New International Accounting Concepts–Impairment

The latest accounting standards of the International Accounting Standards Board (IASB) have been bringing in many changes in the accounting concepts/principles, thus reflecting contemporary thinking/practices in the industry and advanced economies of the world. With this backdrop, this article analyses the key prescriptions of one of the important changes introduced by IAS 39 - Financial Instruments: Recognition and Measurement. The change relates to the recognition and measurement of ‘impairment and uncollectability of financial assets’. The article addresses the impact of the above requirement only in respect of a significant item viz. loans and advances, affecting the financial statements of entities in the financial services industry i.e. banks and financial institutions.

Scope of IAS 39 Impairment Provision Requirements

IAS 39 applies to ‘Financial Assets’ only and therefore the accounting requirements for impairment of non-financial assets such as inventories, plant/machinery, intangibles etc. are subject matter of separate accounting standards (IAS 36, IAS 2 etc).

Further, impairment accounting requirements of IAS 39 apply to three classes of financial assets viz. (i) Loans & receivables (L&R) or Held to Maturity (HTM) investments which are carried at amortised cost (ii) Available for sale (AFS) financial assets and (iii) Financial assets carried at cost. Accordingly, financial assets classified as ‘Held at Fair Value’ thru Profit or Loss Account (P/L account) are not subject to this specific impairment accounting requirements as the periodic ‘Mark to Market’ (MTM) exercise required for those assets is expected to cover the impairment loss, if any.

Timing of Assessment of Impairment and Uncollectability

The international accounting standard requires review and identification of objective evidence of impairment at each balance sheet date. Whilst this results into an annual exercise, for large listed entities with a requirement to prepare/publish quarterly/semi-annual financials this accounting aspect needs to be adhered to at that time as well.

Mechanics of Identification of Impairment and Uncollectability

According to the international accounting standard, a financial asset is impaired and impairment losses are incurred when there is objective evidence of impairment which is the result of one or more events (called ‘loss event’) occurring subsequent to initial recognition of the financial asset. Further, the occurrence of the event should have an impact on the estimated future cash flows of the financial asset. Though, the standard does not specify that the ‘impact’ on the future cash flows has to be ‘adverse or negative’, it is but logical to interpret it in the context of a loss recognition. Needless to mention, while assessing the impact on future cash flows, “All Amounts Due” i.e. principal as well as interest, as per contractual terms should

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be considered. Another interesting aspect to note is regarding the timing of occurrence of 'loss event', which the standard specifies that it should be subsequent to initial recognition of the financial asset. Therefore, a question arises as to how to apply this standard in case of purchase of financial assets that are already impaired or non-performing at the time of purchase. In our view, as the impaired assets are always purchased at a discount to contractual sums receivable and reflect the purchaser’s best estimate of the money recoverable, the purchaser is unlikely to have incurred impairment loss at that time of initial recognition, hence such assets purchased need not be classified as 'impaired'.

Now let us move to understand what is the meaning of objective evidence of impairment? The international accounting standard does

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prescribe certain events or triggers as pointers of objective evidence of impairment. These are basically situations where the borrower is unlikely to fulfil the repayment obligations as per contractual terms e.g. significant financial difficulty being experienced by the borrower, occurrence of default/delays in interest or principal repayments, restructuring of the credit facilities by giving extraordinary concessions to borrower and indications of borrower filing for bankruptcy or insolvency proceedings. For entities in the banking industry, existence of policies/procedures around similar lines is not unusual and adherence to above requirements may not pose any challenge. It is important to note here a key difference between US GAAP (SFAS 114- Accounting by creditors for impairment of a loan) and the International GAAP (IAS/IFRS). The former one categorically states that the standard does not specify how a creditor should identify loans that are to be evaluated for uncollectability and categorically states that a creditor should apply his normal loan loss review procedures in making that judgement. Interestingly, though IAS 39 spells out certain loss events as indication of objective evidence of impairment, it has avoided inclusion of more specific trigger point of impairment i.e. 90 days past due of interest or principal payments which is widely accepted/recognized by banks as well as the banking supervisors across the globe as the primary trigger point for impairment of assets. However, arguably banks can continue (and some international banks have continued) to adopt such criteria under IAS 39 regime also for determination of impairment in the interest of reducing unwarranted dependency on subjectivity.

In the new international GAAP (IAS/IFRS) regime, in order for an impairment loss to be recognised in the financial statements, there should be observable evidence that loss has been 'Incurred' and, therefore, losses 'Expected' in the future cannot be recognised.
Individual Versus Collective Assessment of Impairment Losses

As required by the accounting standard, assessment of impairment losses is categorised into three types:

(a) Assessment at ‘individual’ asset level for all individually significant items.

(b) For individually non-significant items, the entities have a choice either to assess it individually or collectively for a group of assets with similar credit risk features e.g. retail lending portfolios.

(c) Collective assessment of impairment for items where no individual impairment exists but forms part of a group of assets with similar credit characteristics.

In summary, the impairment loss assessment can be grouped under two types viz. Individual Impairment Loss Assessment (IILA) and Collective Impairment Loss Assessment (CILA). In the banking industry, CILA is sometimes termed as ‘Portfolio Impairment Provision (PIP)’. The standard does not define and elaborate as to what is an ‘individually-significant item’, so the management can set this criteria considering their entity-specific needs and practical requirements.

The standard does not define and elaborate as to what is an ‘individually-significant item’, so the management can set this criteria considering their entity-specific needs and practical requirements. It is interesting to note that relevant US GAAP (SFAS 114) on this subject does not apply to large groups of smaller-balance homogeneous loans that have to be collectively evaluated for impairment by applying another standard—SFAS 5—Accounting for Contingencies. So, under US GAAP, there is no IILA requirement for such small value loans like retail banking portfolios.

Further, another important point to note is that individually significant items reviewed for impairment on individual basis can be excluded from CILA ONLY if an impairment loss was identified against those individually significant assets. The rationale for this requirement is that sufficient objective evidence of impairment may not be visible on an individual loan basis but that evidence would be available when evaluated on collective or portfolio basis e.g. recession has set in a particular industry segment leading to financial difficulties but it has not yet been reflected in the credit behaviour of individual borrowers. Also, CILA is required only if the entity has a group of assets with ‘similar credit risk characteristics’ which are reflective of borrower’s ability to pay. It is unlikely to be the case that any bank will have many assets, which do not belong to any group of assets with similar credit risk characteristics.

Now the question is how to apply the above concepts in practice and what is the relevance of credit grading systems or credit management policies employed by the bank in their day-to-day practice or similar policies prescribed by the banking regulators. Internationally active banks or modern banks with sophisticated risk management systems, generally have their proprietary credit grading policies/procedures which categorise various credit facilities into different grades (say Grade 1 to 14 or Grade A to H, etc) primarily reflecting the credit quality of the borrower i.e. the probability of default by the borrower. Further, such banks also follow the policy of categorizing the small value homogeneous loans (Consumer Banking portfolios) based on ‘Past due or Default’ status of the loans for internal credit monitoring. Also, in some cases the banking regulators prescribe loan categorisation based on credit quality where likelihood of credit loss is key factor e.g. the RBI in India requires all credit facilities to be classified into four main categories viz. Standard, Sub-standard, Doubtful and Loss.

In the above scenario, for the purpose of review of impairment of loans under

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International GAAP, the banks can fruitfully utilise their credit management policies and practices and adopt the following simple and administratively practical approach.

**Step 1** – Loans categorised under grades reflecting adverse credit quality (say Non-Performing Assets) can be considered for IILA

**Step 2** – Other category loans (Performing Assets) categories should be considered for CILA

It is unlikely to be the case that many assets considered in Step 1–IILA will have no impairment loss recognised and therefore, need to be additionally included in Step 2–CILA to ensure conformity with IAS requirement that assets considered under IILA and having no impairment loss should also be part of CILA.

**Measurement of Impairment Losses**

The amount of impairment loss that needs to be recognised is the difference between the asset’s carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset’s original effective interest rate (i.e. the effective interest computed at initial recognition of the financial asset). The accounting standard brings in the well-known financial management concept of ‘time value of money’ in the computation and measurement of loan loss provisions. It is worthwhile to note that this concept was used by banks in the past and also prescribed by some regulators (including RBI) in certain limited circumstances e.g. in case of restructured non-performing assets where there was evidence of sacrifice of future interest on the loans. In view of the application of ‘time value of money’ concept, there will be an impairment loss even if the borrower repays full amount but there is a significant delay in the repayments without paying interest for the delayed period or payment of interest at a reduced rate than the original interest rate. Conversely, if the borrower repays full principal plus interest for delayed period also, then there is unlikely to be case of impairment loss because carrying value of assets and discounted future cash flows will be equal. Important points to bear in mind while estimating the future cash flows are:

- As the process is an estimation and judgmental, high degree of professional care and caution needs to be exercised.
- Estimations of cash flows need to be reasonable and supported by logical assumptions and forecasts. Possibly, a range of cash flows may be arrived at.
- Collateral valuations need to be justifiable and supported by external factors/quotes and supported by observable market conditions. Costs likely to be incurred in selling and realising the collaterals and the timing of sale proceeds need to be factored in estimated cash flows bearing in mind the legal and market factors.

**Extra caution needs to be taken while computing Collective Impairment Loss Assessment provisions so that it does not result into recognition of losses expected to occur in the future.**

**Impairment Loss Under CILA**

Assessment and measurement of impairment of losses at individual asset or borrower level is easier, conceptually as well as administratively. However, it is not the case when it comes to application of CILA. Many of the assets falling under this evaluation process would not show any signs of credit deterioration and consequently determination of a suitable methodology for identification/measurement of impairment losses poses a major challenge. Further, the IAS concept that only ‘incurred’ losses and not ‘expected’ losses can be recognised in the accounts adds some more complexities. Here one can adopt the approach and mechanics used by the Insurance industry...
for making provisions for insurance claim losses called ‘Incurred but not reported (IBNR)’. Of course this also requires application of suitable statistical models or formulae to determine the two important components required to assess/quantify the CILA losses. The two important components are:

(a) How to determine the time period required for credit losses to manifest explicitly i.e. losses have been incurred but are not yet specifically identifiable

(b) How to determine the amount of loss that is incurred or is expected to have been incurred at the balance sheet date and not the one expected to occur in future periods.

In respect of the retail credit portfolios which generally have large population with homogeneous risk characters, one of the commonly applied techniques is known as ‘Net Flow to Loss’ method or the ‘Markovian Chain theory’ which predicts the percentage of balances that move from one repayment bucket (Current, 30 days past due, 60 days past due and so on) to another bucket between two reporting periods and ultimately to loss status. The Markovian technique considers additionally ‘back-from’ behaviour or movement of accounts between various payment buckets since it is not necessary that there is only one-way transition i.e. accounts move from good to bad status. Also, these techniques help to determine the time period required for manifestation of impairment status. For corporate portfolios not specifically identified as impaired, individual bank’s Risk Monitoring/Loss Event Identification capabilities play a significant role in determining the average time period taken in the past for identification of credit loss events and also certain components of expected loss models (Probability of Default, Loss Given Default etc) will help determine the amount of loss that is likely to have been incurred.

Historical loss experience is a key factor in the computation of CILA, however, it needs to be in tune with the current changes in the industry/economic conditions; also, the loss estimates used needs to be regularly tested against actual loss experience. The standard permits the use of industry level or peer group loss experience data in the absence of entity specific data.

Method of Accounting for Impairment Losses

The accounting standard specifically recognizes two methods of accounting for impairment losses viz. either direct reduction of carrying amount of the asset or creation of allowance or provision account which gets netted off against the asset account in the balance sheet. The amount of impairment loss determined has to be charged off to P/L account. In subsequent reporting periods, if there is reduction in the impairment loss amount then the reduction in loss will be credited to P/L account. Also, as a precaution, the standard stipulates that asset’s carrying amount can never exceed the carrying amount of the asset before impairment so that impairment loss exercise does not result in application of ‘fair value’ measurement principles for assets that are carried at amortised cost. Further, there is another generally accepted method of accounting for impairment losses, though the standard does not explicitly mention about this, i.e. Direct writeoff method. Under this method loans are written off and charged to Profit & Loss account based upon a certain predetermined past due status. This is mostly applied in case of large portfolio of small-value homogeneous loans such as credit card balances, residential mortgage loans etc.
Interest Income Recognition for Impaired Assets

This aspect is one of the controversial aspects and radical change in the income recognition principles of an impaired or non-performing asset. The standard requires that interest income after impairment loss should be recognized based on the discount rate considered for estimating the present value of future values. In effect, it is the original effective interest rate for the asset. So far, the GAAP across the world and the banking regulatory requirements (which still continue to mandate this principle) mandated recognition of interest on NPAs only on ‘Cash Basis’ and even reversal of interest income accrued but not received when the asset is considered as NPA. That is interest on NPA will be credited to P&L account only when cash is received and if those proceeds can be applied to interest as per individual bank policy. Until the cash is received, interest income was computed and held in a suspense account (Interest in suspense method of accounting) or a memorandum record was maintained for the same. Interestingly, this aspect was deliberated at length when US GAAP (SFAS 114) was introduced and it was considered appropriate by US standard setter (FASB) to leave that policy discretion to individual banks bearing in mind the prevailing regulatory requirements and the system changes required for banks and an amendment to SFAS 114 was issued (SFAS 118). Accordingly, under USGAAP, ‘Interest in suspense’ method of accounting is still acceptable and many internationally large US banks follow this accounting policy. In contrast, International GAAP requires interest income recognition on impaired assets, if the bank expects to receive future interest (i.e. when evaluating the future cash flows and interest income to the extent expected should be recognized as interest income in the P/L account). However, if no future period interest as per contractual terms is expected to be received, interest income that can be recognised will only be unwinding (release) of discount due to increase in discounted cash flows due to passage of time.

There is a need to continue to maintain a record of all contractual interest receivable from the borrower because the banks would not like to give up their claim just because the asset has become impaired. This can be achieved by continuing the ‘Interest in suspense’ method of accounting stated above. Secondly, there is also a need to have an internal policy on the application of cash receipts against the ‘Principal’ or ‘Contractual Interest Due’, otherwise it will have some impact on the base used for computation of future contractual interest due. The international GAAP is silent on this aspect. On a prudent accounting basis, it is appropriate that cash receipts are first applied towards ‘Principal’ outstanding.

The present values of estimated cash flows in subsequent periods may change either simply due to passage of time or on account of estimated cash flows amount/timings. IAS 39 does not give sufficient guidance as to under which line of P/L account (Impairment loss charge or interest income) these changes should be included under. In our view, increase in present values due to passage of time can be reported under interest income line while other changes should be reported as part of impairment loss charge (this is further explained in the example below). The US GAAP as part of amendment of the standard for income recognition principles, mentioned above, allowed entities to use their own policies in this regard and disclose the same.
Practical Application of International GAAP can be illustrated as follows:

A term loan of Rs. 1000/- carrying contractual interest 10% is determined to be impaired as of 31/12/01. Interest of Rs. 100/- for the previous year is unpaid. The bank expects to receive a total of Rs. 800/- towards principal in two annual installments (31/12/202 & 31/12/03) and Rs. 100/- towards interest along with first installment (see Table 1).

Based on Table 1, upon initial impairment recognition as of 31/12/01 an amount of Rs. 315/- will be charged to P/L account as ‘Impairment Loss Charge’ and credited to a balance sheet account called ‘Impairment Loss Provision’. In practice, two separate b/s account can be maintained to separately track impairment loss provision on gross basis and discounted basis. In the second year (31/12/02), there is a total reduction of Rs. 79/- in the impairment loss provision, which will be released to the P/L account. Of the total amount of release, reduction attributable to cash flow discounting is released under ‘interest income’ line and the balance as ‘Impairment Loss Charge’. In the above case, interest of Rs. 100/- received as of 31/12/2002 is applied towards interest unpaid as of 31/12/01. Further, no interest income other than unwinding of discount is recognised as the bank does not expect any interest payment. However, it can accrue the contractual interest and hold it in a suspense account. If the bank determines, no future prospects of recovery as of 31/12/03, loan o/s will be written off against impairment loss provision held. Additionally, subsequent changes in the expected cash flows or actual cash flows, if any, will affect the impairment loss recognition amounts of 31/12/02 or 31/12/03.

Conclusion

Impairment losses charged to P/L account will be based on ‘time value of money’ and therefore will be higher as compared to current accounting methods. In respect of CILA provision related approaches and income recognition principles of impaired assets, there are significant differences between the regulatory requirements and the International GAAP (IAS/IFRS). Also, there exist some differences vis-à-vis US GAAP. Extra caution needs to be taken while computing CILA provisions so that it does not result into recognition of losses expected to occur in the future. The CILA provision computations require a significant refinement/change from the current general loan loss provision methods and require adoption of a more scientific approach.

Table - 1

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<th>31/12/01</th>
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<tr>
<td>1</td>
<td>Principal &amp; Accrued Interest outstanding</td>
<td>1,100</td>
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<td>Expected Future Cash Flow incl interest –Gross</td>
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<td>3</td>
<td>Expected Future Cash Flow –Discounted @ 10%</td>
<td>785</td>
<td>364</td>
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<td>4</td>
<td>Impairment Loss Provision –Gross (1-2)</td>
<td>200</td>
<td>200</td>
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<td>5</td>
<td>Impairment Loss Provision -Discounted (1-3)</td>
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<td>236</td>
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<td>Additional impairment loss provision due to discounting (5-4)</td>
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<td>36</td>
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<td>7</td>
<td>Reduction in discount provision (unwinding of discount)</td>
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<td>(115-36)=79</td>
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