BANK OF MAURITIUS

Guideline on Credit Impairment Measurement and Income Recognition

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1.0 Introduction

This Guideline is issued to all deposit-taking financial institutions regulated by the Bank of Mauritius. The Companies Act 2001, which came into effect on 1 December 2001, requires all companies to prepare their financial statements in accordance with International Accounting Standards issued by the International Accounting Standards Board (IASB). A prime focus of this Guideline is the International Accounting Standard 39 (IAS 39), entitled 'Financial Instruments: Recognition and Measurement'. This Standard deals with, among other things, the impairment and uncollectability of financial assets. The Standard was undergoing revisions recently and the revised Standard applies to annual periods beginning on or after 1 January 2005.

The objective of this Guideline is to ensure that financial institutions have adequate processes for determining allowance for credit losses, the carrying amounts of credit portfolio represent recoverable values, and there is timely recognition of identified losses.

The Guideline also applies to the leasing operations of financial institutions. In defining the scope of IAS 39, its paragraph 2 (b) states that the derecognition and impairment provisions of the Standard apply to lease receivables recognised by a lessor.

The Bank of Mauritius subscribes to the application of International Accounting Standards to financial institutions, which together with any additional prudential requirements of the Bank for their safety and soundness, provide a sound basis for determining the results of their credit operations, and provide meaningful public disclosure of information.

The Guideline is not intended to deal with each and every provision of IAS 39 pertaining to impairment and uncollectability of financial assets. Financial institutions are advised to refer directly to the Standard for complete treatment of the subject. The use of the word 'loan' in the Guideline should be interpreted in the broader sense of 'credit', defined in paragraph 2, unless indicated otherwise.

The Guideline is issued under the authority of the Bank of Mauritius Act 2004 and the Banking Act 2004, in particular section 50 of the former and section 100 of the latter. It supersedes the existing Guideline on Credit Classification for Provisioning Purposes and Income Recognition.

2.0 Interpretation

In this Guideline,

"allowance for credit losses" is a cumulative account maintained by a financial institution, representing the estimated credit-related losses existing in its entire portfolio of on and off-balance sheet items, in accordance with this Guideline. For credit and finance leases, it represents the excess of the recorded investment in them over their estimated realisable value. In the balance sheet of a financial institution, the allowance is (i) deducted from the

applicable asset for balance sheet items, and (ii) included in the liabilities for off-balance sheet items.

“carrying value” of a credit asset or group of credit assets is its (their) recorded investment less related allowances for credit losses and write-offs.

“credit” means loans and advances by whatever instrument granted and includes customers’ lines of credit, overdrafts, bills purchased and discounted, bills receivable, and finance leases.

“effective interest rate” means the contractual interest rate on a loan adjusted for (i) fees and related costs recognised as an adjustment of yield on the loan and (ii) any discount or premium on the loan.

“financial institution” means any deposit-taking body or person regulated by the Bank of Mauritius.

“foreclosed loan” means assets acquired in full or partial settlement of a loan through realisation of collateral or repossession of leased property.

“independent appraiser” means an appraiser who

- is a Chartered Valuation Surveyor certified by the Mauritius Institute of Surveyors, or equivalent as approved by the Bank of Mauritius, or a surveyor certified by an appropriate foreign authority for appraisal of a property located in a foreign country;
- has no direct or indirect financial interest in the property being appraised, or in the transaction involving the financial institution in respect of that property; and
- has no credit granting or investment decision-making authority within the financial institution.

“large credit” is a credit of

- Rs 5 million or over for a bank that has a capital base in excess of Rs 750 million or equivalent if the amount is stated in U.S dollars,

- Rs 2 million or over for a bank that has a capital base of less than Rs 750 million or equivalent if the amount is stated in U.S dollars.

“loan” is a financial asset of a financial institution resulting from commitment of the borrower to repay the amount borrowed on a specified date or dates, or on demand, usually with interest. Loans include:

- consumer instalment and credit card loans;

- residential mortgages;
- non-personal loans, such as commercial mortgages and loans to businesses, financial institutions, government and its agencies;
- loan substitutes, such as debentures that are, in substance, loans; and
- direct financing leases and other financing arrangements that are, in substance, loans.

"provision for credit losses" is an expense account for credit related losses recognised during the year, based on a financial institution's estimate of such losses in respect of on and off-balance sheet items that are assessed to be impaired during the year, in accordance with this Guideline.

3.0 Impairment Recognition and Measurement Policy

A financial institution must implement an effective credit risk management and control policy, supplemented by effective credit impairment recognition and measurement policy. The policies must be supported by appropriate accounting and documentation processes, information systems, and internal controls to ensure their integrity.

3.1 Formulation of Policy

The recognition and valuation of credit instruments, individually or in groups, will involve implementation of appropriate rules for the purpose, and the exercise of prudential judgment by management of a financial institution. In formulating and implementing its loan impairment recognition and measurement policy, the institution must:

- establish properly documented analytical framework and procedures for assessing loan quality, which are applied consistently and contain a proviso that loan quality assessment shall be carried out and reflected in financial statements no less frequently than quarterly or a shorter interval, if warranted, to ensure the adequacy of allowance for credit losses;

- ensure that all estimates of cash flows in realisation of loans assessed individually, are reasonable, based on supportable assumptions, and backed by effective internal controls, including a second review of estimates on large credits, and supported by proper documentation;

- for loans assessed on a 'portfolio' basis, ensure that it has in place a rational process for aggregating loans in the portfolio into individual groups having similar characteristics, and the application of effective methodology for determining loss estimates;

- ensure that any impact of changes in general economic activity or sectoral conditions is based on sound assumptions to produce conservative results;

- establish a program of periodic monitoring and analysis of collateral taken in loans to ensure that their appraised values and estimated realisation values in the event of loan foreclosure, are realistic and supported by proper documentation;

- employ suitably qualified staff to assess the loan recovery prospects and subsequent follow-up, with appropriate segregation of duties between those responsible for original analysis and approval of credit and the ones engaged in impairment assessment; and

- ensure that all analytical work carried out, methodology applied and any changes thereto, and management's judgment exercised, are properly documented and duly validated by signatures of individuals responsible.

3.2 Role of the Board of Directors

Taking account of the factors listed in paragraph 3.1, the board of directors of a financial institution must:

- establish credit risk management policy, including credit impairment recognition and measurement policy, the associated internal controls, documentation processes, and information systems;

- review at least once a year the policies and the associated controls and systems;

- ensure through audit and inspection, adherence to the policies; and

- review, either itself or through a board committee, valuations of all impaired credits of the size that could individually affect adversely the financial well-being of the bank.

In the case of the branch operation of a foreign bank, the above responsibilities of the board shall be ascribed to the head office or to a committee in Mauritius designated for the purpose by the head office.

4.0 Application of IAS 39 in Assessing Credit Impairment

The part of IAS 39 dealing with Impairment and Uncollectability of Financial Assets is reproduced in Appendix A. Paragraph 58 of the Standard states

> "An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss."

The two operative concepts in the above paragraph are to have 'objective' evidence that an asset may be impaired, and to determine the amount of any impairment loss.

4.1 'Objective' evidence

'Objective' evidence provides the trigger point for launching an investigation into the impairment of the financial asset to assess the degree of its impairment. The Standard lists the following items of 'objective' evidence:

- "significant financial difficulty of the borrower;
- an actual breach of contract, such as a default or delinquency in interest or principal payments;
- granting by the lender to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, of a concession that the lender would not otherwise consider;
- a high probability of bankruptcy or other financial reorganisation of the issuer;
- recognition of an impairment loss on that asset in a prior financial reporting period;
- the disappearance of an active market for that financial asset due to financial difficulties; or
- a historical pattern of collections of accounts receivable that indicates that the entire face amount of a portfolio of accounts receivable will not be collected."

It should be underlined that according to the above criteria, when a borrower misses a contractual instalment payment on interest or principal, his loan is forthwith designated for an **assessment** of the degree of impairment. This assessment must be completed within 60 days of the first indication of impairment.

Additional sources of evidence of impairment that should merit investigation and assessment, include:

- Funds obtained under the loan agreement were not used for the purpose for which they were loaned;
- The project financed by the loan has become non-viable e.g. a failing restaurant;
- The borrower is about to default and the lender advances it funds to meet its current payment obligations;

- The borrower belongs to a group of entities that has credits outstanding from the financial institution or other financial institutions and one or more members of the group have defaulted;

- The borrower is engaged in a large number of undertakings leading to over-extension of its resources. It has begun shifting support from one undertaking to another, which may lead to potential delinquency of the loan under review;

- In case of an overdraft, further elements to be considered are the expiry of the approved overdraft limit, and the customer exceeding the approved limit frequently;

- The underlying collateral, which was heavily relied upon in granting the loan, has lost value significantly; or

- There is a loss of confidence in the borrower's integrity.

4.2 Estimation of Recoverable Value

Estimated recoverable value of loans shall be determined either individually or on a 'portfolio' basis. All credits designated for assessment of impairment, using the tests outlined in Paragraph 4.1, shall be assessed individually for estimation of recoverable amounts. All other credits shall be assessed on a 'portfolio' basis.

4.2.1 Individually Assessed Credits

The estimation of recoverable amount of individually assessed credits shall be carried out in the context of broad principles enunciated in paragraph 63 of IAS 39. Future cash flows on credit shall be based on reliable evidence for determining amounts recoverable. The estimation process shall be based on the following factors:

- Assessment of the financial condition of the borrower and the group to which it belongs;

- Assessment of the debt service capacity of the borrower (adequate generation of cash flow) to discharge its contractual obligations on a continuing basis;

- evaluation of any up-to-date business plan of the borrower;

- Regularity of the borrower's past payment record;

- Lender's confidence in the integrity of the borrower;

- In case of a loan to a related party, an evaluation of all factors impinging on the timely recovery of the loan, including seriousness of efforts made by the bank for the recovery;

- In case of a foreign borrower, an assessment of all practical aspects of achieving recovery, including the legal enforceability of loan and related instruments;
- Evaluation of the continued viability of the project financed by the loan;
- Current economic and other conditions, including emerging trends, affecting the industry sector relevant to the borrower;
- Evaluation of country risk applicable to the loan project;
- Length of timeframe for achieving recovery; longer the time period, lesser is the certainty of obtaining recovery;
- Any down-grade of the borrower's credit rating by a reputable rating system or agency;
- Further default occurring in a restructured loan;
- Assessment of value of any personal guarantee of the borrower or guarantee of another party;
- Assessment of the net realisable value of the collateral for the loan.

In assessing future cash flows emanating from an impaired loan, it is not necessary that several of the above factors must be present before it is judged that the flows will be substantially reduced or non-existent. A single factor, such as vulnerable financial condition of the borrower, may justify making an appropriate provision for the loan.

A critical element in the estimation of future cash flows in respect of large credits to businesses that are past due 180 days or more is the existence of a reliable business plan, with attributes outlined in paragraph 4.2.1.1 below. Similarly, large credits to retail clients must be supported by a reliable repayment plan, as outlined in paragraph 4.2.1.2. Retail credits that are not large must also be supported by a repayment plan, which may not be as formal as for large credits. Future cash flows not supported by an acceptable business plan or a repayment plan shall be construed as unrealistic and inappropriate for determining the recoverable value of a credit. In such a case, the recoverable value of the credit shall be limited to the net realisable value of any collateral securing the credit. For business credits other than large credits, it would be appropriate to accept a less formal business plan, but which provides a reasonable indication of cash flows to be generated by the borrower to honour his credit obligations.

In case of a large overdraft facility (meeting the definition of 'large credit'), if a client's approved limit has expired or does not exist or if it does exist, the client has exceeded it by 10 per cent for a period of 30 days and the excess has not been approved by the financial institution's board of directors or a designated board committee, the excess amount shall be viewed as unrecoverable for the purposes of assessing credit impairment and making a

provision for credit losses. In the calculation of the excess amount, any deposit of the customer held by the financial institution may be netted off, providing that it is legally permissible and there is a formal agreement with the customer permitting such offset. Any approval of the excess by the board or board committee shall require effective application of prudential assessment criteria as if the overdraft was a new loan. Any such assessment shall be properly documented. Financial institutions must also rigorously monitor overdraft facilities that do not meet the definition of 'large credit' and establish appropriate criteria for assessing impairment and making a provision for credit losses.

In determining the net realisable value of loans, it would be appropriate to first calculate the difference between the carrying amount of the loan and present value of expected future cash flows as required by IAS 39 and then deduct the discounted net realisable value of the collateral. The ultimate amount will determine the provision for credit losses, to be charged to profit and loss.

All work done, accounting for the applicable criteria in paragraph 4.2.1, in the estimation of the recoverable amount of an individual loan, including judgments made by management, shall be properly documented and validated.

4.2.1.1 Business Plan

An important element in the calculation of the recoverable amount of an impaired large credit to a business customer is the existence of its up-to-date business plan. Reliance placed on the plan will depend on several factors, including whether the plan

- is prepared in a professional manner;
- is sufficiently comprehensive to cover all essential elements;
- uses realistic assumptions;
- uses market and other projections that are soundly based and reasonable;
- envisages use of qualified management resources for implementation of the plan; and
- clearly outlines a realistic strategy for achieving the plan's objectives.

In their regular audit of impaired loans of a financial institution, the auditors must review the adequacy of a borrower's approaches to developing its business plan and the plan's scope, as contained in the bank's files, to ensure that it provides a reasonable basis for loan recovery and that the extent of the impairment has accordingly been fairly recognised in the books of the financial institution.

4.2.1.2 Repayment Plan of a Personal Loan

The repayment plan in respect of an impaired personal loan mentioned in paragraph 4.2.1, must have adequate attributes to demonstrate its soundness. These will include:

- the borrower's analysis of the causes of loan impairment and specific changes envisaged to make the loan performing again;

- delinquencies of any previous credits of the bank or any other bank to the borrower and an explanation of why the circumstances surrounding those delinquencies do not apply to the present credit;

- a clear identification of sources of funds, which will generate sufficient flows on a continuing basis to honour the loan obligations;

- control of the borrower over such sources and identification of risks that might impair their availability; and

- other information supporting the bonafides of the borrower.

4.2.1.3 Collateral

Another important factor in the calculation of the credit loss provision is the value of collateral. The following pre-conditions must be met in determining the appraised value of collateral:

- Appraised value of collateral is based on a conservative view of current market prices, suitably discounted for price volatility and the lack of ready market for assets. All realisation costs, including legal costs, must be taken into account.

- Realisable value of collateral is supported by a written opinion of an independent and qualified appraiser. Management of the financial institution must ensure that the appraisal is reasonably comprehensive, up-to-date and based on assumptions acceptable to it. If the Bank of Mauritius deems it necessary, it may require the institution to have the appraisal carried out, at the institution's expense, by another independent appraiser.

- For any loans past due 540 days or more, proper legal action in the court for the realisation of collateral has been commenced.

The past experience with foreclosed loans indicates that the net realisable value of collateral has not generally exceeded 50 per cent of its appraised value. Unless the financial institution presents reasons to the contrary acceptable to the Bank of Mauritius, the value to be considered in determining the recoverable amount of an impaired loan shall not exceed 50 per cent of the appraised value of collateral, discounted to its present value using the loan's effective interest rate. In case the loan is overdue by 360 days and proper legal action in court for realisation of the collateral has not commenced, the limit shall be 40 per cent. The above limit will not apply to collateral of liquid assets.

Where a financial institution is convinced that it is not going to recover the outstanding amount of the loan, in part or in full, it must take steps to write-off the unrecoverable amount.

Appendix B contains an example of the accounting entries required for an individually assessed impaired loan.

4.2.2 ‘Portfolio’ Assessed Loans

Loans that have not been individually assessed for impairment, will be assessed on a ‘portfolio’ basis. Although there is no current evidence that loans in the ‘portfolio’ are impaired, past loan loss experience indicates that some of them will become non-performing over time.

‘Portfolio’ loans will be divided into groups with similar characteristics and loss attributes, and evaluated for impairment. In determining provision for credit losses for the groups, factors such as past loan loss experience and current economic and other relevant conditions, including known adverse economic conditions likely to affect sectoral financial performance, will be taken into account.

Provision for credit losses on such loans may be assessed using cash flow process envisaged in IAS 39, applying weighted average of effective interest rates. The Bank of Mauritius has not been able to identify any convincing reasons that the use of a more direct approach of applying past loan loss experience adjusted for current economic and credit conditions in Mauritius, will produce results materially different from those attained in the discounted cash flow approach. The Guideline requires that all loans, regardless of size, meeting the criteria of objective evidence of impairment outlined in paragraph 4.1, will be assessed individually for impairment loss.

Financial institutions shall classify loans in the ‘portfolio’ into groups with similar credit risk characteristics, for calculating credit loss provisions. They may use the discounted cash flow approach or the more direct approach mentioned above in assessing the loan loss provisions. However, unless a financial institution makes a case acceptable to the Bank of Mauritius that its loan loss experience has been different, the percentage of loan loss provision to aggregate amount of loans in the entire ‘portfolio’ shall be no less than 1 per cent. If a loan is supported by a collateral of liquid assets, the amount of the liquid collateral will be offset against the amount of the loan for ‘portfolio’ based provisioning. The requirement of the 1 per cent shall not apply to credits extended directly to the Government of Mauritius or to public sector enterprises backed by Government of Mauritius guarantees.

The credit impairment provision for the ‘portfolio’ will be charged to profit and loss for the year in accordance with paragraph 63 of IAS 39. If a loan in the portfolio becomes impaired (according to paragraph 4.1), it will be withdrawn from the ‘portfolio’ and assessed individually for determining the extent of impairment.

4.3 General Provision

IAS 30 (paragraph 44) sets out the circumstances under which a general provision may be established. It states that "Any amounts set aside in respect of losses on loans and advances in addition to those losses that have been specifically identified or potential losses which experience indicates are present in the portfolio of loans and advances should be accounted for as appropriations of retained earnings." The general provision is over and above the provision made on loans assessed individually, or on a 'portfolio' basis where judgment is made on the basis of past experience.

In line with IAS 30, the Guideline envisages the establishment of a general provision to ensure the adequacy of the overall allowance for credit losses. It will be designed to cover potential losses that are not captured in the allowances for individually assessed loans and 'portfolio' loans. Factors in support of a general provision are normally future-oriented and may include:

- potential financial crises giving rise to credit losses that were not previously anticipated;
- emerging changes in lending policies of the bank, its loan review system, ability and depth of its credit department, estimation of risks, and quality of oversight exercised by the board of directors;
- further changes in general economic and business conditions, recent loan loss experience, trends in credit quality and credit concentrations;
- changes in competition faced by the bank and legal and regulatory requirements; and
- emerging changes in the risk profile of the overall credit portfolio.

Management of a bank shall exercise its best prudential judgment in the light of the above factors to determine the amount of the general provision. The provision so determined shall be established as an appropriation of retained earnings of the bank.

5.0 Income Recognition

Financial institutions may accrue income on the present value of the recoverable amount of an individually assessed impaired loan, using the effective interest rate. However, appropriate adjustments shall be made if at the next review of the loan, it is determined that cash flows will not be in accord with the flows originally estimated.

6.0 Role of External Auditors

Financial institutions shall require their auditors to attest to the adequacy of processes used in determining credit loss allowances and the adequacy of total allowance. Any

deficiencies in the allowance or the processes used shall be duly recorded in the auditors' 'opinion' or management letter, depending on their materiality.

7.0 Returns

The Bank of Mauritius may require such data from financial institutions as it deems fit to ensure compliance with the requirements of the Guideline.

8.0 Commencement

This Guideline shall come into effect forthwith.

Bank of Mauritius
November 2004

Appendix A

Excerpts from IAS 39 on Impairment and Uncollectibility of Financial Assets

Impairment and Uncollectibility of Financial Assets

58. An entity shall assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. If any such evidence exists, the entity shall apply paragraph 63 (for financial assets carried at amortised cost), paragraph 66 (for financial assets carried at cost) or paragraph 67 (for available-for-sale financial assets) to determine the amount of any impairment loss.

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 event that occurred after the initial recognition of the asset (a 'loss event') and that loss event has impact on the estimated future cash flows of the financial asset or group of financial assets. 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).

60. The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

61. In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.

62. In some cases the observable data required to estimate the amount of an impairment loss on a financial asset may be limited or no longer fully relevant to current circumstances. For example, this may be the case when a borrower is in financial difficulties and there are few available historical data relating to similar borrowers. In such cases, an entity uses its experienced judgement to estimate the amount of any impairment loss. Similarly an entity uses its experienced judgement to adjust observable data for a group of financial assets to reflect current circumstances (see paragraph AG89). The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

Financial Assets Carried at Amortised Cost

63. If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried 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.

64. An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant (see paragraph 59). If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

65. If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal shall be recognised in profit or loss.

Financial Assets Carried at Cost

66. If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be reliably measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (see paragraph 46(c) and paragraphs AG80 and AG81). Such impairment losses shall not be reversed.

Available-for-Sale Financial Assets

67. When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that had been recognised directly in equity shall be removed from equity and recognised in profit or loss even though the financial asset has not been derecognised.

68. The amount of the cumulative loss that is removed from equity and recognised in profit or loss under paragraph 67 shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss.

69. Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale shall not be reversed through profit or loss.

70. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss shall be reversed, with the amount of the reversal recognised in profit or loss.

No Active Market: Equity Instruments

AG80. The fair value of investments in equity instruments that do not have a quoted market price in an active market and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that instrument or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

AG81. There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument (see paragraphs 46(c) and 47) is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party. However, if the range of reasonable

fair value estimates is significant and the probabilities of the various estimates cannot be reasonably assessed, an entity is precluded from measuring the instrument at fair value.

AG84. Impairment of a financial asset carried at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a loan, receivable or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset carried at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

AG89. Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Interest Income After Impairment Recognition

AG93. Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Appendix B

Example of Accounting for impaired loan

This example is intended to be illustrative only. Any matters of principle should be decided in the context of IAS 39 and this Guideline.

Scenario

ABC Bank Ltd (ABL) grants a loan of Rs 1,200,000 to XYZ Co Ltd on 1st January 2002, under the following terms:

Loan amount:	Rs 1,200,000
Interest rate:	1% per month
Repayment:	Rs 106,618.55 at the end of each month.
Security:	Lien on two lorries belonging to the company

The repayment schedule was given as follows:

	Opening Balance	Interest	Total	Repayment	Closing Balance
31-Jan-02	1,200,000.00	12,000.00	1,212,000.00	106,618.55	1,105,381.45
28-Feb-02	1,105,381.45	11,053.81	1,116,435.26	106,618.55	1,009,816.71
31-Mar-02	1,009,816.71	10,098.17	1,019,914.88	106,618.55	913,296.33
30-Apr-02	913,296.33	9,132.96	922,429.29	106,618.55	815,810.74
31-May-02	815,810.74	8,158.11	823,968.85	106,618.55	717,350.30
30-Jun-02	717,350.30	7,173.50	724,523.81	106,618.55	617,905.26
31-Jul-02	617,905.26	6,179.05	624,084.31	106,618.55	517,465.76
31-Aug-02	517,465.76	5,174.66	522,640.42	106,618.55	416,021.87
30-Sep-02	416,021.87	4,160.22	420,182.08	106,618.55	313,563.53
31-Oct-02	313,563.53	3,135.64	316,699.17	106,618.55	210,080.62
30-Nov-02	210,080.62	2,100.81	212,181.43	106,618.55	105,562.88
31-Dec-02	105,562.88	1,055.63	106,618.50	106,618.55	-

The bank has a capital base of less than Rs 750 million.

On inception (1 January 2002)

Dr Loans	Rs 1,200,000	
Cr Cash		Rs 1,200,000
(To record disbursement of the loan)		

At the end of first quarter of 2002 (31 March 2002)

At 31st March 2002, the bank received payments for the months of January and February on their respective due dates. However, the payment for March has still not been received.

The bank has learned that XYZ Co Ltd is in financial difficulty because one of its clients has gone bankrupt. However, the bank believes that the problem is only temporary and that the company will soon honour its commitment.

Dr Cash	Rs 23,054	
Dr Accrued interest receivable	Rs 10,098	
Cr Interest income		Rs 33,152
(To record interest received/accrued during the quarter)		

Dr Cash	Rs 190,183	
Cr Loan Account		Rs 190,183
(To record capital repayment during the quarter)		

	Quarter ended 31 March 2002 *Rs*
Income Statement (Extract)	
Interest Income	33,152
Provision for credit loss	-
Balance Sheet (Extract)	
Accrued interest receivable	10,098
Loan to XYZ Co Ltd	1,009,817

At the end of second quarter of 2002 (30 June 2002)

At 30 June 2002, XYZ Co Ltd has not met any of its obligations with the bank since February. However, during a meeting with one of the directors of XYZ Co Ltd, it was explained that the current financial condition is due to the bankruptcy of one of the company's major clients, but the director is confident that the company will soon get new clients to make good the shortfall. He promised to pay the whole outstanding amount along with interest by 31 December 2002. The bank has requested XYZ Co Ltd to submit a business plan along with a cash flow projection for the period to 31 December 2002. It

has also requested him to have the business plan and cash flow projections vetted by his auditors / business advisors. However, this has not been received.

After assessing the prevailing economic conditions ABL expects that XYZ Co Ltd will be able to repay only Rs 1,000,000 on 31 December 2002. It is unlikely that the bank will receive other payments. In view of the expected repayment of Rs 1,000,000 on 31 December 2002, the bank has decided not to enforce the security.

The accounting entries for the quarter to 30 June 2002 are:

Dr Accrued interest receivable	Rs 30,904	
Cr Interest income		Rs 30,904
(To record interest accrued during the quarter – 1% p.m. over 3 month on the outstanding balance of Rs 1,019,915 (Rs 1,009,817 + Rs 10,098). Interest is accrued on the carrying amount prior to the decision to write down the loan to its recoverable amount)		

At 30 June 2002, carrying amount of loan is Rs 1,050,819 (capital Rs 1,009,817 + interest accrued at 31 March Rs 10,098 + interest accrued during the quarter Rs 30,904). Recoverable amount is Rs 942,045 (discounting Rs 1,000,000 over 6 month by 1% per month), with the result that there is an impairment loss of Rs 108,774 (i.e Rs 1,050,819 – Rs 942,045).

Dr Provision for credit loss (Profit and Loss)	Rs 108,774	
Cr Allowance for credit loss		Rs 108,774
(To reduce carrying amount of loan to its estimated realisable value)		

	Quarter ended 30 June 2002 *Rs*	**Six month ended 30 June 2002 Rs**
Income Statement (Extract)		
Interest Income	30,904	64,056
Provision for credit loss	(108,774)	(108,774)

Balance Sheet (Extract)		
Accrued interest receivable	41,002	41,002
Loan to XYZ Co Ltd	1,009,817	1,009,817
Allowance for credit loss	(108,774)	(108,774)

At the end of the third quarter of 2002 (30 September 2002)

On 30 September 2002, XYZ Co Ltd has still not yet submitted any business plan or cash flow projection.

According to the Guideline, since the loan is overdue by more than 180 days and no reliable business plan exists, the bank cannot anticipate any cash flow from this account. However, it can account up to 50% of the appraised value of collaterals.

The bank intends to commence legal action in March 2003 in case it does not receive the promised sum in December 2002. It is expected that if legal action is initiated in March 2003, it will run through to 30 September 2003, when the bank, as per valuation report received, expects to obtain a net amount of Rs 500,000 from the realisation of the lorries.

Thus at 30 September 2002 the deemed recoverable value of the collateral, and in fact, loan is Rs 221,862 (discounting 50% of Rs 500,000 by 1% p.m. over 12 months).

Dr Accrued Interest Income	Rs 28,545	
Cr Interest income		Rs 28,545
(To record interest accrued at 1% p.m. on the carrying amount of Rs 942,045 during the quarter.)		

Dr Provision for credit loss (Profit and Loss)	Rs 748,728	
Cr Allowance for credit loss		Rs 748,728
(To reduce carrying amount of loan to its estimated realisable value, which is Rs 221,862)		

	Quarter ended 30 September 2002 ***Rs***	**Nine month ended 30 September 2002 Rs**
Income Statement (Extract)		
Interest Income	28,545	92,601
Provision for credit loss	(748,728)	(857,502)

Balance Sheet (Extract)		
Accrued interest receivable	69,547	69,547
Loan to XYZ Co Ltd	1,009,817	1,009,817
Allowance for credit loss	(857,502)	(857,502)

At the end of the fourth quarter of 2002 (31 December 2002)

During the fourth quarter of 2002, the bank informed XYZ Co Ltd that it was going to initiate legal action against it if it does not settle its account by 31 December 2002. On 31 December 2002, XYZ Co Ltd made a payment of Rs 300,000 and promised to pay the remaining amount during the first quarter of 2003. However, it has not submitted any business plan, including projected cash flows. The bank gave XYZ Co Ltd up to end February to settle the outstanding dues. In the contrary case it will commence legal action in March 2003.

Dr Cash	Rs 300,000	
Cr Provision for credit loss (Profit and Loss)		Rs 300,000
(To account for the repayment of Rs 300,000)		

Dr Allowance for credit loss	Rs 300,000	
Cr Accrued interest receivable		Rs 69,547
Cr Interest income (1% p.m. on the carrying amount of Rs 221,862[1] during the quarter)		Rs 6,723
Cr Loan to XYZ Co Ltd		Rs 223,730
(To adjust the allowance for credit loss, and in consequence the carrying amount of the recorded loan and accrued interest in respect of the Rs 300,000 settled)		

	Quarter ended 30 December 2002 ***Rs***	**Year ended 30 December 2002 Rs**
Income Statement (Extract)		
Interest Income	6,723	99,324
Provision for credit loss	-	(857,502)
Reversal impact of provision for credit loss	300,000	300,000

[1] See workings for the quarter ended 30 September 2002 for details.

Balance Sheet (Extract)		
Accrued interest receivable	-	-
Loan to XYZ Co Ltd (Rs 1,009,817 – Rs 223,730)	786,087	786,087
Allowance for credit loss	(557,502)	(557,502)

Note that the carrying amount of the loan outstanding (net of allowance for credit loss) is Rs 228,585, which is equal to discounting 50% of Rs 500,000 (the appraised realisable value of the lorries) by 1% p.m. over 9 months.

At the end of the first quarter of 2003 (31 March 2003)

At end March 2003 the bank received no further payments from the company. Accordingly in March 2003, the bank initiated legal action in court against XYZ Co Ltd for recovery of the outstanding amount. It is expected that legal action will be completed on 30 September 2003 as originally expected and that the collateral will fetch Rs 500,000.

Negotiation is still on with XYZ Co Ltd. The directors of the company have stated that they will pay Rs 600,000 at 30 June 2003, provided that the bank writes off the remaining debt and withdraws its case against the company. The bank expects that it will not be able to get more than this amount.

Dr Accrued Interest Income	Rs 6,926	
Cr Interest income		Rs 6,926
(To record interest accrued at 1% p.m. on the carrying amount of Rs 228,585 during the quarter.)		
Dr Allowance for credit loss	Rs 210,659	
Cr Loan to XYZ Ltd		Rs 210,659
(To write off the amount of the loan by an amount which in management's judgement, is beyond realistic prospect of recovery. Rs 786,087 + Rs 6,926 – Rs 582,354 i.e. Rs 600,000 discounted by 1% p.m. over 3 months – April to June)		

	Quarter ended 31 March 2003 ***Rs***
Income Statement (Extract)	
Interest Income	6,926
Provision for credit loss	-
Reversal of provision for credit loss	-

Balance Sheet (Extract)

Accrued interest receivable	6,926
Loan to XYZ Co Ltd (Rs 786,087 – Rs 210,659)	575,428
Allowance for credit loss	(346,843)

Note that the carrying amount of the loan (net of allowance for credit loss) is Rs 235,511, which is equal to discounting 50% of Rs 500,000 by 1% p.m. over 6 month.