

IFRS 9: Effective Interest Rate

Extract, IFRS Discussion Group Report on Meeting – September 10, 2015

The expected credit loss model in IFRS 9 *Financial Instruments* uses a dual measurement approach where the loss allowance is measured at an amount equal to either the 12-month expected credit losses (Stage 1) or the lifetime expected credit losses (Stages 2 and 3).

The stages are explained on page 16 of the IASB's [Project Summary of IFRS 9](#):

- “Stage 1: As soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognised in profit or loss and a loss allowance is established. This serves as a proxy for the initial expectations of credit losses. For financial assets, interest revenue is calculated on the gross carrying amount (ie without adjustment for expected credit losses).
- Stage 2: If the credit risk increases significantly and the resulting credit quality is not considered to be low credit risk, full lifetime expected credit losses are recognised. Lifetime expected credit losses are only recognised if the credit risk increases significantly from when the entity originates or purchases the financial instrument. The calculation of interest revenue on financial assets remains the same as for Stage 1.
- Stage 3: If the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount adjusted for the loss allowance). Financial assets in this stage will generally be individually assessed. Lifetime expected credit losses are still recognised on these financial assets.”

The distinction between Stages 2 and 3 is that under Stage 2, impairment is typically assessed on a collective basis, whereas under Stage 3, it is assessed on an individual basis.

The impairment measurement basis depends upon whether there has been a significant increase in credit risk since initial recognition. Generally, if there has been a significant increase in credit risk since initial recognition, then impairment is measured at lifetime expected credit losses. In Stages 1 and 2, interest revenue is calculated based on the gross carrying amount. Under Stage 3, interest revenue is calculated based on the amortized cost of the financial asset (i.e., the gross carrying amount adjusted for the loss allowance).

Paragraph 5.4.1 in IFRS 9 states:

“Interest revenue shall be calculated by using the effective interest method (see Appendix A and paragraphs B5.4.1–B5.4.7). This shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset except for:

- (a) purchased or originated credit-impaired financial assets. For those financial assets, the entity shall apply the credit-adjusted effective interest rate to the amortised cost of the financial asset from initial recognition.

- (b) financial assets that are not purchased or originated credit-impaired financial assets but subsequently have become credit-impaired financial assets. For those financial assets, the entity shall apply the effective interest rate to the amortised cost of the financial asset in subsequent reporting periods.”

Fact Pattern:

Assume that a loan has the following terms:

- a zero coupon and amount repayable at maturity of \$1,000;
- a remaining maturity of two years; and
- an effective interest rate of 10 per cent.

The loan becomes credit impaired at the beginning of the period and the expected cash flows under the loan are \$400.

At the beginning of the period:

- the gross carrying amount is \$826 ($\$1,000 \div 1.1^2$);
- the loss allowance for expected credit losses is \$496 ($\$826 - \$400 \div 1.1^2$); and
- the amortized cost is \$330 ($\$826 - \496).

The interest revenue for the period calculated under paragraph 5.4.1(b) of IFRS 9 would be \$33 ($\330×0.1).

Issue: How should the gross carrying amount and the loss allowance for expected credit losses on the financial asset be calculated at the end of the period when it has become subsequently credit-impaired (assuming there is no change in the expected cash flows)?

View A – Gross carrying amount is adjusted by the amount of interest revenue recognized during the period.

The wording in the definitions of the gross carrying amount, amortized cost and effective interest rate is considered to indicate that the gross carrying amount at the end of the period for credit-impaired assets is calculated as follows:

- the gross carrying amount at the beginning of the period; plus
- the interest revenue recognized for the period using the effective interest method.

The gross carrying amount is increased to \$859 by the amount of interest revenue recognized of \$33. Consequently, the amortized cost is \$363 and the loss allowance is \$496 ($\$859 - \$400 \div 1.1$), which is unchanged from the beginning of the period.

The resulting entry under this view would be a debit to gross carrying amount of \$33 and credit to interest income of \$33.

Under this view, the starting point for the calculation of the gross carrying amount is the amortized cost. Amortized cost is the asset's initial carrying amount plus or minus amortization using the effective interest method. The effective interest method is used for the calculation of interest revenue in profit or loss.

The adjustment to the amortized cost should be based on the interest revenue recognized under the effective interest method. The same adjustment applies to the gross carrying amount as the amortized cost is the starting period for the calculation.

Further, proponents of View A argue that under View B, the loss allowance for expected credit losses would change from \$496 to \$546 but there is no corresponding impairment loss recognized as a result of recognition of interest revenue on a net basis. This is inconsistent with the guidance in paragraph B5.5.33 of IFRS 9, which indicates that any adjustment to the loss allowance for expected credit losses is recognized in profit or loss as an impairment gain or loss.

View B – Gross carrying amount is not affected by the recognition of interest revenue changing from gross to net basis.

The amortized cost is the same under View A such that the adjustment is equal to interest revenue recognized (i.e., amortized cost is \$363). However, the gross carrying value and the loss allowance for expected credit losses are adjusted by the unwinding of the discount rate to reflect the passage of time. Therefore, the gross carrying would be \$909 ($\$1000 \div 1.1$), which changed from \$859. The loss allowance for expected credit losses would be \$546 ($\$909 - \$400 \div 1.1$), which changed from \$496.

The resulting entry under this view would be a debit to gross carrying amount of \$83, credit to loss allowance of \$50 and credit to interest income of \$33.

Under this view, when an asset becomes credit impaired, there is no change to its gross maturity amount and, thus, there should be no change in the application of the effective interest method. The relevant definitions in IFRS 9 do not seem to imply that the calculation of gross carrying amount should change if the financial asset moves between Stages 2 and 3. Also, the method of how to measure the loss allowance for expected credit losses should not change as a result of calculating interest revenue on a net basis in Stage 3.

Proponents of this view argue that View A would create more issues for a financial asset that moves back to Stage 2 from Stage 3 when it is no longer credit-impaired because interest revenue would then be calculated based on the gross carrying amount. Thus, View B generally ensures a consistent application of the concepts of "gross carrying amount" and "loss allowance" across all financial assets, regardless of the stage the asset is in.

The Group's Discussion

Group members supported the view that calculation of gross carrying amount is not affected the by recognition of interest revenue changing from gross to net basis (View B). This view provides a better reflection of the contractual cash flows and more faithfully represents the credit risk associated with the financial asset. One Group member noted that the wording in the definitions of gross carrying amount and amortized cost also does not seem to support View A because neither definition would imply the amount is adjusted by the amount of interest revenue recognized.

Another Group member observed there is more emphasis in IFRS 9 for moving between Stages 1 and 2, but less from Stage 3 to Stage 2 as there would be a higher hurdle to support doing so when a financial asset was considered credit impaired at one point. A few Group members also noted that there are global discussions on this issue. While one global firm has concluded that View B is the appropriate one, other global firms have not yet reached a conclusion.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the [audio clip](#)).