# Recognition of interest income and impairment allowance for credit-impaired assets

**This article aims to:**

– Illustrate the accounting for impairment allowance and interest revenue on credit impaired assets.

With Ind AS 109, *Financial Instruments,* banks in India would have to apply a forward looking model for computing impairment allowance on loans and other financial assets. When applying the Expected Credit Loss (ECL) model, Ind AS 109 specifies three different approaches for different types of financial assets, which are:

- *Simplified approach:* Adopted for trade and lease receivables, entities need to compute lifetime expected credit losses for these assets
- *General approach:* Adopted for financial assets, which are not credit impaired on initial recognition. Under this approach entities need to assess the stage allocation of the asset for computing either 12-month or lifetime ECL; and
- *Change in lifetime expected credit loss approach:* Adopted for assets that are credit-impaired on original recognition (POCI assets).

Financial assets are considered to be credit impaired when events that have a detrimental impact on the estimated future cash flows of the asset, take place. It may not be possible to identify a single discrete event that caused the asset to be credit-impaired. Instead, the combined effect of several events may cause financial assets to become credit-impaired.

In our previous article (refer issue no. 13/2017, August 2017), we illustrated the three stages to which financial assets may be allocated based on whether there has been a significant increase in credit risk or a default in repayment of their dues. Assets identified as credit impaired during their contractual period (i.e. not on original recognition) are allocated to stage 3.

There are certain assets that are considered to be credit impaired on original recognition (i.e. either on purchase of the asset or its origination). These are referred to as assets that are Purchased or Originated Credit Impaired (POCI). There are separate accounting considerations for the recognition, measurement and impairment of POCI assets which are not covered in this article.

This article aims to describe the approach that may be followed to recognise an impairment allowance and interest income on financial assets that are credit impaired (allocated to stage 3 post their initial recognition). Further, our article highlights some of the key differences between the accounting for stage 3 assets and current regulatory requirements for banking/ Non-banking Finance Company (NBFC) entities in India.

## Key characteristics of loan

Bank C had advanced a 12 year unsecured term loan of INR200 million at 15 per cent per annum (payable annually) to a telecom company, company P in 2010-11. The loan was repayable in 10 equal annual instalments with effect from 30 September 2013. The amount outstanding on 1 April 2018 is INR120 million. Effective Interest Rate (EIR) of the loan on initial recognition is 14.76 per cent. Bank C expects to hold the loan within a business model with an objective to collect its contractual cash flows, which are solely in the nature of principal and interest on the principal amount outstanding. It has therefore, classified and subsequently measured the loan at amortised cost.

Bank C has a credit risk department which monitors the entity's loan portfolio and reassesses its credit risk on an ongoing basis. Based on this monitoring, all exposures are allocated a credit quality rating or a risk grade. The entity's credit risk department also closely monitors high-risk loans that have been placed on a 'watchlist.'

Over the past two to three years, there was significant financial stress within the telecom sector. This adversely affected company P's financial performance. It reported losses and delayed repayment of two instalments by a period of 40 to 50 days. Due to these factors, bank C assessed the loan as 'high risk' and placed it on the bank's watchlist. Company P defaulted in the repayment of its annual principal and interest instalment due on 30 September 2017 by more than 90 days. The bank is in discussion with company P for restructuring its repayment schedule.

Bank C has not changed the terms of the loan. It expects to receive the principal and interest instalment pertaining to financial year 2017-18 by 30 April 2018. There is no change in timeline for the balance instalments, however, bank C expects that only 80 per cent of the total amount due (including interest) will be repaid by company P on an annual basis.

## Accounting issue

Bank C needs to determine whether the current market conditions and delays in repayment of dues indicate a significant increase in credit risk or indicate that the loan advanced to company P has become credit impaired, in accordance with its internal credit risk management policy. It also needs to determine the accounting treatment for the loan and the related recognition of impairment loss in accordance with Ind AS 109.

## Accounting guidance

Computation of interest revenue and ECL differs for assets in stages 1, 2 and 3 and for assets that are credit impaired on initial recognition. Figure 1 summarises the approach adopted by entities for computation of interest and ECL for POCI assets and other assets in the three stages.

**Figure 1: Approach adopted for computation of ECL and interest revenue on financial assets**

| Particulars | Stage 1 | Stage 2 | Stage 3 | POCI |
|---|---|---|---|---|
| | No significant increase in credit risk | Significant increase in credit risk | Asset becomes credit-impaired | Assets are credit impaired on original recognition |
| Impairment loss | 12-month ECLs | Lifetime ECLs | Lifetime ECLs | Change in lifetime ECLs |
| Interest revenue | Effective interest rate (EIR) applied to gross carrying amount | Effective interest rate (EIR) applied to gross carrying amount | EIR applied to amortised cost | Credit-adjusted EIR applied to amortised cost |

(Source: KPMG in India's analysis, 2017 read with Insights into IFRS, KPMG IFRG Ltd.'s publication, 14th edition September 2017)

## Analysis

Two critical concepts to be considered while computing ECL are determining (a) whether there has been a significant increase in credit risk of an asset, and (b) whether there has been a default in repayment of an asset. Ind AS 109 requires entities to define these in context of their specified assets based on their internal credit risk management practices. Entities may consider various quantitative, qualitative and backstop indicators when determining these.

*Significant increase in credit risk*

On 1 April 2017, the date of transition to Ind AS, bank C observed that the telecom industry was under financial stress, which had an adverse effect on company P's financial performance. It also resulted in company P delaying the repayment of the loan, and being placed on the watchlist of the bank. Ind AS 109 also specifies a 'backstop' indicator to determine whether there has been a significant increase in credit risk, i.e., when payments are more than 30 days past due. This factor, combined with other qualitative and quantitative factors indicated an increase in the probability of company P defaulting in the repayment of its loans. Hence, the bank assessed that there was a significant increase in the credit risk of the loan. On the date of transition, bank C was therefore required to recognise lifetime ECL on the loan (it was categorised as a stage 2 asset). Based on the assumption that the impairment allowance was estimated as INR12 million, the accounting treatment for the transaction is:

| Date | Accounting entry* | | Amount (INR in million) |
|---|---|---|---|
| 1 April 2017 | Recording the ECL on the loan on transition to Ind AS | | |
| | ECL allowance (Profit and Loss) | Dr | 12 |
| | ECL allowance (Balance Sheet) | Cr | 12 |

* We have ignored other transitional adjustments and tax effects for the purpose of this illustration

*Credit impaired assets*

Ind AS 109 defines financial assets as credit impaired when one or more events have taken place that have a detrimental impact on estimated future cash flows of the asset. In the current case study, company P had been reporting financial losses for the past two years and had been assessed as a high risk loan by the bank. Further, it delayed the repayment of the loan and interest due on 30 September 2017 by more than 90 days. Ind AS 109 presumes that an asset is in default no later than when it is more than 90 days past due. This presumption cannot be rebutted unless an entity has reasonable and supportable information to support a more lagging criterion of default. In the absence of supporting evidence that rebuts the 90 days past due presumption, bank C concludes that there has been a default on the loan advanced to company P. This default event, considered along with the current economic conditions, which are unlikely to improve in the near future, indicate that the loan advanced to company P is credit impaired as on 31 March 2018.

For credit-impaired financial assets (not being POCI assets), an entity measures the ECLs as the difference between:

- The gross carrying amount, and
- The present value of estimated future cash flows that the bank expects to receive, discounted at the assets' original effective interest rate.

**Computation of gross carrying amount of credit impaired assets**

The gross carrying amount of assets that become credit-impaired after initial recognition will be computed in the same way as for financial assets that are not credit-impaired. Accordingly, as on 31 March 2018, the gross carrying amount of the loan is approximately INR145 million**.

**Computation of present value of estimated future cash flows and ECL on the credit-impaired asset**

Bank C expects that only 80 per cent of the total instalments due will be repaid by company P (i.e. 80 per cent of principal and interest due on each instalment date). The present value of the estimated future cash flows, discounted at the original EIR of the loan is estimated at approximately INR123 million. Accordingly, the total ECL allowance on the credit impaired asset as on 31 March 2018 would be INR22 million.

** Amount computed considering legal costs as 2 per cent and processing fees as 1 per cent of the loan.

The approximate interest and ECL along with the accounting entries as on 31 March 2018 are:

| Date | Accounting entry | | Amount (INR in million) |
|---|---|---|---|
| 31 March 2018 | *Accrual of interest (as per normal provisions)* | | |
| | Loan | Dr | 16 |
| | Interest income | Cr | 16 |
| 31 March 2018 | *Estimated impairment allowance (ECL)* | | |
| | ECL allowance (Profit and Loss) (22-12) | Dr | 10 |
| | ECL allowance (Balance Sheet) (22-12[1]) | Cr | 10 |

*Computation of interest on credit-impaired financial assets*

Interest revenue on credit impaired assets is calculated by applying the EIR to the amortised cost of the asset in reporting periods subsequent to the asset becoming credit-impaired. In this case study, bank C assessed that the loan extended to company P had become credit-impaired on 31 March 2018. Hence, the interest revenue for the period 2018-19 will be computed by applying the original EIR (14.76 per cent) to the amortised cost of the asset, after considering any repayments during the year. This amounts to approximately INR11 million. The calculation of interest on a net basis only affects the recognition of income in profit or loss and does not affect the measurement of the gross carrying amount. The balance amount represents an increase in the allowance for estimated lifetime ECL for the period. Hence, the accounting entries for the gross carrying amount, interest income and ECL are given below:

| Date | Accounting entry | | Amount (INR in million) |
|---|---|---|---|
| 30 Apr 2018 | Cash/bank | Dr | 38 |
| | Loan | Cr | 38 |
| | (Loan instalment received on 30 April 2018) | | |
| 30 Sep 2018 | Cash/bank | Dr | 28 |
| | Loan | Cr | 28 |
| | (80 per cent of loan instalment received on 30 September 2018) | | |
| 31 Mar 2019 | Recording interest and ECL on the loan | | |
| | Loan | Dr | 14[2] |
| | Interest | Cr | 11[3] |
| | ECL allowance (increase in impairment allowance) | Cr | 3[4] |
| | (Interest accrued only on amortised cost and balance amount adjusted as additional ECL allowance) | | |

1. Additional impairment allowance to be recognised, being the difference between ECL computed at 31 March 2018 and 1 April 2017 respectively.
2. The gross carrying amount of the loan increases based on the interest accrued at the EIR on the previous gross carrying amount.
3. Interest is accrued at the EIR on the amortised cost of the loan (net of ECL previously recognised).
4. The increase in impairment allowance represents the interest income that is not expected to be collected by the bank but is included in the gross carrying amount of the loan.

## Regulatory provisions in India

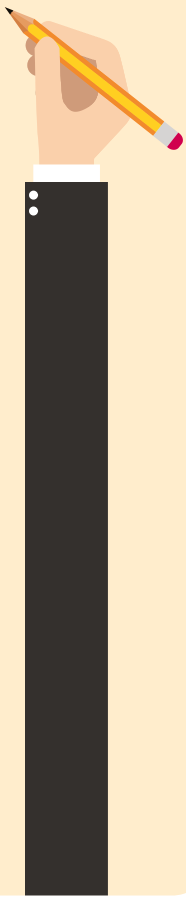
In India, the Reserve Bank of India (RBI) has issued prudential norms for income recognition, asset classification and provisioning for advances portfolio of banks (the norms). These norms provide guidance to banks for identifying Non-Performing Assets (NPAs) and recognising income on such assets.

As per the norms, a bank is generally required to consider a term loan as an NPA if the interest and/or principal thereon remain overdue (i.e. not paid on due date) for a period of more than 90 days.

The norms further specify, that the policy of income recognition has to be objective and based on the record of recovery. Hence, banks should not charge and take to income account interest on any NPA on accrual basis. Instead, it should be booked when it is actually received. Where interest income has been accrued prior to the loan becoming an NPA, it should be reversed if not realised. Accordingly, as per the current RBI regulations, the interest income of INR11 million, computed in accordance with Ind AS 109 would not be recognised in the financial statements. However, the norms permit banks to continue to record such accrued interest in a memorandum account in their books.

## Consider this

- Entities may leverage the existing regulatory processes to identify assets or portfolio of assets that have defaulted or have become credit-impaired. While doing this, entities should ensure that any indicators of default adopted by the regulator include the Ind AS 109 indicators of credit-impaired assets. Where the indicators included in the regulatory definition differ from those in Ind AS 109, the use of such regulatory definitions could lead to different results that may not comply with Ind AS 109.
- When there is no reasonable expectation of recovery of the entire or part of the gross carrying amount of a financial asset, it is reduced or written off. A write-off constitutes a derecognition event. It does not have an impact on profit or loss, because the amounts written off are reflected in the loss allowance.
- Credit-impaired assets should be moved back to Stage 2 once they are no longer considered credit-impaired and meet the internally established definition of 'cured'. Similar to the probation period[5], this may require certain conditions being met over a set time frame. Such conditions may include full recovery of previously missed payments and charges. Correspondingly, the calculation of interest revenue will revert to the gross basis in subsequent reporting periods.
- Conceptually, an entity would assess whether financial assets have become credit-impaired on an ongoing basis and reflect this assessment in the presentation of interest revenue. However, because this approach would be unduly onerous, an entity is only required to make assessment of whether a financial asset is credit-impaired at each reporting date and change the interest calculation from the beginning of the following reporting period. An entity is not precluded from adjusting the interest calculation more frequently if it assesses impairment more frequently.
- If in the above case study, bank C and company P had re-negotiated the terms of the loan, such that the loan was 'modified', and resulted in derecognition in the books of bank C, then the modified asset would have to be considered as a new asset by bank C. Accordingly, the date of modification would be treated as the date of initial recognition for the purpose of impairment. Such modification could be an evidence that the modified financial asset is credit-impaired on initial recognition.



5. Probation period is defined by the entity. It generally is a set time frame over which certain conditions are met, such as meeting certain number of contractual payments.