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IFRS Developments

Curing of a credit impaired financial asset

What you need to know

- The IFRS IC confirmed its previous tentative agenda decision in March 2019
- When a credit impaired asset cures, the interest that was previously unrecognised should be reported as a credit to impairment expense rather than a credit to interest evenue

Highlights

The IFRS Interpretations Committee (the Interpretations Committee or the IFRS IC) received a request as to how an entity presents unrecognised interest when a credit-impaired financial asset (commonly referred to as a 'Stage 3' financial asset) is subsequently paid in full or is no longer credit-impaired. More specifically, the request asked whether an entity can present the reversal related to previously unrecognised interest within interest revenue.

At its March 2019 meeting, the Interpretations Committee published a final agenda decision concluding that an entity is required to present the difference described in the request as a reversal of impairment losses.

Background

IFRS 9 *Financial Instruments*[1] requires entities to calculate interest revenue on financial assets that are not credit impaired (i.e., in stages 1 and 2) by applying the effective interest rate (EIR) to the gross carrying amount of the asset. In contrast, once an asset is credit impaired (i.e., in stage 3), interest revenue is calculated by applying the EIR to the amortised cost of the financial asset, i.e., the gross amount less the expected credit losses (ECLs). This results in a difference between:

- The interest that would be calculated by applying the EIR to the gross carrying amount of the credit-impaired financial asset

  And

- The interest revenue recognised for that asset

If a financial asset 'cures', so that it is transferred back to stage 2 or stage 1, interest revenue would once again be recognised based on the gross carrying amount. The request to the IFRS IC asked whether, following the curing of the financial asset, an entity can present the difference as interest revenue or, instead, it is required to present this as a reversal of impairment losses.

The Committee observed that an entity recognises the adjustment required to bring the loss allowance to the amount required to be recognised in accordance with IFRS 9 as a reversal of expected credit losses ECLs in profit or loss.[2] The allowance would be reversed to zero if the asset is recovered in full. The amount of this adjustment includes the effect of the unwinding of the discount on the loss allowance during the period that the financial asset was credit impaired. Ultimately, the reversal of impairment losses may exceed the impairment losses recognised in profit or loss over the life of the asset if amounts collected exceed the expected cash flows.

[1] IFRS 9:5.4.1(b)
[2] IFRS 9.5.5.8

Committee decision

At its November 2018 meeting, the Interpretations Committee tentatively concluded that an entity is required to present the difference described in the request as a reversal of impairment losses following the curing of a credit-impaired financial asset. It also tentatively concluded that the existing requirements in IFRS provide an adequate basis to conclude that an entity should recognise and present the reversal of ECLs following the curing of a credit-impaired financial asset in the fact pattern described in the request. Consequently, the Interpretations Committee decided not to add this matter to its agenda.

Following the comment period, the Committee re-convened in March 2019, and confirmed its previous tentative agenda decision.

Illustrative example

- An existing loan with an effective interest rate of 10% has become credit impaired. Lifetime expected losses have been recognised on the loan as of 1 January Year N.
- The expected shortfall in cash flows is shown in Table 1 and remain unchanged until 31 December N+3. Discounted at the EIR this gives an ECL as at 1 January of CU59,000, as shown in Table 1.
- For illustrative purposes, assume that the contractual cash flows (principal + accrued interest) are fully recovered, unexpectedly, on 31 December N+3.
- For simplification purposes, interest is not accrued on unpaid interest.

Table 1: Contractual & expected cash flows in CU000

Cash flows as at 31 Dec	N	N+1	N+2	N+3	Total
Contractual cash flows	10	10	10	110	140
Expected cash flows	0	0	0	60	60
Expected shortfall in cash flows	10	10	10	50	80
ECL as at 1 January N (shortfall discounted at EIR)	(9)	(8)	(8)	(34)	(59)

Table 2: Stage 3 accounting in CU000

	31 December				Cumulative P/L effect	
	N	N+1	N+2	N+3		
Gross carrying amount: Opening balance	100	110	120	130		
Interest calculated based on gross carrying amount	10	10	10	10		
Settlement	0	0	0	(140)		
Gross carrying amount: Closing balance	**110**	**120**	**130**	**0**		
ECL allowance: Opening balance	(59)	(65)	(70)	(75)	(59)	*Initial allowance*
Unwinding of discount	(6)	(5)	(5)	(5)		
Reversal of ECL allowance	0	0	0	80	80	*Reversal of unused allowance*
ECL allowance: Closing balance	**(65)**	**(70)**	**(75)**	**0**	**21**	**Impairment expense**
Amortised cost: Opening balance	41	45	50	55		
Interest revenue based on the amortised cost	4	5	5	5	19	Interest on the amortised cost
Settlement	0	0	0	(60)		
Amortised cost: Closing balance	**45**	**50**	**55**	**0**	**19**	**Interest revenue**

As the loan is credit impaired, interest revenue is restricted to the amount derived from applying the EIR to the amortised cost of the loan. The Interpretations Committee's decision clarifies that the reversal of the ECL allowance is recognised in full in the impairment expense line. The impact of this on a cumulative basis is that some of the effective interest on the gross carrying amount of the loan (CU40,000) would not be presented as interest revenue, but rather, as a reversal of impairment. This is the portion (CU21,000) which represents the unwinding of discount on the ECL provision while the loan was credit impaired.

How we see it

While the overall profit or loss before tax figure will not be affected by the decision, the recognition of the reversal of the ECL allowance in the impairment losses line instead of interest revenue is likely to affect several important ratios, especially for financial services entities. These would include the impairment loss ratios, net interest margin, etc. The change may also affect an entity's internal performance measures. Preparers will need to consider the impact that the change could have on financial reporting ratios and key performance indicators and be pro-active in explaining the changes to their internal and external users.

The Interpretations Committee's guidance could present a significant operational change for entities that previously recognised such reversals in interest revenue.

The Interpretations Committee decided not to add the matter to its agenda. Therefore, for implementation purposes, entities should refer to the IASB's publication: *Agenda decisions – time is of the essence*[3] on the implementation of accounting policy changes resulting from published IFRS IC agenda decisions. This publication notes that entities should be allowed sufficient time to implement such changes following publication of the decision.

[3] IASB feature: Agenda decisions- time is of the essence, published 20 March 2019.