ICPAK

Uphold Public Interest

IFRS vs Prudential Guidelines

Interest revenue recognition on non-performing loans in IFRS financial statements

Preamble

There is currently a divergence between IFRS requirements and the Prudential Guidelines on the recognition of interest income on non-performing/credit-impaired loans and advances by banks in Kenya.

Furthermore, there are inconsistencies in the presentation and disclosures of the suspended interest income in the financial statements of banks in Kenya. This matter continues to generate conversations at various stake-holders forums, particularly on whether the financial statements comply with IFRS where no income is recognised on non-performing loans in accordance with the Prudential Guidelines.

Executive summary

An entity should not stop accruing interest on loans that are credit-impaired. When credit-impaired loans are reviewed for impairment, the collection or non-collection of the future interest payments would be taken into account in the estimation of future cash flows for the purposes of the impairment calculation. Interest income should subsequently be recognised as the discount unwinds.

Financial institutions reporting under IFRS should recognise interest income on the amortised cost of credit-impaired loans and advances (stage 3 loans) in line with IFRS 9 requirements.

If financial institutions do not treat interest income in accordance with IFRS, this may result in a material deviation from what should be in the IFRS financial statements/non-compliance with IFRS.

For regulatory reporting to CBK, the entities will need to continue applying the requirements to suspend interest on non-performing loans as mandated by the Prudential Guidelines.

Technical analysis - IFRS requirements

The recognition of interest revenue on financial assets is dealt with by IFRS 9 Financial Instruments which is effective for annual periods beginning on or after 1 January 2018.

Interest revenue recognition

Interest revenue shall be calculated by using the effective interest method [IFRS 9.A, B5.4.1-B5.4.7]. This is calculated by applying the effective interest rate (EIR) to the gross carrying amount of a financial asset except for purchased or originated credit-impaired financial assets (POCIs) and financial assets which have subsequently become credit-impaired [IFRS 9 5.4.1.a and b]. This is further analysed below.

Stage 1 (Performing financial assets)

When a loan is originated or purchased, expected credit losses (ECLs) resulting from default events that are possible within the next 12 months are recognised (12-month ECL) and a loss allowance is established. On subsequent reporting dates, 12-month ECL also applies to existing loans with no significant increase in credit risk since their initial recognition.

Interest revenue is calculated on the loan's gross carrying amount (that is, without deduction for ECLs).

Stage 2 (Under-performing financial assets)

If a loan's credit risk has increased significantly since initial recognition and is not considered low, lifetime ECLs are recognised.

The calculation of interest income is the same as for Stage 1.

Stage 3 (Non-performing (credit-impaired) financial assets)

For credit-impaired financial assets, interest revenue is calculated by applying the EIR (or credit-adjusted EIR if the asset was credit-impaired on initial recognition) to the amortised cost (that is, after deduction of ECLs) of the asset in subsequent reporting periods. An asset is credit-impaired if:

— It was credit impaired on initial recognition (POCI asset); or
— It became credit-impaired after initial recognition. [IFRS 9.5.4.1]

For an asset that became credit-impaired after initial recognition, interest revenue is calculated by applying the EIR to the amortised cost of the asset in reporting periods subsequent to the asset becoming credit-impaired. The calculation of interest revenue reverts to the gross basis in subsequent reporting periods if the asset is no longer credit-impaired. However, for POCI assets, the calculation of interest revenue can never revert to a gross basis, even if the credit risk of the asset improves. [IFRS 9.5.4.1 – 5.4.2].

If a financial asset becomes credit-impaired after initial recognition, when should the basis of calculation for interest revenue be changed?

IFRS 9.5.4.1(b) refers to applying the effective interest rate to the amortised cost of loans and advances (financial assets) “in subsequent reporting periods”.

In the basis for conclusions paragraph to IFRS 9, the IASB noted that, 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 income. However, because this approach would be unduly onerous, an entity is only required to make the 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. [IFRS 9.5.5.3, BC5.78]

The term ‘reporting period’ refers to a period for which financial information is externally published in accordance with IFRS Standards (i.e. interim financial reports as defined in IAS 34 Interim Financial Reporting or annual financial statements as defined in IAS 1 Presentation of Financial Statements).

To illustrate, a loan becomes credit-impaired after initial recognition at 15 May 2018. The next financial statements reporting date is 31 December 2018 however as required by the Central Bank of Kenya, the bank is required to publish quarterly information as at 30 June 2018 and 30 September 2018. The subsequent reporting period would therefore commence on 1 July 2018. The entity produces internal monthly management reports.

The entity is required to calculate interest revenue by applying the effective interest rate to the gross carrying amount of the loan for the reporting period to 30 June 2018. It is then required to change the basis of calculation for interest revenue in accordance with IFRS 9.5.4.1(b) from 1 July 2018.

The fact that the entity produces an internal monthly report for May 2018 does not change this assessment because the month covered by that internal management report is not a reporting period as defined in IFRS Standards and, consequently, 1 June 2018 cannot be considered to be the beginning of a new reporting period.

Technical analysis – CBK Prudential Guidelines requirements

Provisioning of loans is governed by the Prudential Guideline (January 2013) on risk classification of assets, provisioning and limitation of interest recoverable on non-performing loans (CBK/PG/04) as issued by the Central Bank of Kenya.

CBK/PG/04 Section 3.6 states that 'When a loan is classified to non-performing category, an institution should either cease the accrual of interest or continue to accrue interest suspended in accordance with the criteria set out in this guideline and should not be treated as income. Interest in suspense shall be taken into account in the computation of provisions for non-performing loans'. For non-performing loans, the percentage provisions (as stated in CBK/PG/04 Section 3.6 (b)) are applied to the net balances after deduction of the realisable value of the security and interest in suspense.

Further, CBK/PG/04 Section 1.4.5 of the Prudential Guidelines defines interest in suspense as interest accrued on non-performing loans that is not recognized as income in an institution's income statements. The question that arises is whether the suspension of interest in the financial statements of banks to comply with the above guidelines meet the requirements of International Financial Reporting Standards (IFRSs).

Under IFRS, an entity should not stop accruing interest on loans that are credit-impaired. When credit-impaired loans are reviewed for impairment, the collection or non-collection of the future interest payments would be taken into account in the estimation of the present value of future cash flows for the purposes of the impairment calculation. Interest income would be recognised on the amortised cost as the discount unwinds.

Additionally, IFRS 9 states that financial assets for which there is evidence of impairment (i.e. credit impaired loans) lifetime Expected Credit Losses are recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance).

Financial institutions reporting under IFRS should recognise interest income on credit-impaired loans and advances (stage 3 loans) in line with IFRS 9 requirements as explained above.

If financial institutions do not treat interest income in accordance with IFRS, this may result in a material deviation from what should be in the IFRS financial statements/non-compliance with IFRS.

Other considerations

Prior year adjustments considerations (if applicable/necessary)

Where, in prior years, an entity did not recognise interest income on non-performing loans as revenue in accordance with IAS 39 AG93, management should apply the following guidance in assessing whether the suspension of interest in the prior periods constituted an error in terms of IAS 8.

(a) Materiality

The entity shall consider materiality when assessing a prior period error. IAS 8 para 5 states that omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

(b) Correction of prior period errors

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. [IAS 8.5]

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretation of facts, and fraud.

Errors can arise in respect of the recognition, measurement, presentation or disclosure of elements of financial statements.

It would be inappropriate to make, or leave uncorrected, immaterial departures from IFRSs to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

Potential current period errors discovered in that period are corrected before the financial statements are authorised for issue. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period [IAS 8.42-47].

An entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

- restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented. [IAS 8.42]

Presentation

IAS 1.40 A requires an entity to present a statement of financial position as at the beginning of the preceding period (third statement of financial position) if:

(a) it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and

(b) the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the third statement of financial position.

Conclusion

Based on the above guidance, the regulatory requirement to suspend interest on impaired/ non-performing loans is not in compliance with the requirements of IFRS. Therefore, to comply with the requirements of the IFRS 9 entities should recognize interest on the amortised cost of credit-impaired loans in their IFRS financial statements.

For regulatory reporting to CBK, the entities will need to continue applying the requirements to suspend interest on non-performing loans as mandated by the Prudential Guidelines.

Appendix

Defined terms [IFRS 9.A]

Amortised cost of a financial asset or liability
The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance. [IFRS 9.5.4.1]

Credit adjusted effective interest rate
The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the amortised cost of a financial asset that is a purchased or originated credit-impaired financial asset. When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and expected credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate [IFRS 9 B5.4.1 B5.4.3], transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Credit-impaired financial assets
A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:

(a) significant financial difficulty of the issuer or the borrower;
(b) a breach of contract, such as a default or past due event;
(c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
(d) it is 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) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event—instead, the combined effect of several events may have caused financial assets to become credit-impaired. [IFRS 9 5.4.1, 5.5.13 and B5.5.33]

Effective interest method
The method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

Effective interest rate
The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses.

The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate [IFRS 9 B5.4.1–B5.4.3], transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Gross carrying amount of a financial asset

The amortised cost of a financial asset, before adjusting for any loss allowance.

Purchased or originated credit-impaired (POCI) financial asset

Purchased or originated financial asset(s) that are credit-impaired on initial recognition.

Transaction costs

Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability [IFRS 9 B5.4.8]. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

References

IFRS 9 Financial Instruments

IAS 8 Accounting policies, changes in accounting estimates and errors

IAS 1 Presentation of Financial Statements

CBK Prudential Guidelines (January 2013)