

Practical Workshop for NBU Staff and Bankers

Impairment IAS 39 and Effective Interest Rate



STAREP is supported with funding provided in part by European Union, Austria's Federal Ministry of Finance, Austrian Development Cooperation, Luxembourg's Ministry of Finance, SECO - State Secretariat for Economic Affairs

Shamim Diouman
Consultant, CFRR,
the World Bank

May 2016



Introduction and key objectives

- » IAS 39 impairment has been criticized as “too little too late”.
- » Impairment in IAS 39 is based on a triggering event happening in the past:
Objective evidence of impairment.
- » The reason of this approach in IAS 39 is to avoid a “cookie jar” in the balance sheet.
- » One of the key words in the impairment methodology in IAS 39 is “Objective”:
“Something must have happened...”.
- » IAS 39 will be replaced by IFRS 9 as from 2018. Early adoptions is possible.
- » However, to have a good understanding on IFRS 9, it is important to understand IAS 39.



Introduction and key objectives

- » IAS 39 has very complicated requirements on impairment. And the prudential rules (whether Basel II or Basel 2.5) had no clear and specific guidance or regulations to compare prudential loan loss provisioning and IAS 39 accounting impairment.
- » This “gap” between IAS 39 and Basel II or Basel 2.5 was considered by some stakeholders as a “weakness”. This is why there are more guidelines and regulations to compare IFRS 9 impairment and Basel III loan loss provisioning.
- » Basel III was developed with IFRS 9 in mind.
- » A comparison between IAS 39 impairment, IFRS 9 impairment and loan loss provisioning is provided in the session on IFRS 9 impairment.
- » Banks must have a good and clear understanding about these differences in accounting treatments and prudential regulations.
- » This session on IAS 39 must be read in conjunction with the IFRS 9 sessions.



Measurement

- » Assess at each reporting date whether there is **objective evidence** that a financial asset (group of financial assets) **is impaired**. If there is evidence of impairment:
 - » Financial assets at amortised cost
 - » Amount of the loss is measured as the **difference between the asset's carrying amount and the present value of estimated future cash flows discounted using the asset's original effective interest rate**. Future credit losses that have not been incurred are excluded.
 - » The carrying amount of the asset is reduced either directly or through the use of an allowance account.
 - » The impairment loss is recognised in profit or loss.



Objective

- » The incurred loss approach has the advantage of being **fairly objective** – **there has to have been a past event** – for example, an actual default or a breach of a debt covenant. This objectivity **reduces the risk of profit smoothing** by companies as they are unable to estimate anticipated future losses.
- » IAS 39, *Financial Instruments: Recognition and Measurement* (IAS 39), **does not require financial assets classified at fair value through profit or loss (FVTP&L) and fair value through other comprehensive income (FVTOCI) to be subject to impairment reviews.** Therefore impairment reviews are only required in respect of financial assets that are classified as amortised cost – for example, loans, debt securities and trade receivables.



Objective evidence

- » IAS 39 para 58: An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired.

Evidence of impairment

- » IAS 39 para 59:
- » **Losses expected as a result of future events, no matter how likely, are not recognised.** Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:
 - » **significant financial difficulty** of the issuer or obligor;
 - » **a breach of contract**, such as a default or delinquency in interest or principal payments;
 - » the lender, for economic or legal reasons relating to the borrower's financial difficulty, **granting to the borrower a concession that the lender would not otherwise consider**;
 - » it **becoming probable that the borrower will enter bankruptcy** or other financial reorganisation;
 - » the disappearance of an active market for that financial asset **because of financial difficulties**; or



Evidence of impairment

- » observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
 - » adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
 - » national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).



Exercise

- » The bank negotiates a restructuring of the loans and expects the customers will meet the new terms and conditions.
- » In which above cases, is there an impairment?



Changes in amount or timing

» Case Study

- » A: X will pay the full principal amount of the original loan five years after the original due date, but none of the interest due under the original terms.
- » B: Y will pay the full principal amount of the original loan on the original due date, but none of the interest due under the original terms.
- » C: Z will pay the full principal amount of the original loan on the original due date but with interest at a lower interest rate than the interest rate in the original terms and conditions.
- » D: Alpha will pay the full principal amount of the original loan five years after the original due date and all interest accrued during the original loan term but no interest for the extended term.
- » E: Beta will pay the full principal amount of the original loan five years after the original due date and all interest, including interest on all outstanding amounts for both the original term of the loan and the extended term.



Collateral

- » In measuring the impairment of a collateralised or secured loan, the cash flows used should reflect those that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable. IAS 39 AG 84
- » The collateral itself should not be recognised as a separate asset unless it meets the recognition criteria for an asset in another standard.



Impairment approach

- » IAS 39 Guidance explains that the process for estimating impairment should consider all credit exposures, not only those of low credit quality. For example, if an internal credit rating system is used, all credit grades should be considered and assessed for impairment, not only those reflecting severe credit deterioration IAS 39 AG 85. Possibility of impairment existing in high quality portfolio should not be ignored.
- » The process used to estimate impairment loss may produce one single amount or a range of possible amounts/outcomes. It is the “best estimate” within the range that should be recognised as the impairment loss. This estimate should take into account all relevant information about known conditions that existed at the end of the reporting period. For selection of best estimate: IAS 37 and IAS 39 AG 86.

Financial Instruments at Amortised Cost

- » Financial instruments in this category are initially recognised at fair value, plus directly attributable transaction costs, **and then subsequently at amortised cost using the effective interest rate method (EIR)**.
- » Amortised cost is defined as being: “the amount at which the financial asset or financial liability is measured at initial recognition minus 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 minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.”

- » The effective interest rate is the rate that exactly discounts the estimated future cash flows (both payments and 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.
- » The effective interest method is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period. It is important to note that the effective interest rate may be different to the actual interest rate contracted to the instrument. A common example of this is when loan establishment fees have been paid.
- » When calculating the effective interest rate, an entity estimates cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options, premiums and discounts) **but does 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, transaction costs, and all other premiums or discounts.
- » The EIR is based on estimated, not contractual, cash flows and IFRS presumes that the cash flows can be estimated reliably. If not, one should use the contractual cash flows. IAS 39.9
- » Incurred credit losses should be included in the estimated cash flows when computing the EIR. IAS 39 AG5. If not higher interest income than the inherent in the price paid for the instrument would be recognised. However, expected future defaults should not be included in estimates of cash flows because this would be a departure from the incurred loss model for impairment IAS 39 BC32.

How does EIR work?

- » Company C takes out a loan of \$500,000 that matures in two (2) years time from Bank B. B charges \$5,000 in fees for setting up the loan. The contractual rate of interest per the loan agreement is ten percent (10%). Interest is payable annually. The loan principal will be repaid at the end of the loan contract.
- » The cash flows on the loan are as follows (for C):

Year	Amount
0	495,000
1	-50,000
2	-550,000



How does EIR work?

- » To calculate the effective interest rate on the loan, C needs to calculate an interest rate that exactly discounts the cash outflows in Year 1 of 50,000 and Year 2 of 450,000 to the cash inflow of 495,000 received from B initially at Year 0. In other words the internal rate of return (“the IRR”) of the cash flows needs to be determined. (Trick can be done in Excel using function “IRR”).
- » The effective interest rate on the loan in the above example is 10.5807%. This is different from the contractual interest rate of 10% on the loan due to the fact that the loan establishment fee must be included in the effective interest rate determination.

Journal entries for EIR calculation on the loan

» Year 0 From C's perspective:

Dr Cash	495,000	
	Cr Loan payable to bank	495,000

Loan less fee

» Year 1

Dr Interest paid	52,374	
	Cr Cash (cash payment to bank contract)	50,000
	Cr loan payable to bank	2,374*

*adjustment to loan balance to measure the liability

Interest = 495,000 x EIR

Journal entries for EIR calculation on the loan

» Year 2

Dr Interest paid	52,626	
Cr Cash (cash payment to bank contract)		50,000
Cr loan payable to bank		2,626*

*adjustment to loan balance to measure the liability

$$\text{Interest} = 497,374 \times \text{EIR}$$

Dr Loan payable to bank	500,000	
Cr Cash		500,000

$$\text{Repayment of loan principal at the end of Year 2} = 495,000 + 2,374 + 2626$$

(Example from BDO)



Effective interest rate

- » In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. Entities include such incurred credit losses in the estimated cash flows when computing the effective interest rate.
- » When applying the effective interest method, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the instrument. However, a shorter period is used if this is the period to which the fees, points paid or received, transaction costs, premiums or discounts relate. This will be the case when the variable to which the fees, points paid or received, transaction costs, premiums or discounts relate is repriced to market rates before the expected maturity of the instrument.



Effective interest rate

- » In such a case, the appropriate amortisation period is the period to the next such repricing date. For example, if a premium or discount on a floating rate instrument reflects interest that has accrued on the instrument since interest was last paid, or changes in market rates since the floating interest rate was reset to market rates, it will be amortised to the next date when the floating interest is reset to market rates.
- » This is because the premium or discount relates to the period to the next interest reset date because, at that date, the variable to which the premium or discount relates (ie interest rates) is reset to market rates. If, however, the premium or discount results from a change in the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates, it is amortised over the expected life of the instrument.
- » If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows.



EIR and interest receivable

- » The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate.
- » Where appropriate, interest receivable on AFS assets is recognised in P&L using the EIR and dividends receivable are recognised in P&L when a right to receive payment is established.

- » Impairment and EIR in IAS 39
 - » Based on a triggering event in the past.
 - » Objective evidence of impairment to avoid “cookie-jar”.
 - » NPV of expected cashflows.
 - » “Too little too late”.
 - » EIR used to accrue interest and calculate amortised costs.
 - » Some cashflows allowed and some cashflows not allowed for the calculation of the EIR.



Conclusion

- » The “problem” with IAS 39 is that it is not forward looking.
- » Similarities and differences between IAS 39 and Basel 2 loan loss provisioning were not properly understood by stakeholders and hence regulations, in this crucial area for banks, were limited and not properly defined.
- » IFRS 9 impairment and Basel III loan loss provision try to provide a better solution by comparing the differences between the 2 methodologies and there are new regulations to address these differences.