Practical Workshop for NBU Staff and Bankers

Amortisation of Fees

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Introduction

- Fees and commissions have specific treatment in IAS 39.
- The amortisation of fees should be based on the EIR.
- The EIR is a method to recognise and “spread” the fees over the life of the instrument. IFRS does not allow the recognition of all the fees upfront.
- This session will cover why the “spread” of fees is required and how to “spread” the fees.
- The spread (amortisation) of fees will also impact the P&L.

IAS 39

- The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. 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).

IAS 18

- **Rendering of services**
- For revenue arising from the rendering of services, provided that all of the following criteria are met, revenue should be recognised by reference to the stage of completion of the transaction at the balance sheet date (the percentage-of-completion method): [IAS 18.20]
  - the amount of revenue can be measured reliably;
  - it is probable that the economic benefits will flow to the seller;
  - the stage of completion at the balance sheet date can be measured reliably;
  - and the costs incurred, or to be incurred, in respect of the transaction can be measured reliably.
- When the above criteria are not met, revenue arising from the rendering of services should be recognised only to the extent of the expenses recognised that are recoverable (a "cost-recovery approach". [IAS 18.26]

Annual report disclosure

- Fee income is earned from a diverse range of services provided by HSBC to its customers. Fee income is
- accounted for as follows:
- − income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
- − income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- − income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in ‘Interest income’.

Example of amortisation of fees

- Example – Fixed interest loan repayable at maturity using EIR method of amortisation
- At 1.1X5 Bank B lend LCY1m for 10 years at 7%
- Origination fee charged LCY 12,500
- Origination costs incurred LCY 25,000
- Original EIR 6.823%
- Loan Principal1,000,000
- Origination fee charged (12,500)
- Origination costs incurred 25,000
- Initial carrying amount 1,012,500

Calculations of amortisation of fees

	Cash inflows	Interest income	Amortisation of net fees	Carrying amount
1/X5	70,000			1,012,500
12/X5	70,000	69,083	917	1,011,588
12/X6	70,000	69,025	975	1,010,613
12/X7	70,000	68,959	1,041	1,009,572
12/X8	70,000	68,888	1,112	1,008,460
12/X9	70,000	68,812	1,188	1,007,272

Calculations… (cont'd)

	Cash inflows	Interest income	Amortisation of net fees	Carrying amount
12/Y0	70,000	68,731	1,269	1,006,003
12/Y1	70,000	68,644	1,356	1,004,647
12/Y2	70,000	68,552	1,448	1,003,199
12/Y3	70,000	68,453	1,547	1,001,652
12/Y4	70,000	68,348	1,652	1,000,000
TOTAL	700,000	687,500	12,500	
			REPAYMEMT	1,000,000

- Accounting entries

1.1 X5 Loan account 1,000,000

Cash 1,000,000

Amount lent to borrower

1.1.X5 Loan account 25,000

Cash 25,000

Origination costs incurred by lender

Double entries

1.1.X5 Cash 12,500

Loan account 12,500

Origination Fees charged to borrower

31.12 X5 Debtors 70,000

Interest income account 69,083

Loan account 917

Contractual interest accrued at the due date

Double entries

2.1 X6 Cash 70,000

Debtors 70,000

Receipt of interest payment

Et Voilà!

- The revenue recognition standard IAS 18 will be replaced by IFRS 15 on or after 1 January 2017.
- The same principle that applies to the spread of fees based on service offered or performance delivered will also apply in IFRS 15.
- In general it is not expected that IFRS 15 will have massive implications to banks. Especially banks with no complex products.

The objective of IFRS 15 is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer. [IFRS 15:1]

Conclusion

- The EIR is used to value the loan and to amortise the fees.
- It is also used to treat interest income.
- This approach is in line with the matching principle.
  - Recognising income as and when the service is delivered.
  - Matching means recognising the income as and when the service is delivered or performed.
- It is a key principle in revenue recognition in IFRS whether IAS 18 or IFRS 15.