Impairment of Financial Assets

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< EXECUTIVE SUMMARY >

◆ Provision for Impairment of Financial Assets signifies the allowance made or considered reasonable by the management towards the probable event of non-collection of a debt or receivable. Developing reliable and adequate estimates to be reflected in the financial statements is the responsibility of the management. Assessing the appropriateness of principles, and methodology and adequacy of such estimates is a part of independent auditors duty.

In this article an attempt is made to highlight the salient principles of identifying and measuring Impairment of Financial Assets under different frameworks. Further, the principles are compared with the Indian accepted accounting principles to draw the differences and to focus on the areas of improvement based on the developments across the world.

INTRODUCTION

Provision for impairment of financial asset signifies the allowance made or considered reasonable by the management towards the probable event of non-collection of a debt or receivable. This is based on estimates developed by the management. Developing reliable and adequate estimates to be reflected in the financial statements is the responsibility of the management. Assessing the appropriateness of principles, and methodology and, adequacy of such estimates in order to confirm true and fairness of the financial statements is part of independent auditors duty. Assessment and adequacy of impairment of financial assets of entities in banking industry assumes higher importance as provision for non-performing assets and, loans and advances form significant elements of profit and loss account and balance sheet respectively.

In this article an attempt is made to highlight the salient principles of identifying and measuring impairment of financial assets under different frameworks. Further the principles are compared with the Indian accepted accounting principles to draw the differences and to focus on the areas of improvement based on the developments across the world.

Identification and measurement of impairment of financial asset, in view of being a subjective in nature, had been a central point of discussion worldwide. Several models or principles of measuring the impairment have been in practice under different frame works. This is an evolving topic with new concepts and factors influencing the assessment. Banking industry and entities

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involved in providing banking services, accounting bodies and members of profession directly contributed to this process. Industry practice and statues operating in the respective countries have also a bearing on evolution of these principles.

In this article I have restricted the area of discussion to the impairment of financial asset to debts arising from financing activities of banks and similar institutions. The discussion that follows is more with a focus on the banking industry and debts arising from banking business.

US GAAP

Under the US GAAP FAS 5 "Accounting for Contingencies" and FAS 114 "Accounting by Creditor of Impairment of a Loan" deals accounting for loan losses. Further Staff Accounting Bulletin 102 of SEC (this can be referred to on the internet at http://www.sec.gov/.), FIN 14 and Statement of Policy of Federal Financial Institutions Examination Council (the original policy statement can be referred to on the internet at http://www.ldic.gov/ under the section Federal Register Citations, Statements of Policy) also provide additional guidance on recognition, measurement, disclosure and documentation of the impairment to loan and loan portfolio.

The principles under these authoritative pronouncements came out after extended discussion among several accounting and enforcement agencies in US. The statements and standards issued under US GAAP generally visualise practical situations and hence, are more of prescriptive in nature.

FAS 5 Accounting for Contingencies lays down the principles of identifying impairment loss and FAS 114 recommends the steps and methods that should apply in measuring impairment of individual loans. Both the Statements of Financial Accounting Standards are complimentary to each other.

ACCRUAL FOR IMPAIRMENT

Per FAS 5

An estimated loss from contingency shall be accrued by a charge to income if both of the following conditions are met

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated.

A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. The statement however, does not specify how a creditor should determine that is probable that total amount per the contract is not collectible. A Bank or an entity engaged in banking activities should frame set of conditions or parameters based on which it would consider a loan or group of loan balances or receivables as impaired. The entities should lay down clear review procedures by which they would be able identify loans or receivables which are impaired. These review procedures or parameters may not be identical to all the banks, as it would depend on the composition and quality of its loan portfolio. The parameters and conditions relate to the performance of the loan or customer, willingness and ability to pay, the direction of business of the customer, the general trend of the industry, sector etc. The individual loans with unique risk attributes and portfolio of segmented loans should be evaluated with a set of parameters, appropriate to them, to determine if they are impaired.

GRADING

The statements recommends identification of the underlying risk characteristics of a loan to group them based on homogenous risk attributes. The accounting and regulatory bodies across the world are moving towards a framework where a loan can be identified and graded based on the underlying risk attributes of the loan. Risk attributes of a loan include risks relevant to the sector or industry in which the entity is operating or likely to operate, past history of the customer, type of loan, area in which the industry or customer is operating etc. All the sector or industries in an economy do not possess the same risk or reward attributes. Some of the industries carry higher rate of risk compared to other industries or sectors. Likewise all the entities or business groups do not possess identical risk quotient. Entities reputed for the business success carry lower risk quotient. The quantum of loan loss that might arise on account of impairment depends on the quality of the portfolio or receivables of an entity. A grading can be based on type of loan, sector, industry, region and risk attributes.

Loan grading is to facilitate evaluation and measurement of impaired loans of homogenous attributes. Significant individual loans and loans with unique risk

attributes may require separate analysis to assess impairment. Such loans should be separated from the total loan population of the bank.

MEASUREMENT

FAS 114 lays downs the methods of measurement of the impairment. Separate methods of measurement are prescribed to individual and graded loans. For measuring impairment of individual loans entities have an option to choose from methods such as net present value of the future cash flows, market value of the collateral if the loan is collateral dependent, and observable market price of the loan. Under net present value method the bank should estimate the realisable value of the underlying security and costs that may have to be incurred to realise the security. This would provide the management with an estimate of the amount realisable from the loan or receivable. Estimation of the future expected cash flows depends on the past experience of the entity, if any, and proper assessment of the realisable value of security, which in certain circumstances may have to be referred to experts. Management had to apply the original interest rate applicable to the loan or the market rate wherever applicable to discount the future cash flows. The net present value of the future cash flows discounted at appropriate rate should be deducted from the carrying value to quantify the amount of allowance for loan loss. This should be charged to the profit and loss account. The amount of allowance towards loan loss so assessed should be reviewed periodically to identify any movements and to provide or release the allowance based on such review.

Small loans with homogenous characteristics should be assessed for the their impairment based on the parameters set forth. If the bank or an entity is exposed to a particular sector or industry, which is currently under recession, then the entity might consider providing for impairment against the loan balances in the particular sector as allowance towards loan loss. Statistical information of over dues, dishonor of cheques, etc of the graded or segmented loans should also provide evidence of any likely event of non-collectibility of the receivables. Allowance may have to be considered appropriate even though the individual loan balances may be performing well in view of the fact that based on the assessment of impairment of the loan portfolio to which it belongs, it is probable that part of the loans within the portfolio are likely to be uncollected.

LOSS RATES

Management should apply loan loss rates on the portfolio balances (segmented/graded loans with homogeneous attributes) to arrive at the allowance of impairment of the loan portfolio. Loss rates have to be developed based on the past history/experience, trends of recovery, value of the underlying security, current developments and trends having a bearing on the recovery. These rates should be reviewed at periodical intervals to revise by taking current trends and developments.

The basis, assumptions and measurement methodology should be properly documented by each entity. The pronouncements under US GAAP strictly prohibit creation of reserves or provision on general basis to meet unspecified general risk to act as a cushion against any future contingency.

The following salient points emerge from the above discussion:

- Grading and segmentation into homogenous groups based on common risk attributes;
- Net present value of future cash flows to be estimated only in case of individual loan balances which are impaired;
- Loan loss rates to be developed and applied only in case of portfolio (segmented/graded loans) of loan balances.

IAS FRAMEWORK

International Accounting Standard 39 Recognition and Measurement of Financial Instruments lays down the principles of recognition and measurement of financial assets. Financial assets under IAS 39 are to be classified as trading, held to maturity, available for sale and originated loans and receivables. Trade debts and debts arising from financing activities fall under the category of originated loans and receivables. Originated loans and receivables are to be recognised at amortised cost initially and should be carried at amortised cost less provision for impairment, if any, subsequent to the initial measurement. The basic principles pronounced under the International Accounting Standards are similar to the principles under the US GAAP.

It is the duty of the entities to identify any financial asset, which might have been impaired based on objective evidence. IAS gives examples of objective evidence, which could have contributed to impairment of the financial assets. A fall in the market values, erosion of the net worth of the debtor, decline the market share, inability to meet the commitments may be some of the factors

which could indicate impairment of the financial asset. A financial asset is impaired if the carrying value is greater than the net present value of the future expected cash flows. The IAS allows assessment of impairment on individual financial assets whose carrying value is material or on a portfolio basis based on the common risk attributes. Subjective judgment of the management is required to reliably estimate three significant elements impairment assessment. They are, ability to identify an impaired financial asset based on objective evidence, estimate future cash flows based on the present condition of the debtor and underlying security, if any and selection of appropriate discounting rate for computing net present values. The difference between the carrying value and the net present value of the future expected cash flows is then charged to profit and loss either through a provision account or otherwise.

Under IAS net present value of all the impaired financial assets has to be computed to measure the impairment. Though the standard allows identification of impairment either on individual or portfolio basis it expects measurement of impairment on net present value method under both the situations. It assumes the possibility or ability of the entity to estimate expected future cash flows of portfolio of as well. In practice it is highly difficult to estimate future cash flows as compared to individual loans.

However, the prescription of only one method of measurement (net present value) should be understood in the background that International Accounting Standards Committee is discontinuation the practice of prescribing alternative methods of application of accounting principles to afford uniformity of financial statements prepared under IAS and to enable comparison. However, it would have been appropriate had the standard laid down method measurement separately for individual and portfolio loans.

INDIAN FRAMEWORK

There is no specific Accounting Standard under the Indian GAAP dealing with impairment of financial assets. The recently issued Accounting Standard 28 excludes financial assets from its scope, as was the International Accounting Standard on impairment of assets. Impairment of financial assets under the International Accounting Standards is dealt by IAS 39 recognition and measurement of financial instruments.

Under the Indian GAAP all the banks are required to comply with Reserve Bank of India circular for provision towards impairment of Non-Performing Assets (NPA). Guidance Note on Audit of Banks provides the guidelines to the auditors in discharge of their attest function in the audit of banks. The circular prescribes classification of advances based on criteria established for NP assets. Advances have to be classified as standard, substandard, doubtful and loss assets. The following rates have to be applied for calculating the provision towards impairment of Non Performing Assets:

Standard (not impaired)	- 0.25% of total outstanding balances
Sub- standard	- 10% of outstanding balance
Doubtful	- Full provision of unsecured portion after taking into account claim under DICGC/ECGC
Loss assets	- The entire outstanding amount should be written off or provided for

If any financial asset has significant underlying security then such advance should not be treated as loss assets. Unlike under other international frameworks discussed above, accepted accounting practice under the Indian statutes permit creation of general provision towards unspecified risks inherent in a financial assets. Auditor in discharge of his duties should ensure that the banks establish a minimum provision towards non- performing assets at the rates prescribed by Reserve Bank of India. If in the opinion of the auditors the provision established by the banks per the guidelines of RBI is not adequate to cover the likely non-collectibility of the debts, he may request upward revision of the provision. Strangely so, the auditor cannot recommend the level of provision, which is below the limits laid down by RBI circular. From the above guidelines of RBI it may be probable that all our banks might be overprovided due to the general provision to cover unspecified risk. Accepted practice in India definitely complies with the concepts of conservatism. It may be sound from the financial and viable health of the banks but may fall short of reflecting true and fair financial position of the bank.

The following are some of the areas of focus which may need a reevaluation.

RISK MODEL

The banks in India extend credit facility to various sectors and some banks exclusively cater to specific sectors. Agriculture is one of the sectors to which credit facilities are extended through specified banks and co-

operative banks. Specified banks also cater small and large-scale industries. The health of a bank is measured in terms of the underlying portfolio and the level of provision that is warranted on its NPA. Hence, there is a growing need to realize the inherent underlying inherent risk in the portfolio. All the banks are in the process of developing or have developed a enterprise wide risk model to effectively mitigate the business risks to optimize stakeholders value for his investment. The logical progression of this risk analysis would be to analyze the portfolio in to homogenous portfolio segments with similar risk attributes. This process may enable them to balance the composition of their risk in the portfolio and enable them to develop estimates towards provision for NPA on move realistic basis. The deregulation of Indian banking industry had made all the banks to assess their financial strengths and weaknesses. They are made to focus their attention on key risks and means of mitigating these risks.

The eventuality of a portion of the total of the loan portfolio remaining uncollected is a significant and certain risk and it is the result of the composition of the portfolio. Banks should develop a disciplined approach to assess and estimate the quantum non- collectibility and this should reflect the summary of the risk model. It might be unique to a bank or to banks with similar loan portfolio and it is most unlikely to be similar to all the banks across board. Hence, it may be appropriate to revaluate the provisioning policy followed in India with this background.

COMPARISON OF EXPERIENCE WITH ESTIMATES

Banks have accumulated knowledge and experience of over last 40 years in developing estimates towards NPA and actual loss on account of non-collection. It may be appropriate to compare the estimates made against a particular debt with the actual loss subsequently. This would provide a statistical evidence to determine how far are the estimates developed from the actual experience. This evidence should be used in developing estimates towards future provision for NPA after suitably giving effect to the current factors.

CONCLUSION

The following summarizes the principles of provisioning policy under the Indian accounting practice and the issues arising out of the same based on the above discussion:

- RBI circular expects identification of impairment on individual of loan basis. It does not allow classification or segmentation or grading based on homogeneous risk attributes;
- It applies the rates of loss on the individual loans without estimating the expected future cash flows from the realisation of security or from the borrower.
- Identification of NPA based on quantitative characteristics such as the period for which interest/principal amounts are overdue. The basis totally disregards or ignores the qualitative characteristics such as risk profile while assessing and identifying NPA;
- Absence of mechanism to test percentages per the actual experience;
- Absence of relevance of time value of money in the realisation of security
- Banks catering to different segments or sectors of the economy such industrial banks, housing banks, small-scale industries, export oriented credit etc are required to apply identical principles to measure the impairment without regard to the underlying performance of the sectors to which they cater.

The following are some of the advantages of the provision method under RBI rules:

- Uniformity in provision policies - across board to all banks affords comparability of the performance of the banks;
- This leaves little or no room to the discretion of the management of the banks in determining the quantum of the provision towards non performing assets

The following are some of the areas requiring attention towards refinement Classification of loan portfolio based on the risk attributes or homogeneous characteristics. This may be used for measuring impairment.

- Identification of impaired asset should also take into consideration the risk attributes of the loan or loan portfolio;
- Correlation enterprise risk analysis to the portfolio risk analysis
- It is accepted economic theory that all sectors or industries in an economy pass through different phases of growth. Industries and sectors in their recovery and growth phase carry lower risk rates as compared to industries in their recessionary phases.
- Industrial groups reputed for their business success carry lower risk characteristics. ■