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1. **Addressing complexity in loan acquisitions**

Market conditions over the past few years may have changed the level and nature of loan portfolio sales and acquisitions, but such sales have continued to be a way for many banks to rationalise non-core assets, dispose of non-performing portfolios and fund the origination of additional loan portfolios. From the purchaser’s perspective, acquisitions, including those that are part of business combinations, have made it possible to acquire loans suited to their risk appetite without the need to complete full origination processes. They also have enabled purchasers to take advantage of attractively priced portfolios of loans.

Acquiring loan portfolios can involve complex accounting issues or a need to apply general accounting guidance to the specific circumstances of a business combination or a direct loan acquisition. This *IFRS Practice Issues for Banks* publication discusses some of these issues and provides practical examples.

On an acquisition of loans, key items for banks to consider include the following.

- The amount to be recognised initially, taking into account the transaction price, the items included in the acquisition and the bank’s process to determine fair value.
- How to subsequently measure the loans, including how to differentiate the impact of cash flow changes between interest income and impairment losses when the loans are measured at amortised cost. Such a consideration needs to be made when the acquisition includes loans acquired at a deep discount that reflects incurred credit losses, as well as when it does not.
- The treatment of any loan commitments acquired or indemnities/guarantees received in relation to the acquisition.

The primary standard providing guidance on the accounting for loans is IAS 39 *Financial Instruments: Recognition and Measurement*. It sets out the general principles for recognising and measuring financial assets, which are to be applied to loans and certain loan commitments, both those that are originated and those that are acquired.

The term *loan* used throughout this publication refers to a non-quoted financial asset with fixed or determinable payments that is not in the legal form of a security and so refers to the general use of the term by banks. The term is not explicitly defined in IFRSs and is different from the term ‘loans and receivables’, which is defined by IFRSs and discussed in this publication.

This publication addresses initial recognition, classification and subsequent measurement of loans acquired either separately or as part of a business combination. Other aspects of financial reporting for loans and other financial instruments, including disclosure requirements, are discussed in *Insights into IFRS*, our practical guide to IFRSs.

Section 8 of this publication discusses the impact of forthcoming standards, including IFRS 9 *Financial Instruments* and IFRS 13 *Fair Value Measurement*. 
2. When should the acquisition of a loan be recognised in financial statements?

2.1 Party to a contract and regular way transactions

IAS 39.14 Like other financial instruments, a loan is recognised in the statement of financial position when an entity becomes party to a contract that is a financial instrument. Examples of when this happens include origination, direct purchase and acquisition as part of a business combination.

IAS 39.9, AG53–AG56 Becoming a party to a contract also includes committing to a purchase of a loan. When such a commitment is part of a regular way purchase, the accounting follows the guidance described in 2.2 below. A regular way transaction is the purchase or sale of a financial asset under a contract that will be settled within the time frame established by regulation or convention in the market concerned, not necessarily an organised market.

IAS 39.AG54 When the commitment to purchase a loan is not a regular way transaction, an entity accounts for the transaction as a derivative, with fair value changes recognised in profit or loss between the trade and settlement dates.

IAS 39.AG35 In contrast, planned but not committed future transactions, no matter how likely, are not financial assets because they do not represent situations in which the entity becomes a party to a contract.

IFRS 3 Business Combinations provides guidance on the timing of the recognition of loans that are acquired as part of a business combination.

2.2 Trade date vs settlement date accounting

IAS 39.38, AG55, AG56 Entities have flexibility to use either trade date or settlement date accounting for initial recognition of regular way purchases of financial assets. Generally, trade date is the date on which an entity commits itself to purchasing or selling an asset and settlement date is the date on which an asset is delivered to or by an entity.

IAS 39.AG12 IAS 39 recognises that for many financial institutions it is common practice to use settlement date accounting for financial assets and that it would be cumbersome to account for such transactions as derivatives between the trade and settlement dates. Thus, a non-derivative financial asset, e.g. a loan, that will be delivered within the time frame generally established by regulation or convention in the market concerned (e.g. a regular way transaction) may be recognised on the date that the entity commits to the transaction (trade date) or on the date that the instrument actually is transferred (settlement date).

IAS 39.AG53 An entity should choose a method to be applied consistently to all purchases and all sales of financial assets in the same category, e.g. all loans and receivables.

IAS 39.57, AG56 If an entity decides to use settlement date accounting and the loan portfolio purchased is subsequently measured at amortised cost, then any change in the fair value of the loans between trade date and settlement date is not recognised, subject to impairment and onerous contract considerations; see section 6 for further discussion on impairment. Therefore, if an entity applies settlement date accounting, then the loans’ fair values are determined at the trade date although the loans are recognised initially on the settlement date.

1 See chapter 2.6 of our publication Insights into IFRS (7th 2010/11 and 8th 2011/12 Editions) for further discussion of business combination acquisition accounting.
However, if the loans purchased are measured subsequent to initial recognition at fair value, then the purchaser recognises changes in the fair value of the instruments between the trade date and the settlement date, regardless of whether trade date or settlement date accounting is applied. Thus, under settlement date accounting, any fair value adjustment following the trade date is shown in the statement of financial position as a receivable or payable until the settlement date, at which point the receivable or payable adjusts the amount recognised initially for the asset. This results in the asset being measured at its fair value on the settlement date. Fair value changes between trade date and settlement date are recognised in profit or loss for financial assets classified as at fair value through profit or loss, or in other comprehensive income for financial assets classified as available for sale.
3. At what amount should acquired loans be recognised initially?

3.1 General requirements

IFRS 3.18, IAS 39.43, AG64
Loans, whether acquired as part of a business combination or acquired in a direct asset purchase, are measured initially by the purchaser at their fair value at the acquisition date. In general, fair value is determined on an individual loan basis. However, if loans are acquired on a portfolio basis at a single price, then an individual loan’s price may not be available to assist in the determination of fair value and further work often is required to determine an individual loan’s fair value.

IFRS 3.53, IAS 39.43
The amount recognised initially for loans that are purchased directly and not measured subsequently at fair value through profit or loss includes directly attributable transaction costs. However, when loans are acquired as part of a business combination, acquisition-related costs incurred to effect the combination generally are accounted for as an expense in the period incurred.

IAS 39.9, AG13
Transaction costs that are included in the initial measurement of loans purchased directly are only those costs that are directly attributable to acquiring the loans. They are incremental costs that would not have been incurred if the loans had not been acquired, such as direct legal fees and due diligence costs. In practice, few internal costs are likely to meet this requirement. In our view, the only internal transaction costs allowed to be included in the initial measurement of a loan are commissions, bonuses and other payments that are made to employees only on completion of each individual transaction. We believe that internal semi-variable costs (e.g. the costs of marketing a new product or of employing additional staff to deal with an increase in the volume of transactions) do not qualify as transaction costs.

3.2 Is acquisition price always the same as fair value at the acquisition date?

IAS 39.43, AG64, AG76
Normally, the fair value at initial recognition is the transaction price, i.e. the amount of consideration given or received. However, if the transaction is not based on market terms, then the consideration given may include compensation for something in addition to the loans. If no market prices are observable for such a transaction, then it is necessary to use a valuation technique to determine the appropriate fair value for initial recognition of the loans. For example, an entity may discount the estimated future cash receipts using the current market interest rate for a similar financial instrument. Any excess of the consideration given over this estimate is recognised as an expense in profit or loss, unless it qualifies as another type of asset.

IAS 39.AG76
Sometimes, the fair value of a financial instrument can be evidenced by comparison with other observable current market transactions in the same financial instrument or by a valuation technique that uses only observable market data as inputs. However, in our experience this evidence is rarely available for a loan because loans generally are not traded in an active market and often require non-observable inputs in their valuation. But if the fair value of a loan is evidenced by comparison with other observable current market transactions for the same loan or using a valuation model that includes only data from observable markets, then that fair value, rather than the transaction price, is used for the initial recognition of the loan; the difference is recognised in profit or loss.
Example 1 – Fair value at initial recognition

Bank P acquires a portfolio of impaired loans for 30 from Bank S. The carrying amount of the loans in Bank S’s financial statements is 29 (a principal amount of 100, less impairment losses of 71). Bank P has superior cash collection processes in place and accordingly values the loan portfolio at 36.

In our view, it would not be appropriate to conclude that the transaction price of 30 does not represent the fair value of the loan portfolio acquired. The valuation technique used to arrive at the value of 36 takes into account Bank P’s specific cash collection processes, which is not appropriate because the valuation technique employed should aim to arrive at a realistic estimate of the fair value of the loans; this would reflect how the market would price them and incorporate all inputs that market participants would consider in setting a price.

Consequently, Bank P should recognise the portfolio of loans acquired at the transaction price. Bank P’s estimates in respect of the amounts and timing of cash flows should be used to determine the loans’ effective interest rate, which should be used in subsequent periods to measure the loans and recognise interest income. See section 6 for further discussion of effective interest rates and subsequent measurement.

If a gain or loss is not recognised on initial recognition of a loan portfolio because there is no appropriate evidence that the fair value of the loans is different from the transaction price, then for loans measured subsequently at fair value, it is not appropriate to recognise a gain or loss subsequently unless the market factors relevant to determining the fair value at initial recognition have changed. This guidance is not relevant for assets measured subsequently at amortised cost.

3.3 Additional considerations when the purchaser pays a premium on acquisition

In certain instances, an entity may pay a premium to acquire a loan portfolio, i.e. the purchase price may be higher than the fair value of the loans in the portfolio. In this circumstance, the purchaser should consider whether there are any other elements that qualify for asset recognition in addition to the loans, such as customer contracts and related customer relationships. Since many of the services performed by banks are based on contractual relationships with their customers, there are many types of customer-related intangible assets that may be present when a loan portfolio is acquired, either directly or through a business combination.

An intangible asset is an identifiable non-monetary asset without physical substance. An asset is identifiable if it either is separable (e.g. can be separated from the entity and sold or transferred) or arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations. These criteria apply to all intangible assets, whether they are acquired separately or in a business combination.

Customer-related intangible assets may meet the contractual-legal and/or the separability criterion. The relationship that an entity has with its customers may encompass a number of distinct intangible assets that need to be recognised separately from each other, e.g. a specific contract with a customer may need to be recognised separately from the relationship with that customer.

To ensure that all identifiable intangible assets are recognised, careful consideration should be given to the customer relationships from which projected cash flows originate. Typical customer-related intangible assets (both contractual and non-contractual) that are recognised in an acquisition by a bank related to loan assets include customer relationships (e.g. borrower base or banking service relationships), purchased credit card relationships, customer lists and management/servicing rights. In addition, other types of intangible assets may be present, such as trademarks and brands.
The identification analysis should consider all rights, relationships and contracts attaching to the acquisition, including the ability to market additional services/cross-selling opportunities, as detailed within the deal documentation and the purchaser’s due diligence and valuation models.

The development of reliable valuations for the intangible assets identified requires that a purchaser gather facts about the elements of the entity or the group of assets acquired, and the potential cash flows to be considered in measuring those intangible assets. Entities should also determine whether they have obtained sufficient and supportable information for use in their valuations. Performance of this analysis, and defining the appropriate valuation model(s) to be utilised, assists in allocating the purchase price, in subsequent periodic impairment evaluations and in determining the useful life and the pattern in which future benefits are expected to flow to the purchaser from the intangible assets.

3.4 Can fair value be calculated on a portfolio basis?

Generally, fair value is determined on an instrument-by-instrument basis. However, in our view in some cases a portfolio valuation approach may be appropriate as a practical expedient in order to determine the sum of the fair values of the constituent individual instruments within a portfolio. For example, an entity may purchase a portfolio of non-performing consumer loans. Due to the nature of the loans, generally no quoted prices for identical individual loans are available in an active market. Therefore, in an orderly transaction that is based solely on inputs from observable markets, and absent any evidence to the contrary, it may be argued that the transaction price for the portfolio represents the best evidence of the sum of the fair values of the individual loans. In such a case, it may be appropriate to measure the fair value of the entire portfolio based on the portfolio's transaction price. The fair value of the portfolio would reflect a market participant’s view with respect to relevant valuation parameters, such as discount rates and expected losses at a portfolio level.

3.5 How can fair value be established if loans are acquired as part of a larger transaction such as a business combination?

If an acquisition of a loan portfolio is part of a larger business combination, then an individual transaction price often is not available to assist in determining fair value. Additional work often is needed. Determining fair value of the loans in such circumstances involves analysis of all the elements of the overall transaction, which may include intangible and other assets, in addition to the acquired financial assets, as discussed in 3.3.

An entity is required to use the fair value that is closest to a market transaction in the specific financial asset. In other words, valuation techniques and models are not used to override an observable market price.

Banks often use their existing internal valuation models and comparisons with recent market loan portfolio transactions, i.e. relative value analyses, to develop a base value for a portfolio of loans that they acquire. Such internal valuation models can take the form of discounted future cash flows, which include credit spreads derived from credit default swaps or from corporate bonds of similar credit quality to the instruments being valued, and pricing data for loans that the banks are originating themselves. These models incorporate the terms and conditions of the loans within the portfolio (e.g. existence and type of collateral, expected prepayment patterns etc.), as well as current market conditions. Discount rates, when applied in the models, generally take into account expected maturities, cash flow patterns, the underlying currency of the loans, credit risk, collateral, interest basis and other factors. Banks often use this base value as a reference point in negotiating the price of a transaction.

IAS 39 provides guidance on possible approaches to determining the fair value of a loan, including comparison with interest rates currently charged by the entity or by others for similar debt instruments,
e.g., those with a similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis.

In our view, it would not be appropriate to adjust the results of a model-based valuation for entity-specific factors such as liquidity or administration costs. We believe that a valuation model should incorporate only factors that market participants as a whole would consider in setting a price. Furthermore, it is not appropriate to adjust the results of a valuation technique to reflect the model risk of the model used, unless other market participants would make similar adjustments. Also, it is necessary for the validity of the results of the technique to be tested regularly so that the technique can be calibrated as required.

If the outcome of the valuation model is a range of estimates, then the probabilities of the estimates within the range are determined and applied to arrive at a single estimate of fair value. In our view, if different models are used and each model gives a different outcome, then judgement should be used in determining which outcome is likely to be the most reliable. We do not believe that it is appropriate simply to average the outcomes of the various valuations.

### 3.6 If an acquired loan is impaired, then can the purchaser set up an impairment allowance on the date of acquisition?

In our view, it is not appropriate to set up an impairment allowance account on the initial recognition of a loan or a portfolio of loans. Impairment is recognised only if there is objective evidence of impairment as a result of events that occur after the initial recognition of the assets. In addition, IFRS 3 provides specific guidance for business combinations: the purchaser in a business combination does not recognise a separate valuation allowance as of the acquisition date for assets acquired in a business combination that are measured at their acquisition date fair values; this is because the uncertainty about future cash flows is included in the fair value measurement.

**Example 2 – A loan purchase**

On 1 January 2011 Bank P purchases a loan from Bank S for 42, which is the fair value of the loan on the date of acquisition. The loan has a contractual principal amount of 50. Bank S considered the loan to be impaired and had established an impairment allowance against it of 5. The carrying amount of the loan in Bank S’s financial statements on the date of sale is 45.

Bank P recognises the loan at 42 initially, which represents the fair value of the loan on the date of initial recognition. For example, Bank P does not recognise the loan at 47 and an impairment allowance of 5 because the incurred loss of 5 occurred before the loan was acquired.

### 3.7 What if the acquisition is from a related party?

In our view, the requirement to recognise all financial assets at fair value initially applies to all loans, including those purchased from related parties.

If a loan from a related party is not on market terms, then the purchaser should consider the appropriate accounting taking into account all terms and conditions of the loan. For example, in our view such an acquisition from a shareholder acting in the capacity as shareholder may result in recognition in equity of a capital contribution or distribution reflecting the non-market terms.
4. How are acquired loans classified at initial recognition?

IFRS 3.15, 16, IAS 39.9, 45

At initial recognition, a loan is classified into one of the measurement categories for financial assets set out in IAS 39. The classification is based on conditions that exist on the date of the purchase or business combination, i.e. the date on which the purchaser first becomes party to the loan's contractual provisions, and may be different from the classification in the seller's financial statements. Initial classification determines the subsequent measurement of the asset in the financial statements. Subsequent measurement is discussed in section 6.

IAS 39.9

A loan normally would be classified as a loan and receivable, but might also qualify as a financial asset at fair value through profit or loss or be classified as an available-for-sale financial asset. These classifications are discussed below. However, as discussed in section 5, the presence of an embedded derivative within the loan contract may affect its classification.

4.1 Loans and receivables

Typically, banks use the loans and receivables classification category to measure the loans subsequently at amortised cost. The only other amortised cost measurement category is held-to-maturity investments (see 4.3). However, it contains more restrictions, as discussed below, and cannot be used if the acquired assets meet the definition of loans and receivables.

IAS 39.9

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

- those that the entity intends to sell immediately or in the near term, which are classified as held for trading, and those that the entity designates at fair value through profit or loss on initial recognition (see 4.2);
- those that the entity designates as available for sale on initial recognition (see 4.3); and
- those for which the entity may not recover substantially all of its initial investment, other than because of credit deterioration, which are classified as available for sale.

IAS 39.9

An interest acquired in a pool of assets that are not loans or receivables (e.g. an interest in a mutual fund or a similar fund) is not a loan or receivable.

IAS 39.BC28

Both originated and purchased loans may be classified as loans and receivables.

4.2 Financial assets at fair value through profit or loss

IAS 39.9

Alternatively, acquired loans may be classified as financial assets at fair value through profit or loss. A loan is classified as at fair value through profit or loss if it is held for trading or if it is designated into the fair value through profit or loss category at acquisition.

The held-for-trading classification is mandatory if the loan meets one of the following conditions:

- it is acquired principally for the purpose of selling it in the near term; or
- on initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.
A loan also may be designated by the entity as at fair value through profit or loss on initial recognition. An entity may use this designation only when the loan contains a separable embedded derivative (see section 5) or when doing so results in more relevant information, because either:

- it eliminates or significantly reduces an inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- a group of financial instruments is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and the entity’s key management personnel internally receive information about the group on that basis.

### 4.3 Available-for-sale financial assets and held-to-maturity investments

In addition, an entity has a free choice of classifying any loan, other than one that is held for trading, as available for sale at initial recognition.

Entities also can classify loans that do not meet the definition of loans and receivables as held-to-maturity investments should they have the positive intention and ability to hold the loans to maturity. For example, loans may fail the definition of loans and receivables if they are quoted in an active market, which in our experience is rare. However, if an entity sells or transfers more than an insignificant amount from the portfolio of held-to-maturity investments, then it may not classify any investment as held-to-maturity for the rest of the current financial year or for the subsequent two financial years. Additionally, all investments classified as held to maturity on the date of the sale or transfer are reclassified to the available-for-sale category and remeasured at fair value.
5. When does an embedded derivative require separation?

IAS 39.11

An embedded derivative is required to be separated from the host contract, e.g. a loan, and accounted for as a stand-alone derivative if all of the following conditions are met:

- the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract (see below);
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative (defined in IAS 39.9); and
- the hybrid (combined) instrument, e.g. loan containing an embedded derivative, is not measured at fair value with changes in fair value recognised in profit or loss.

If none of these three conditions is met, then separate accounting for the host and the embedded derivative is not permitted.

IAS 39.AG30, AG33

To determine whether the host contract and the embedded derivative are closely related, the economic risks and characteristics of the host contract and of the embedded derivative have to be considered. However, a derivative with economic characteristics and risk factors similar to those of the host contract is not necessarily closely related to the host contract. For example, if a leverage feature that is not insignificant is present and the feature is such that it increases the variability of the contractual cash flows of the hybrid instrument at a rate greater than would be inferred from the host instrument’s economic relationship with the relevant underlying, then usually the embedded derivative is not closely related.

IAS 39.AG30(c), AG30(g)

IAS 39 provides the following specific guidance on embedded derivatives that is particularly relevant to loans.

- An option or automatic provision to extend the remaining term to maturity of a loan is not closely related to the host debt instrument, i.e. the loan, unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. However, depending on its terms, an entity may consider an extension feature in a loan host contract to be equivalent to a loan commitment that would not be within the scope of IAS 39, and consequently would not meet the definition of a derivative. In our view, if an entity adopts this approach, then it would not separate the extension feature from the host loan contract.

- A call, put or prepayment option embedded in a host loan contract is closely related to the host contract in either of the following scenarios.
  - The exercise price of the option is approximately equal on each exercise date to the amortised cost of the host loan instrument.
  - The exercise price of the prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid, multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate that the lender would receive at the prepayment date if it re-invested the principal amount prepaid in a similar contract for the remaining term of the host contract. This exception is conditional on the exercise price compensating the lender for loss of interest by reducing the economic loss from re-investment risk.
Generally it is presumed that a call, put or prepayment option is closely related to the host contract when the exercise price is approximately equal to the amortised cost of the host contract at each exercise date. However, in our view this presumption is relevant only when the assessment relates to a call, put or prepayment option that otherwise shares similar economic characteristics and risks to those of the host contract.

### Example 3 – Loan with a contingent early call feature

A five-year loan contains an early call feature that permits the lender to require repayment at any time after the third anniversary date of the loan, if the price of the borrower’s shares for 10 consecutive trading days is less than 90 percent of the entity’s share price at the issue date of the loan. As the call option’s underlying risk exposure is the share price of the borrowing entity rather than the interest rate and credit risk of the host loan contract, in our view the feature should be separated from the host contract and measured at fair value through profit or loss.

### IFRIC 9.7

An assessment of whether an embedded derivative requires separation is made when an entity first becomes a party to the contract and is not subsequently reassessed unless certain conditions are met. Such conditions include a change in terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract. An entity may first become a party to the contract when the loan is originated, purchased or acquired as part of a business combination (see section 2).

### IAS 39.43, AG6

When an entity first becomes party to a contract, the initial measurement of the non-impaired loan at fair value as at the acquisition date may differ from the loan’s principal amount. If the acquired loan, which contains an early repayment option, subsequently is measured at amortised cost, then the initial premium or discount on acquisition is amortised to profit or loss as part of recognition of interest on an effective interest basis. See 6.1 and 6.2 for further discussion of effective interest rates.

### IFRIC 9.7

Therefore, an embedded derivative that previously may not have required separation by the seller may require separation by the purchaser; similarly, an embedded derivative that previously was separated by the seller may not require separation by the purchaser. This analysis can be complex and requires careful consideration.

### IAS 39.11A, AG33A

If the loan is a hybrid financial asset, then an entity is able to designate the entire loan as a financial asset at fair value through profit or loss unless:

- the embedded derivative does not significantly modify the cash flows that would otherwise arise on the loan; or
- it is clear with little or no analysis when a similar hybrid instrument is first considered that separation would be prohibited.

IAS 39 does not contain guidance on what should be regarded as a significant modification to the cash flows, so determining what constitutes a significant modification is a matter of judgement, taking into account the particular facts and circumstances.
As noted above, if an embedded derivative is not required to be separated, then separation is not permitted, i.e. separation is not optional. If an embedded derivative is separated from a loan host, then the loan host is accounted for under IAS 39.

Separable embedded derivatives are measured in the same way as stand-alone derivatives, i.e. at fair value with all changes in fair value recognised in profit or loss, unless they form part of a qualifying cash flow or net investment hedging relationship. The initial bifurcation of a separable embedded derivative does not result in any gain or loss being recognised because the initial carrying amount of the host instrument is equal to the residual amount after separating the embedded derivative.
6. How are loans measured subsequent to initial recognition?

IAS 39.46, 55, 56

The subsequent measurement of loans depends on their initial classification. Loans classified as loans and receivables are measured subsequently at amortised cost using the effective interest method (discussed below); those classified as financial assets at fair value through profit or loss and available-for-sale financial assets are measured subsequently at their fair values.

IFRS 7B5(e), IAS 1.35

For financial assets at fair value through profit or loss, fair value changes are included in profit or loss. If interest income is presented separately from other fair value changes, then it is measured on an effective interest basis and presented as interest income.

IAS 39.55(b)

For available-for-sale loan assets, fair value changes (being the difference between amortised cost and fair value) are presented in other comprehensive income. Interest, calculated using the effective interest method, impairment losses and foreign exchange gains and losses (because loans are generally monetary items) are recognised in profit or loss.

6.1 Effective interest rate: General requirements

IAS 39.9

An effective interest rate calculation is required to determine interest income for all financial instruments measured at amortised cost or classified as available for sale, or if interest on fair value through profit or loss instruments is presented separately from other fair value changes. Therefore, at the acquisition date, the fair value determined for the loans and the total cash flows expected over the remaining term of the loans are used by the purchaser to calculate an effective interest rate for the loans. This new effective interest rate should be used to determine subsequent interest income in the purchaser’s consolidated financial statements, but has no impact on the acquiree’s accounting in its own financial statements.

IAS 39.9, AG6

The effective interest rate is calculated on initial recognition of a loan and reflects a constant periodic return on the carrying amount of the loans. It is the rate that exactly discounts estimated future receipts through the expected life of the loan, or when appropriate a shorter period, to the net carrying amount of the loan on initial recognition. The calculation of the effective interest rate includes all fees and points paid or received between the contracting parties that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a loan, or a portfolio consisting of similar loans, can be estimated reliably.

IAS 39.AG5, AG6

The calculation of the effective interest rate takes into account the estimated cash flows, which consider all contractual terms of the loan, e.g. prepayment, call and similar options that are not subject to embedded derivative separation (see section 5), but without inclusion of future credit losses. However, if an entity acquires financial assets at a deep discount that reflects incurred credit losses, then it includes the incurred credit losses in the estimated cash flows when computing the effective interest rate. See 6.5 for further discussion of acquisitions at a deep discount.

In our view, if a loan gives either the lender or the borrower the option to require the loan to be repaid or cancelled early, and the loan’s terms are such that the option does not require separation and it is not certain whether the option will be exercised, then the probability of the option being exercised should be assessed in determining the estimated cash flows.

IAS 39.9

In the rare instances in which it is not possible to estimate the timing or amount of future cash flows reliably, either for an individual loan or for a portfolio of similar loans, IAS 39 indicates that an entity should use the contractual cash flows over the full contractual term of the loan or the portfolio. In some cases, e.g. prepayable mortgages, historical prepayment patterns may be useful in estimating expected lives.
If there is a change in the timing or amount of estimated future cash flows (other than due to impairment), then the carrying amount of the group of loans is adjusted in the period of change to reflect the actual and/or revised estimated cash flows with a corresponding gain or loss recognised in profit or loss. The revised carrying amount is recalculated by discounting the revised estimated future cash flows at the portfolio’s original effective interest rate. In our view, this approach on changes in estimated cash flows should apply to changing prepayment expectations, but not to a renegotiation of the contractual terms of the loans.

Example 4 – Calculating the effective interest rate for a loan portfolio purchased without incurred losses

On 1 January 2011 Bank Y purchases a group of prepayable loans with a total principal of 50,000. The loans pay a fixed interest rate of 3 percent of principal annually on the last day of each year. The expected average life of the portfolio as determined by Bank Y is five years; assume that the total principal amount is paid back at this date. Bank Y pays 49,000 for the portfolio and the purchase price reflects future credit losses of 1,200; assume the present value of the future losses is 1,000.

Bank Y determines the effective interest rate to be 3.4 percent (this is the internal rate of return assuming the initial cash outflow of 49,000 and inflow of annual coupon of 1,500 and principal of 50,000 at the expected repayment date) and accretes the initial carrying amount of 49,000 to the 50,000 principal amount over the five-year term using the effective interest rate. The future expected losses are not incorporated into the effective interest rate.

On 31 December 2011 a year after acquisition, the prepayment expectations for the portfolio increase such that the expected average life of the portfolio is revised to three years, i.e. a year shorter than the original expectation at the acquisition date. Bank Y then recalculates the carrying amount reflecting the revised cash flows, which include earlier receipt of the loan portfolio’s principal, offset partially by a year of foregone interest, discounted at the original effective interest rate for the portfolio of 3.4 percent. The resulting gain of 193 is recognised immediately in profit or loss.

6.2 Effective interest rate: Amortisation period for discounts or premiums and transaction costs

The straight-line amortisation of discounts or premiums is not permitted when the impact is material. Instead, discounts and premiums (including fees, points paid or received and transaction costs) are recognised as interest income over the expected life of the related instrument, e.g. loan portfolio, using the effective interest rate.

However, in some cases discounts or premiums should be recognised over a shorter time if they relate to a specific period, e.g. when the variable is repriced to market rates before the expected maturity of the loan.

Accordingly, if a discount or premium arises on the acquisition of a floating rate loan portfolio, then it is important to identify the reason for it. For example, to the extent that it reflects changes in market (benchmark) interest rates since the floating interest portfolio was last repriced, then it will be amortised to the next repricing date. Alternatively, to the extent that the premium or discount results from a change in the credit spread over the floating rate as a result of a change in credit risk, then it is amortised over the expected life of the portfolio. Accordingly, a loan portfolio acquisition may require

2 Alternatively, when applicable, the revised effective interest rate is calculated in accordance with paragraph 92 of IAS 39, which explains the amortisation of a fair value hedge adjustment in the case of fair value hedges.
a discount or premium paid to be separated into two parts, reflecting changes in market (benchmark) interest and changes in credit risk, which may need to be amortised over different periods.

If interest-bearing loans are acquired between interest payment dates, then normally the purchaser has an obligation to pay the accrued interest to the seller when it is received, or pays a higher price for the loans to reimburse the seller for the accrued interest that will be paid to the purchaser. Interest that has accrued on interest-bearing loans before they are acquired is not recognised as income. If there is an obligation to pay the accrued interest to the seller, then a receivable and a corresponding payable are recognised in respect of the accrued interest.

A specific methodology for amortising transaction costs for a floating rate loan is not prescribed, except as outlined in IAS 39 AG6 as discussed above. In our view, any consistent methodology that would establish a reasonable basis for amortisation may be used. For example, it would be reasonable to determine an amortisation schedule of the transaction costs based on the interest rate in effect at inception.

6.3 Calculating impairment losses: General requirements

If there is objective evidence that a financial asset is impaired, then an entity determines the amount of any impairment loss. It first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether it is significant or not, then it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.

See 3.6.1370–1600 in the 7th Edition 2010/11 of our publication Insights into IFRS (7.6.450–700 in the 8th Edition 2011/12) for further guidance on the accounting for the impairment of financial assets, including collective impairment and recognition of impairment losses incurred but not reported.

The measurement of the impairment loss differs for assets carried at amortised cost and available-for-sale financial assets. For a loan carried at amortised cost, impairment is measured as the difference between the loan’s carrying amount and the present value of estimated future cash flows discounted using the original effective interest rate. The estimated future cash flows include only those credit losses that have been incurred at the time of the impairment loss calculation. Losses expected as a result of future events, no matter how likely, are not taken into account. This is particularly relevant when loans are evaluated for impairment collectively. See 3.6.1430.15 in the 7th Edition 2010/11 of our publication Insights into IFRS (7.6.510.20 in the 8th Edition 2011/12) for further guidance.

However, for a loan classified as available for sale, an impairment loss is calculated as the difference between the loan’s amortised cost and its fair value, which reflects market interest rates and market expectations of expected future, as well as incurred, credit losses.

The estimated future cash flows determined for assets carried at amortised cost assessed for impairment on a collective basis are discounted at a rate that approximates the original effective interest rate. For portfolios of similar loans, the assets will have a range of interest rates and therefore judgement is necessary to determine a discounting methodology appropriate to that portfolio. This may result in using the average effective yield if it is a homogeneous portfolio.

See 3.6.1460 in the 7th Edition 2010/11 of our publication Insights into IFRS (7.6.550 in the 8th Edition 2011/12) for examples of impairment calculations.
6.4 Reversals of impairment: General requirements

IAS 39.65, AG8

If, in a subsequent period, the amount of any impairment loss of a loan or group of loans measured at amortised cost decreases due to an event occurring subsequent to the write-down, then the previously recognised impairment loss is reversed through profit or loss with a corresponding increase in the carrying amount of the underlying asset(s). The reversal is limited to an amount that does not state the asset at more than what its amortised cost would have been in the absence of impairment. Also, in our view, to the extent that the incurred loss has never been recognised by the purchaser of the asset in profit or loss, the purchaser cannot subsequently present such increase in cash flows as a reversal of impairment.

IAS 39.70

A reversal of impairment for a loan classified as available for sale can involve additional complexities because available-for-sale assets are measured at fair value and so consideration has to be given to whether subsequent increases in fair value are actually a reversal of impairment. If, in a subsequent period, the fair value of an available-for-sale loan increases and the increase can be related objectively to an event occurring after the impairment loss was recognised, then the impairment loss is reversed; the amount of the reversal is recognised in profit or loss. IAS 39 does not further describe the nature of an event that gives rise to this, nor does it discuss situations in which there continues to be some objective evidence of impairment but in which the amount of the impairment may be reduced. See 3.6.1520.40–70 in the 7th Edition 2010/11 of our publication Insights into IFRS (7.6.610.30–130 in the 8th Edition 2011/12) for discussion and illustration of the types of events that trigger reversal, and how to measure the amount of any reversal.

6.5 Acquiring a loan portfolio at a deep discount that reflects incurred credit losses

6.5.1 Initial calculation of effective interest rate

IAS 39.9

As discussed in 6.1, future expected credit losses are not taken into account by the purchaser in determining the effective interest rate for the portfolio at acquisition because doing otherwise would be a departure from the incurred loss model for impairment. Therefore, the amortised cost calculation cannot be used to remove credit spread from interest income to cover future losses.

IFRS 3.B41, IAS 39.AG8

However, if a financial asset is acquired at a deep discount that reflects incurred credit losses, then such credit losses are included in the estimated cash flows when computing the effective interest rate. Therefore, for a loan portfolio that is impaired at the acquisition date, the estimated cash flows are determined on the basis of the expected receipts after reduction for incurred credit losses, rather than on the basis of the cash flows that would arise if borrowers complied with the full contractual terms. Generally, the expected cash flows should exclude any future credit losses, i.e. those expected in addition to the losses incurred at the acquisition date. In practice, it may be difficult to make a distinction between incurred and future losses for assets that are already impaired. However, to the extent that the distinction can be made, future losses should be excluded from the estimates.
Example 5 – Purchase of a loan with incurred credit losses: Calculating effective interest rate

On 31 December 2010 Bank P purchases a fixed rate, non-recourse loan to a property manager with a principal amount of 100. The loan is collateralised by various income-producing properties. The purchase price paid is 80, which is the loan’s fair value on the date of acquisition. The expected remaining life of the loan is six years. Assume that the difference between the principal amount of the loan and the transaction price of 20 (100 - 80) comprises the following:

- increase in the market interest rate since origination: 8;
- liquidity/risk premium discount: 6;
- incurred credit losses: 4 (assuming all interest is to be received and only 95 of the principal amount is to be received at maturity); and
- additional expected future credit losses: 2 (estimated using a probability-weighted average of expected outcomes).

The loan is classified as part of loans and receivables by Bank P.

What cash flows should Bank P take into account in calculating the effective interest rate for the loan on initial acquisition?

Bank P records the loan at initial recognition at 80 as the transaction price is equal to fair value on that date. The loan is impaired on the acquisition date because it contains incurred credit losses and therefore Bank P estimates future cash flows inclusive of such incurred losses but exclusive of future expected credit losses when calculating the effective interest rate.

Also, Bank P excludes discounts related to changes in market rates of interest and in liquidity/risk premium in calculating the effective interest rate because the cash flows that it expects to receive under the contract are not affected by such discounts. These discounts affect the amount that a market participant would pay for the loan in a secondary market, but do not necessarily affect the expected contractual cash flows from the loan.

Accordingly, the cash flows that Bank P takes into account in calculating the effective interest rate are the initial outlay of 80, annual interest for six years and the principal to be received at maturity of 95, which reflects only losses determined to be incurred at the date of acquisition.

The future expected impairment loss of 2 will be recognised in profit or loss if and when the estimated expected future losses become actual incurred losses. The credit losses incurred at acquisition will be incorporated within the original effective interest rate and reflected in interest income. Therefore, the purchaser’s consolidated financial statements include gross presentation of interest income and impairment losses incurred after initial recognition (even if they are expected at initial recognition), and net presentation within interest income of losses determined to be already incurred at initial recognition.

If the above loan were acquired as part of a business combination, then the effective interest rate that would continue to be applied by the acquiree would be different from that applied in the consolidated financial statements of the purchaser. Therefore, two effective interest rates would have to be used until derecognition of the loan.
TREATMENT OF SUBSEQUENT REVISIONS IN CASH FLOWS

The re-estimation of future cash flows can be performed on a loan-by-loan basis or on a portfolio basis. In some cases, the acquisition of a large group of loans may consist of more than one portfolio of homogenous loans, i.e. loans with similar terms, interest rates etc. In the case of a portfolio of homogeneous loans that is subject to prepayment risk, it may be easier to estimate future cash flows, inclusive of prepayment expectations, on a portfolio basis.

IFRS 3.10, 18

If acquisition of a loan portfolio results from a business combination, then interest income and impairment charges on the acquired portfolio are likely to be different in the acquiree from the consolidated financial statements of the purchaser. Therefore, consolidation adjustments may be required until the acquired portfolio is derecognised.

IAS 39.58, AG5, AG8

When portfolios of loans are acquired inclusive of incurred credit losses, the treatment of the subsequent revisions to cash flows gives rise to some accounting complexities because it is necessary to separate revisions to cash flows that relate to impairment from other revisions in estimates. The purchaser therefore has to keep sufficiently granular records. Changes in cash flow estimates generally are presented as part of interest income unless there is subsequent evidence of impairment, in which case the changes generally are presented as impairment losses or reversals of impairment in the impairment charge line in profit or loss.

The following four examples illustrate the accounting treatment of subsequent revisions to cash flows on a loan acquired with incurred credit losses and classified as loans and receivables.

Example 6 – Expected cash flows revised upwards from initial recognition

Continuing with the fact pattern of Example 5, assume that a year after acquisition the only change in estimated cash flows is a reduction of incurred losses, so that the principal to be received at maturity becomes 98 and the net present value of future cash flows, calculated applying the effective interest rate as the discount factor, increases to 84. Assume that the amortised cost of the loan at that time is 82.

If expected cash flows from the loan subsequently are revised upwards due to an improvement in the borrower’s credit quality, then in our view the upward revision of 2 is recognised in profit or loss in interest income and should not be presented as a reversal of impairment. This is because no impairment loss had been recognised in the consolidated financial statements on the loan subsequent to initial recognition and therefore there is no impairment to reverse.

Example 7 – Expected cash flows revised downwards from initial recognition

Continuing with the fact pattern of Example 5, assume instead that a year after acquisition of the loan there is a reduction in the expected future cash flows, so the principal to be received at maturity becomes 91 and the net present value of future cash flows, calculated applying the effective interest rate as the discount factor, reduces to 79. Assume that the amortised cost of the loan at that time is 82.

A decrease in the estimated future cash flows from an impaired loan usually indicates further impairment, unless it can be attributed to other factors. If the decrease relates to further impairment, then Bank P records 3 (79 less 82) as an impairment loss.
Example 8 – Expected cash flows revised upwards and then downwards

Continuing with the fact pattern of Example 6, assume that a subsequent increase in the expected cash flows a year after the initial recognition is then followed by a reduction in expected cash flows. To summarise:

- The purchased impaired loan was recognised initially at 80.
- A year after the acquisition, the net present value of the expected cash flows was revised upwards to 84 due to an improved credit standing of the borrower and the difference between the then-amortised cost of 82 and 84 was recognised as part of interest income, as discussed in Example 6.
- Two years after the acquisition, the net present value of the expected cash flows is revised downwards to 86 due to the borrower’s deteriorating credit standing, with the principal to be received at maturity revised from 98 to 97. The amortised cost of the loan at this time is 87.

**How should the decrease in the carrying amount of the loan of 1 resulting from the reduction in expected cash flows at the end of year two be recorded by Bank P?**

In our view, two approaches are possible.

- Recognise the subsequent reduction in the carrying amount of the loan of 1 as an adjustment to interest or other income on the basis that the reduced recoverability is not below that expected on initial recognition of the debt instrument, i.e. the principal to be received at maturity is 97 compared with an initial expectation of 95; therefore, it can be argued that such a decline does not represent a loss event that has occurred since initial recognition. This analysis is based on the premise that for a loss event to occur subsequent to initial recognition, it has to reduce the expected cash flows below those expected on initial recognition.

- Recognise an impairment loss of 1 on the basis that a loss event has occurred in the period since the initial recognition of the debt instrument.

Example 9 – Expected cash flows revised downwards and then upwards

Building on the fact pattern from Example 7, assume the following.

- The purchased impaired loan was recognised initially at 80.
- A year after the acquisition, the net present value of the expected cash flows was revised downwards to 79 due to deterioration in the credit standing of the borrower and the difference between the then-amortised cost of 82 and 79 was recognised as an impairment charge, as discussed in Example 7.
- Two years after the acquisition, the net present value of the cash flows is revised upwards to 88 due to improving credit standing of the borrower, with the principal to be received at maturity revised from 91 to 100. The amortised cost of the loan at this time is 81.

**How does Bank P account for the upward revision to the expected cash flows at the end of year two?**

As the increase in expected future cash flows can be related to an event occurring after the impairment loss was recognised originally (a year after acquisition), the previously recognised impairment loss is reversed. This reversal should not exceed the amount recognised previously by Bank P as an impairment charge (3). The excess of the total increase in the net present value of future cash flows (7) over the amount recognised as reversal of impairment (3) of 4 is recognised in profit or loss immediately, generally as interest income.
Also, the amount of impairment reversal should not result in a carrying amount of the loan that exceeds what the amortised cost would have been had the impairment loss of 3 not been recognised.
7. Additional loan portfolio acquisition issues

7.1 Loan commitments

IFRS 3.18 In accordance with IFRS 3, identifiable assets acquired and liabilities assumed, including those not in the scope of IAS 39, generally are measured at their acquisition date fair values.

IAS 39.2(h), 4 Generally, loan commitments are excluded from the scope of the financial instruments standard. However, a loan commitment falls within the scope of that standard in the following circumstances:

- if an entity designates the loan commitment as a financial liability at fair value through profit or loss;
- if a loan commitment can be settled net in cash or another financial instrument;
- if an entity has a past practice of selling the assets resulting from its loan commitments shortly after their origination or acquisition; or
- if the commitment is to provide a loan at below market rate.

IAS 39.9 When an entity acquires a loan commitment within the scope of IAS 39 through a direct purchase or a business combination, then in our view it should classify such commitment applying the normal classification rules outlined in section 4. For example, the purchaser can, for the purpose of its financial statements, designate the purchased loan commitment as at fair value through profit or loss, or discontinue fair value through profit or loss if this designation was adopted previously by the acquiree.

IAS 39.47(d) When an entity enters into a commitment to provide a loan at a below-market interest rate, then the loan commitment is measured initially at fair value and subsequently at the higher of:

- the amount recognised under IAS 37 Provisions, Contingent Liabilities and Contingent Assets; and
- the amount recognised initially less cumulative amortisation recognised under IAS 18 Revenue.

IAS 39.4 A purchaser of a loan portfolio has to evaluate at initial recognition, i.e. on the date of acquisition, whether the portfolio includes commitments to provide loans at below-market rates. This may arise, for example, if market rates of interest have increased between origination of the loan commitment and purchase of the loan portfolio. If at the acquisition date the portfolio includes commitments to provide loans at below-market rates, then the commitments are within the scope of IAS 39 from the perspective of the purchaser; this is irrespective of whether they were considered to be within the scope of the standard by the seller. Subsequently, the commitments are measured in accordance with the specific guidance as outlined above, unless designated at fair value through profit or loss.

IAS 37.2, 36, 66 All loan commitments that are not within the scope of IAS 39 are accounted for under IAS 37. In our view, under that standard it is likely that a provision for a loan commitment would be recognised either if an entity is committed to making a loan that would be considered impaired or when the contract becomes onerous.
7.2 Certain considerations when indemnities are provided as part of the acquisition of loans

7.2.1 Indemnities provided as part of business combination

**IFRS 3.27**

When an indemnity is issued by a seller in a transaction that is a business combination, including those provided to compensate the purchaser for the uncertainty related to losses on the loans sold, the indemnification asset is accounted for in accordance with the business combinations standard. This guidance includes an indemnification that would meet the definition of a financial guarantee contract in IAS 39.

**IFRS 3.27, 28, 57**

The purchaser recognises an indemnification asset at the same time and measures it on the same basis as the indemnified loans, subject to management's assessment of the collectability of the asset. This accounting does not apply for general representations and warranties provided by the seller that do not create a specific right of reimbursement.

7.2.2 Other indemnities

**IAS 39.9**

There is no specific guidance on accounting by the purchaser when indemnification is provided in a direct purchase of loans. Such an indemnification may take the form of guarantees issued by the seller or by a third party, such as a government agency, to the purchaser in respect of the loans being acquired. These contracts would meet the definition of financial guarantees if they require the issuer to make specified payments to reimburse the holder for a loss that it incurs if a borrower fails to make payment when it is due in accordance with the terms of the loan. Other credit-related contracts that require payment in other circumstances (e.g. if there is no failure to make payment) are credit derivatives that are measured at fair value.

In our view, a key consideration in the holder's accounting for a financial guarantee contract is whether the guarantee is an integral part of the loan. Determining whether it is an integral part of the loan is a matter of judgement that typically includes, but is not limited to, consideration of:

- whether the terms of the loan include the guarantee;
- whether the pricing of the loan includes the guarantee; and
- the party who issued the guarantee.

Based on these considerations, it would be unusual for a guarantee provided by the seller to be an integral part of the loan.

If the guarantee is considered integral to the loan, then the loan and the guarantee are accounted for by the holder as one instrument, with subsequent measurement including the impact of the guarantee on the expected cash flows from the loan.

Alternatively, if the holder assesses the guarantee as non-integral, then the loan and the guarantee are accounted for separately. In our view, the holder accounts for such a financial guarantee contract as a prepayment measured at an amount equal to the guarantee premium and a compensation right accounted for by analogy to the guidance for reimbursements in IAS 37.

**IAS 39.AG50**

An additional consideration when the seller provides a guarantee is whether the guarantee results in the seller not meeting the derecognition requirements in respect of the assets transferred. If the derecognition requirements are not met, then the purchaser recognises a receivable from the seller rather than the loan assets transferred.

7.3 Acquisition of a subsidiary in a business combination: Consolidation adjustments

IFRS 3.18, IAS 27

If a loan portfolio is acquired as part of the purchase of a business, then it is recognised initially at fair value in the purchaser’s consolidated financial statements, but the accounting by the acquiree in its own financial statements is not impacted. Consolidation adjustments then are required at each reporting date to reflect the differences in required accounting between the two sets of financial statements.

Such adjustments often are complex and require the maintenance of sufficiently detailed data to be able to reflect the consolidation adjustments related to the calculation of effective interest rate, interest income, impairment charges and reversals and the carrying amounts of the related loans. From the purchaser’s perspective, often the full removal of the acquiree’s accounting for the loan portfolio and the recording of the purchaser’s accounting from the date of acquisition is the simplest way to process the consolidation adjustment.

The following example illustrates some of the differences that may arise between the acquiree’s and the purchaser’s accounting in respect of loan portfolios held by the acquiree.

### Example 10 – Acquisition as part of a business combination: Consolidation adjustments

On 1 January 2010 Bank S originated a loan with a total principal amount of 50,000, which pays an annual fixed rate interest rate of 3 percent (Loan X). Bank S incurred qualifying transaction costs of 1,000. The expected life of the loan was determined by Bank S to be five years. Bank S determined the effective interest rate to be 2.6 percent. Bank S therefore amortises the amount recognised at initial recognition of the loan of 51,000 to the 50,000 total expected principal repayment amount at the end of the life of the loan as part of the effective interest rate calculation.

On 1 January 2011 Bank T purchases Bank S in a transaction that meets the definition of a business combination under the business combinations standard. Bank T estimates the market interest rate on Loan X on the date of acquisition to be 3.5 percent and the fair value of the loan to be 45,000, taking into account expected future losses of 3,500 and a discount off the principal amount of 1,500 related to the increase in interest rates. Bank T therefore determines the effective interest rate to be 6.4 percent, which is the rate that would accrete the amount at which the loan is recognised initially of 45,000 to the 50,000 contractual principal at the expected maturity date.

On 31 December 2011 the loan has a carrying amount of 50,615 in Bank S’s individual financial statements and a carrying amount of 46,136 in Bank T’s consolidated financial statements. Assume that at that date an incurred impairment loss event is identified, which is expected to lead to a reduction in principal collection of 3,000. Therefore, the carrying amount of the loan is reduced by its excess over the present value of expected future cash flows discounted using the loan’s original effective interest rate.

As the original effective interest rate in Bank S’s own financial statements is different from the one in Bank T’s consolidated financial statements, the present values of the expected reduced principal receipts also are different. Therefore, Bank S’s carrying amount is reduced by 2,780 and Bank T’s carrying amount by 2,490, with a corresponding charge recognised in profit or loss. Bank S and Bank T subsequently recognise interest income by applying their respective effective interest rates to their respective carrying amounts for the loan.
Therefore, in preparing the consolidated financial statements for 2011, Bank T records consolidation adjustments in respect of the following:

- carrying amount of the loan;
- interest income (pre- and post-impairment); and
- impairment losses (and any reversals).

See chapter 2.6 of our publication *Insights into IFRS (7th 2010/11 and 8th 2011/12 Editions)* for discussion of other business combination-related accounting issues.
8. Selected future considerations arising from IFRS 9 and IFRS 13

8.1 General requirements of IFRS 9

In November 2009 the IASB published the first chapters of IFRS 9, dealing with the classification and measurement of financial assets. Selected items from these chapters potentially impacting loan acquisition accounting are discussed below.

IFRS 9.71 IFRS 9, which is intended to supersede IAS 39, has a current effective date of annual periods beginning on or after 1 January 2013, with earlier application permitted. However, on 4 August 2011 the IASB proposed to push back the effective date to annual periods beginning on or after 1 January 2015\(^3\); comments are due by 21 October 2011.

8.2 Initial recognition under IFRS 9

IFRS 9.3.1, IAS 39.14, AG34, AG35 A financial asset, e.g. a loan, is recognised when and only when an entity becomes a party to the contractual provisions of the instrument. IFRS 9 does not amend substantively the initial recognition requirements of IAS 39.

8.3 Classification under IFRS 9

IFRS 9.4.1.1 On initial recognition, financial assets are classified into one of two primary measurement categories: amortised cost and fair value.

IFRS 9.4.1.2 A financial asset qualifies for amortised cost measurement only if it meets both of the following conditions:

- it is held within a business model whose objective is to hold assets in order to collect contractual cash flows (the HTC criterion or HTC business model); and
- its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (the SPPI criterion).

If a financial asset does not meet both of these conditions, then it is measured at fair value. If a financial asset does meet both of these conditions, then it qualifies for measurement at amortised cost, even if it is an instrument that is quoted in an active market.

IFRS 9.4.1.5 An entity may however choose to designate a financial asset that otherwise would qualify for amortised cost accounting as measured at fair value through profit or loss on initial recognition. This optional designation is permitted only if it eliminates or significantly reduces a measurement or recognition inconsistency (an ‘accounting mismatch’) that otherwise would arise from measuring assets or liabilities, or recognising gains or losses on them, on different bases. The election is available only on initial recognition and is irrevocable. This option is retained from IAS 39 and the relevant application guidance in IAS 39 continues to apply. However, the other two fair value designation conditions available currently in IAS 39 (i.e. for instruments managed on a fair value basis and for certain hybrid instruments) are not retained in IFRS 9 as the requirements of IFRS 9 rendered them redundant for financial assets.

IFRS 9.3.1.1 An asset is classified at its initial recognition. Accordingly, a purchaser of an asset makes the classification assessment on the date of acquisition.

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\(^3\) Exposure draft ED/2011/3 Mandatory Effective Date of IFRS 9.
8.3.1

Business model

The objective of an entity’s business model is not based on management’s intentions with respect to an individual instrument, but rather is determined at a higher level of aggregation. The assessment of the objective of the entity’s business model should reflect the way the entity manages its business or businesses.

For example, a single reporting entity may have more than one business model for managing its financial instruments and the standard provides an example of different portfolios being managed on different bases. In this case, the objective of the business model is assessed for each portfolio rather than determining classification based on a single assessment at the reporting entity level. Therefore, an entity holding a portfolio of investments that it manages in order to collect contractual cash flows may have a different classification for financial assets in that portfolio from the classification for those assets in a portfolio that it manages in order to trade to realise fair value changes.

An entity should consider at what level of its business activities different business models and their objectives should be identified and assessed. Generally, an entity’s business model is a matter of fact that can be observed from the way in which the entity is managed and the information provided to management. However, there may be circumstances in which it is not clear whether a particular activity involves one business model with some infrequent sales of assets or whether these anticipated sales indicate that in fact an entity has two business models, only one of which would meet the HTC criterion.

Acquiring financial assets with incurred losses is not in itself inconsistent with an HTC business model. For example, a bank may have a business model to acquire impaired loans and then collect the contractual cash flows by chasing the debtors for payment.

It is possible that the purchaser of loan assets or of a business that includes loan assets may intend to place them in a business model that is different from the one operated by the acquiree. For example, if the purchaser intends to securitise or syndicate the loan assets, then they may have to be classified as measured at fair value through profit or loss.

8.3.2

Cash flow characteristics

The second criterion that an entity assesses to determine whether a financial asset qualifies for amortised cost measurement is whether the cash flows from the financial assets represent, on specified dates, solely payments of principal and interest on the principal amount outstanding.

For this purpose, interest is defined as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period. The assessment of whether cash flows meet this definition is made in the currency in which the financial assets are denominated.

Interest rates that are fixed or variable may be consistent with the SPPI criterion.

Contractual terms that permit the issuer to prepay before maturity, the holder to put the financial asset back to the issuer before maturity or either party to extend the term of a financial asset meet the SPPI criterion only if:

- the feature is not contingent on future events or, if it is contingent, it protects:
  - the holder against a credit deterioration or change in control of the issuer; or
  - the holder or the issuer against changes in relevant taxation or law;
- in the case of a prepayment or put feature, the prepayment amount substantially represents unpaid principal and interest, but may include reasonable additional compensation for early termination; or
- in the case of a term extension option, it results only in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.
Any contractual term that changes the timing or amount of payments does not meet the SPPI criterion unless it is a variable interest rate that represents consideration for the time value of money and credit risk or is a qualifying prepayment, term extension or put feature (see above).

As the contractual terms of an asset usually are not affected by the terms of their acquisition, the analysis of whether they meet the SPPI criterion generally should be similar for the acquiree and the purchaser. However, differences may arise in practice. For example, a term within a loan might have linked the interest rate to an equity index for a period that expired prior to the acquisition of the loan, causing the interest rate to change to a rate based solely on LIBOR. In this case, the purchaser may determine that at the acquisition date the loan meets the SPPI criterion, while the seller would have determined that this criterion was not met when it originated the loan.

Similarly, a different conclusion in respect of the SPPI criterion may be reached by the purchaser of contractually linked securities, e.g. a tranche of notes issued by a special purpose vehicle, from that reached by the seller of the securities when it first acquired them. Assume that the special purpose vehicle was originally set up a number of years ago to hold commercial mortgage loans. However, at the time the purchaser acquired the contractually linked securities, most of the commercial mortgages had been repaid and the only substantial assets owned by the vehicle were repossessed commercial properties that it held for sale. The seller of the contractually linked securities may have concluded in the past that the securities met the SPPI criterion if the mortgage loans held by the vehicle themselves met the SPPI criterion. However, the purchaser would not be able to arrive at the same conclusion given the change in the nature of the vehicle's assets.


8.4 Fair value measurement considerations under IFRS 13

In May 2011 the IASB issued IFRS 13, which provides new guidance on fair value measurement and new disclosures requirements, particularly when fair value measurements rely on unobservable inputs. The standard applies to annual periods beginning on or after 1 January 2013, with early application permitted.

The standard provides a single source of guidance on how fair value is measured, but does not establish new requirements for when fair value is required. The guidance is to be applied when fair value is permitted or required under other IFRSs. The standard’s framework for determining fair value, which outlines the key principles and factors to be considered in estimating fair value, includes descriptions of certain valuation approaches and techniques, but does not establish standards on how valuations should be performed. Similar to IAS 39, the standard requires that if a valuation technique is used, then the observable inputs should be maximised and unobservable inputs should be minimised.

Fair value measurement will remain an area of significant judgement when prices in an active market are not available.
About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited), in collaboration with IFRS banking specialists across the KPMG network.

Content

This *IFRS Practice Issues for Banks* publication considers the accounting requirements related to the acquisition of loans. The text of this publication is referenced to IAS 39 and IFRS 3 and to other selected IFRSs in issue and effective at 30 June 2011. References in the left-hand margin identify the relevant paragraphs. Section 8 briefly discusses certain considerations resulting from the application of the chapters of IFRS 9 issued up to 31 July 2011 and IFRS 13 issued in May 2011, which are effective from 2013. However, as noted in 8.1, the effective date of IFRS 9 may be pushed back to annual periods beginning on or after 1 January 2015. The publication also references certain sections of *Insights into IFRS*, KPMG’s practical guide to International Financial Reporting Standards, 7th Edition 2010/11 and 8th Edition 2011/12.

This publication considers some of the key issues that a bank may encounter when applying the requirements of IFRSs relating to loan portfolio acquisitions, but it is not a comprehensive analysis of the requirements of IFRSs for loan acquisitions or financial instrument recognition, measurement or disclosure. In most cases, further analysis will be necessary for a bank to apply the requirements to its own facts, circumstances and individual transactions.

When preparing financial statements in accordance with IFRSs, a bank should have regard to its local legal and regulatory requirements. This publication does not consider any specific requirements of any particular jurisdiction.

IFRSs and their interpretation change over time. Accordingly, neither this publication nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves.

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