2015

Bogle and Company

[Loan Loss provision as prescribed by IAS 39. (Banking industry)]

Impairment and uncollectibility of financial assets measured at amortised cost

An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets measured at amortised cost is impaired. If any such evidence exists, the entity shall apply (IAS 39.63) to determine the amount of any impairment loss. (IAS 39.58).

(IAS 39.59)A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following loss events:

(a) significant financial difficulty of the issuer or obligor;

(b) a breach of contract, such as a default or delinquency in interest or principal payments;

(c) the lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;

(d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

(e) the disappearance of an active market for that financial asset because of financial difficulties; or

(f) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

(i) adverse changes in the payment status of borrowers in the group (eg an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or

(ii) national or local economic conditions that correlate with defaults on the assets in the group (eg an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as 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 (ie the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss (IAS 39.63).

IAS 39 applied in Banking for Loan Loss Provision as interpreted by the International Monetary Fund (IMF)

IAS 39 recognizes that loss estimates may lie within a range of possible losses and directs entities to select the best estimate within a range of possible losses. While the use of experienced judgment in part reflects the nature of financial reporting,[1] further elaborations and examples from the IASB to clarify the meaning of 'objective evidence' would have assisted banks in implementing IAS 39 and may have improved the quantity and timeliness of provisions. IAS 39 requires the occurrence of a loss event or events (trigger events or objective evidence), with impairment losses being assessed and measured both on an individual and group basis. If no impairment loss is identified on an asset assessed on an individual basis, the asset is grouped with those that have similar credit characteristics, and impairment loss is estimated collectively for the group. Group assessment is considered an interim step, and once losses can be associated with an individual loan, the loan is removed from the portfolio. Even though formula-based approaches or statistical methods are allowed for group assessment, impairment losses assessed on a collective basis are not supposed to deviate from the incurred loss principle. IAS 39 considers these losses "incurred but not reported," which should be differentiated from credit losses that are expected to occur in the future under the prudential framework.

For individual assets, the amount of impairment losses is measured as the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). In practice, the measurement of impairment losses on a group basis can use historical loss experience adjusted with current observable data to arrive at present values of future cash flows.

The calculated impairment losses are recognized in the Income Statement. In contrast, credit losses expected as a result of future events, no matter how likely, are not reported in the Income Statement.[2] The carrying amount of the loan on the Balance Sheet is reduced either directly or through the use of an "allowance account."

[1] The standard explicitly supports the use of experienced judgment to estimate the amount of impairment losses. According to IAS 39, Paragraph 62, the use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

[2] The additional amounts set aside by an entity for foreseeable credit losses that cannot be supported by objective evidence are not reported as impairment losses in the Income Statement. See Annex 2.2 for financial reporting treatment of these amounts.

The information above have been taken from the unaccompanied Standards as issued by the International Accounting Standards Board (IASB) and the published paper of Ellen Gaston and In Won Song of the International Monetary Fund (IMF)