of Financial Instruments (‘the ITG’) for their views on the issue identified.

Accounting requirements

3. Paragraph 5.5.17 of IFRS 9 requires that the time value of money must be taken into account when measuring expected credit losses:

5.5.17 An entity shall measure expected credit losses of a financial instrument in a way that reflects:

- (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- (b) the time value of money; and
- (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

4. Further guidance regarding the appropriate discount rate to use is contained in paragraph B5.5.44 of IFRS 9 [emphasis added]:

B5.5.44 Expected credit losses shall be discounted to the reporting date, not to the expected default or some other date, **using the effective interest rate determined at initial recognition or an approximation thereof.** If a financial instrument has a **variable interest rate**, expected credit losses shall be discounted using the **current effective interest rate determined in accordance with paragraph B5.4.5.**

5. Paragraph B5.4.5 of IFRS 9 provides the following guidance with regards to the determination of the effective interest rate for floating-rate financial instruments [emphasis added]:

B5.4.5 For floating-rate financial assets and floating-rate financial liabilities, **periodic re-estimation of cash flows to reflect the movements in the market rates of interest alters the effective interest rate.** If a floating-rate financial asset or a floating-rate financial liability is

recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or the liability.

6. The requirement set out in paragraph B5.5.44 of IFRS 9 differed from the one that was proposed in the 2013 *Impairment Exposure Draft* ('the 2013 ED'). The 2013 ED proposed that an entity would be allowed to choose a discount rate between the effective interest rate and the risk-free rate. However, as noted in paragraph BC5.272 of IFRS 9, a number of respondents raised concerns about this proposal. In addition to citing concerns over the permitted range of rates being too flexible, they also noted that the rate used to recognise interest revenue should be the same as the rate used to discount expected credit losses. The IASB considered these concerns and noted in paragraph BC5.273 of IFRS 9 that there would be a number of advantages to using the effective interest rate, including the fact that it is the conceptually correct rate and is consistent with the amortised cost measurement.
7. Consequently, the IASB decided to amend the proposal contained within the 2013 ED, which allowed an entity to choose a discount rate within a specified range for the purpose of measuring expected credit losses. However, mindful of the fact that entities currently face challenges in determining the effective interest rate, in particular for open portfolios, the IASB decided to require the use of the effective interest rate (or an approximation thereof) as set out in paragraphs BC5.274-BC5.275 of IFRS 9:

BC5.274 [.....] However, the IASB noted that even in accordance with the requirements of IAS 39 to use the effective interest rate to discount expected cash flows, there are operational challenges with using the effective interest rate for open portfolios and that entities use approximations of the effective interest rate.

BC5.275 Consequently, on the basis of the feedback received and the advantages noted in paragraph BC5.273,

the IASB decided to require the use of the effective interest rate (or an approximation of it) when discounting expected credit losses.

8. With the exception of some minor wording updates, the definition of the effective interest rate in IFRS 9 remains the same as the definition that was contained within IAS 39 *Financial Instruments – Recognition and Measurement*.¹

Potential implementation issue identified

9. The submitter notes that in accordance with paragraph B5.5.44 of IFRS 9, if a financial instrument has a variable interest rate, expected credit losses are discounted using the current effective interest rate as determined in accordance with paragraph B5.4.5 of IFRS 9. In the submitter's view, the question arises as to what is meant by 'the current effective interest rate' for a floating-rate financial asset when an entity recognises interest income in each period based on the actual floating rate applicable to that period.
10. In order to illustrate the issue, the submitter presents the following scenario:

Consider the following example:

A financial asset has a remaining maturity of 10 years and bears a floating rate of interest indexed to 12-month LIBOR (the credit spread is assumed to be zero for the purposes of this example):

- the LIBOR rate is reset at the end of each year;
- at the reporting date, 12-month LIBOR is 2 per cent per annum and is expected to increase to 10 per cent per annum at the time the last coupon is reset; and
- interest income is recognised using the 12-month LIBOR rate at the reporting date—ie 2 per cent.

¹ Appendix A reproduces both the IAS 39 and IFRS 9 definitions of the effective interest rate.

11. Within the context of the example presented, the submitter asks which LIBOR rate should be used to measure expected credit losses at the reporting date and presents two views:
- (a) *View 1:* the LIBOR rate that is current as at the reporting date—in the example, a rate of 2 per cent per annum applied to all cash shortfalls; or
 - (b) *View 2:* the LIBOR rates derived from the current yield curve—in the example, a rate of 2 per cent per annum applied to cash shortfalls arising during Year 1 and the applicable LIBOR rates derived from the current yield curve for each of the subsequent cash flows.
12. In the submitter's view, the approach described in View 1, which interprets the term 'current effective interest rate' to mean 'current as at the reporting date', would be the most natural interpretation of the word 'current' and would also be the easiest approach to implement from an operational perspective.
13. In contrast, the submitter considers that the approach described in View 2 would be far more challenging to implement operationally. However, the submitter observes that it may be more appropriate to use the effective interest rates that will apply over the period when the respective shortfalls arise (based on current estimates derived from the current yield curve) because there should be consistency between:²
- (a) the interest rates used to project future cash flows arising under the contract and associated cash shortfalls; and
 - (b) the effective interest rates used to discount those cash shortfalls.
14. Consequently, in accordance with this view, the only circumstance in which the approach outlined in View 1 may be used is when it provides an acceptable approximation of the effective interest rate in accordance with paragraph B5.5.44 of IFRS 9.

² The submitter notes that this approach was contemplated in paragraphs B11(b) and B12(b) of the 2009 Exposure Draft *Financial Instruments: Amortised Cost and Impairment* ('the 2009 ED').

Review of accounting requirements

15. In accordance with paragraph B5.5.44 of IFRS 9, an entity is required to discount expected credit losses using the original effective interest rate (or an approximation thereof). Within the context of a floating-rate financial instrument, the effective interest rate changes in line with changes in the market rate of interest. Consequently, paragraph B5.5.44 of IFRS 9 requires expected credit losses to be discounted using the current effective interest rate as determined in accordance with paragraph B5.4.5 of IFRS 9.
16. We note that the requirement set out in paragraph B5.5.44 of IFRS 9 differed from the one that was proposed in the 2013 ED. The 2013 ED proposed that an entity would be allowed to choose a discount rate between the effective interest rate and the risk-free rate. The rationale behind the IASB's decision to require entities to use the effective interest rate (or an approximation thereof) is set out in paragraphs BC5.272–BC5.275 of IFRS 9.
17. In this regard we note that some respondents commenting on the 2013 ED cited concerns over permitting entities to use a range of discount rates. They also noted that the rate used to recognise interest revenue should be the same as the rate used to discount expected credit losses. The IASB acknowledged these points and noted that requiring the use of the effective interest rate (or an approximation thereof)³ would aid comparability and would also be the conceptually correct approach that would be consistent with the amortised cost measurement.
18. These discussions highlight that the discount rate to be used for the measurement of expected credit losses should be the same as the rate used for the purpose of interest revenue recognition. Consequently, if, in accordance with paragraph B5.4.5 of IFRS 9, an entity is using the current LIBOR rate at the reporting date for the purposes of interest revenue recognition, then this would also be the

³ As noted in paragraph 7, the IASB required the use of the effective interest rate (or an approximation thereof) in acknowledgement of that fact that entities already faced challenges in determining the effective interest rate for the purposes of interest revenue recognition.

appropriate rate to use for the purposes of measuring expected credit losses at that same reporting date.

19. We observe that the approach outlined by the submitter in paragraph 13 was proposed in the 2009 ED but this was not carried forward to the final version of IFRS 9. We also note that as highlighted in paragraph 8, with the exception of some minor wording updates, the definition of the effective interest rate in IFRS 9 remains the same as the definition that was contained within IAS 39.

Question for ITG members

What are your views on the issue presented above?

Appendix A

Extracts from IAS 39

9 [.....] The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 *Revenue*), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Extracts from IFRS 9—Appendix A

Effective Interest Rate - The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected

cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see paragraphs B5.4.1–B5.4.3), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).