

STAFF PAPER

11 December 2015

Project	Transition Resource Group for Impairment of Financial Instruments		
Paper topic	Measurement of the loss allowance for credit-impaired financial assets		
CONTACT(S)	Hannah King	hking@ifrs.org	+44 (0)20 7246 6961
	Kumar Dasgupta	kdasgupta@ifrs.org	+44 (0)20 7246 6902

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the Transition Resource Group for Impairment of Financial Instruments. It does not represent the views of the IASB or any individual members of either the IASB or staff. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs.

Introduction

1. We have received a submission about the measurement of the gross carrying amount and the loss allowance for financial instruments that are measured at amortised cost and are credit-impaired (but not purchased or originated credit-impaired).
2. In particular the submitter asks how the amount recognised as interest revenue interacts with the calculation of the gross carrying amount and the loss allowance for such credit-impaired financial assets.
3. This paper:
 - (a) sets out the relevant accounting requirements in IFRS 9 *Financial Instruments* (2014);
 - (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

4. As defined in Appendix A of IFRS 9, a financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Credit-impaired assets are commonly referred to as 'Stage 3' financial assets.
5. IFRS 9 contains requirements for the measurement of:
 - (a) interest revenue; and
 - (b) loss allowances.
6. In this section we summarise the relevant accounting requirements for credit-impaired financial assets that are not purchased or originated credit-impaired financial assets.

Interest revenue

7. Paragraph 5.4.1 of IFRS 9 notes that interest revenue shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset ('gross interest revenue'). However for financial assets that are not purchased or originated credit-impaired financial assets and have subsequently become credit-impaired financial assets, the entity shall calculate interest revenue by applying the effective interest rate to the 'amortised cost' of the financial asset ('net interest revenue'). See paragraph 12 for the definition of amortised cost.

Loss allowance

8. The loss allowance for financial assets for which there has been a significant increase in credit risk since initial recognition is measured at each reporting date at an amount equal to the lifetime expected credit losses. This includes

credit-impaired (Stage 3) financial assets as well as Stage 2 financial assets (see paragraph 5.5.3 of IFRS 9).¹

9. Paragraph 5.5.17 of IFRS 9 requires that an entity shall measure expected credit losses in a way that reflects the time value of money.
10. Paragraph B5.5.44 of IFRS 9 states that expected credit losses should be discounted to the reporting date using the effective interest rate determined at initial recognition or an approximation thereof. In addition, a credit loss is defined in Appendix A of IFRS 9 as:

The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets).

11. The effective interest rate is defined in Appendix A of IFRS 9 as follows:

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**. ...

12. The gross carrying amount of a financial asset is defined in IFRS 9 as the 'amortised cost of a financial asset, before adjusting for any loss allowance'. Appendix A of IFRS 9 defines the amortised cost of a financial asset or financial liability as:

¹ Stage 2 financial assets are financial assets for which there has been a significant increase in credit risk since initial recognition, but which are not yet credit-impaired.

The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

13. In addition, paragraph B5.5.33 of IFRS 9 provides further guidance in respect of credit-impaired financial assets:

For a financial asset that is credit-impaired at the reporting date, but that is not a purchased or originated credit-impaired financial asset, an entity shall measure the expected credit losses as the difference between the asset's gross carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. ...

Potential implementation issue identified

14. The submitter asks for guidance about how to measure the gross carrying amount and the loss allowance for financial instruments that are measured at amortised cost and are credit-impaired (but not purchased or originated credit-impaired).
15. The submitter suggests three different approaches for calculating the loss allowance and illustrates these using the following simplified example:

Entity X holds a financial asset measured at amortised cost, that was not credit-impaired on purchase or origination. The gross carrying amount of the asset (before deducting the loss allowance) was CU100 on 31 December 20X1². The effective interest rate is 10 per cent. The asset becomes credit-impaired on 31 December 20X1 and the loss allowance is determined to be CU60. Accordingly the asset has an amortised cost of CU40 at 31 December 20X1.

² In this paper, currency amounts are denominated in 'currency units' (CU).

At 31 December 20X2, there have been no cash settlements and no change in the expected timing or amount of cash flows on the asset. For simplicity it is assumed that on applying the effective interest rate, interest revenue for the 12 months to 31 December 20X2 will be $CU4 = CU40 \times 10 \text{ per cent}$, in accordance with paragraph 5.4.1(b) of IFRS 9 and the amortised cost of the asset at 31 December 20X2 will be $CU44 = CU40 + (CU40 \times 10 \text{ per cent})$.³

The possible approaches to calculating the loss allowance and gross carrying amount at 31 December 20X2 are:

Approach A: The gross carrying amount is discounted using the effective interest rate of 10 per cent. Hence at 31 December 20X2, the gross carrying amount is $CU110 = CU100 + (CU100 \times 10 \text{ per cent})$. The loss allowance is calculated as the balancing figure between the gross carrying amount and the amortised cost. Because both the gross carrying amount and amortised cost have been calculated by applying the effective interest rate, the loss allowance will also be discounted at the effective interest rate of 10 per cent. At 31 December loss allowance is $CU66 = CU110 - CU44$ (or $CU60 + (CU60 \times 10 \text{ per cent})$).

Approach B: The loss allowance remains constant at CU60. The gross carrying amount is calculated as the balancing figure between amortised cost and the loss allowance. In other words, the gross carrying amount is increased by the amount of the interest revenue for the period ending 31 December 20X2 of CU4. At 31 December 20X2 the gross carrying amount is $CU104 = CU44 + CU60$ (or $CU100 + CU4$).

Approach C: The gross carrying amount remains constant at CU100. The loss allowance is calculated as the balancing figure between the gross carrying amount and the amortised cost. In other words, the corresponding amount of the interest revenue of CU4 is debited to the loss allowance in its entirety. At 31 December 20X2 the loss allowance would be $CU56 = CU100 - CU44$ (or $CU60 - CU4$).

The submitter notes that each approach gives rise to a different combination of gross carrying amount and loss allowance subsequent to the financial asset becoming credit-impaired. However, the resulting amortised cost is the same for each approach. The following table summarises the outcome of the three approaches at 31 December 20X2 in this simplified example:

³ For the purposes of this illustration, the effects of compound interest have been ignored and it has been assumed that there are no changes to the estimated contractual or expected cash flows.

	A	B	C
Gross carrying amount	110	104	100
Loss allowance	(66)	(60)	(56)
Amortised cost	44	44	44

16. The submitter comments that in their experience there is currently some diversity in practice when entities use a loss allowance as permitted in accordance with IAS 39 *Financial instruments: Recognition and Measurement* in respect of financial instruments measured at amortised cost for which there is objective evidence of impairment on an incurred-loss basis.
17. In the submitter's view, only Approach A is consistent with the requirements in IFRS 9 for credit-impaired financial assets. This is because under Approach A, the gross carrying amount reflects the estimated contractual cash flows discounted using the original effective interest rate. In addition, the amortised cost reflects the expected cash flows discounted using the original effective interest rate. Hence the loss allowance, which is the difference between the gross carrying amount and amortised cost, would reflect the expected cash shortfalls discounted by the original effective interest rate.

Review of accounting requirements

Measurement of the loss allowance

18. The requirements for the measurement of the loss allowance for credit-impaired (Stage 3) financial assets that are not purchased or originated credit-impaired are the same as those for Stage 2 financial assets. The loss allowance for Stage 2 and Stage 3 financial assets is measured at each reporting date at an amount equal to the lifetime expected credit losses (see paragraph 8).
19. As noted in paragraphs 9-11, the Standard is clear that:
- (a) such expected credit losses, and hence the loss allowance, are calculated by discounting the expected cash shortfalls to the reporting

date using the original effective interest rate determined at initial recognition or an approximation thereof; where

- (b) the effective interest rate is the rate that exactly discounts the estimated future cash receipts through the expected life of the financial asset to the gross carrying amount of a financial asset.

20. As explained in paragraph 12, the gross carrying amount of a financial asset is effectively defined as: *the amount at which the financial asset is measured at initial recognition minus the principal repayments, plus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, before adjusting for any loss allowance.* The effective interest method applies the effective interest rate to the estimated contractual cash flows before considering expected credit losses.

21. We observe that Approaches B and C in the submitter's illustrative example are not consistent with these requirements. This is because when calculating the gross carrying amount and loss allowance, Approaches B and C do *not* calculate:

- (a) the gross carrying amount by discounting the estimated contractual cash flows using the original effective interest rate; or
- (b) the loss allowance by discounting the expected cash shortfalls using the original effective interest rate.

Interest revenue

22. We note that interest revenue is recognised on a net basis for credit-impaired (Stage 3) financial assets, instead of the gross basis used for Stage 2 financial assets (see paragraph 7). Interest revenue for credit-impaired financial assets that are not purchased or originated credit-impaired financial assets is calculated by applying the effective interest rate to the amortised cost of the financial asset.

Question for ITG members

What are your views on the issue discussed in this paper?