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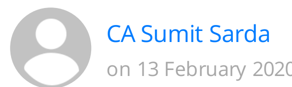
Banks and Ind AS


CA Sumit Sarda
on 13 February 2020

In October, 2018, the Ministry of Corporate Affairs notified **Division III to Schedule III** to the Companies Act, 2013 which contained the format of Financial Statements as well as Disclosure Requirements for Non- Banking Financial Companies and RBI has issued report of working group on implementation of Ind AS by banks in India. So the question arises is Ind AS for banks different from that of other companies?

Remember the standards and content remain the same with just a little application pattern difference since banks only deal with money unlike others providing products or services. For others money is a intermediary of transactions.

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Bank deal in various activities like

- Lending money,
- Saving money,
- Providing interest,
- Safeguarding money,
- Enabling you using your money (credit cards, cheques, etc.).

As a result, the financial reporting of banks' activities looks different.

We will look at Financial Instruments as a major concern over here.

Financial Instruments (Ind AS 32, 107 and 109)

1 Impairment of financial assets

As per Ind AS 109 para 5.5.1 expected credit loss model is used for recognizing loss allowance to financial assets measured at ACM or FVTOCI.

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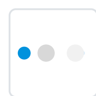
Majority of other types of companies have only Trade receivables, contract assets and lease receivables, they are permitted as per para 5.5.15 to use simplified approach for the impairment of financial assets and calculate loss allowances solely in the amount of life-time expected credit losses.

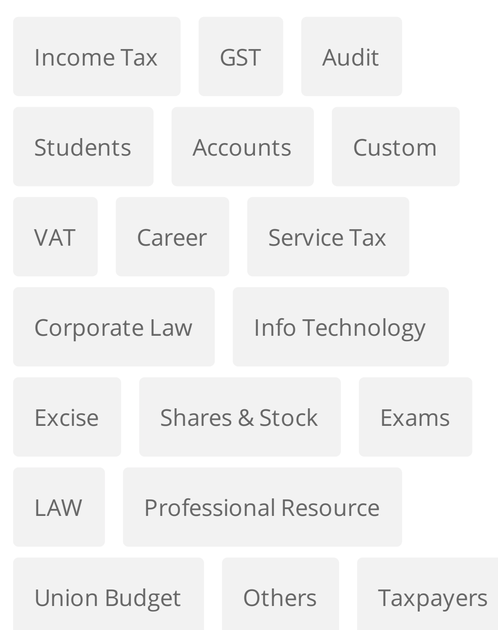


Eg.

A Ltd, trade receivables with gross carrying amount of Rs.500 000 at the end of 20X1. Analysis of the trade receivables showed the following:

- One of customer, B, filed for bankruptcy proceedings during 20X1. A Ltd receivable to debtor B amounts to Rs.2000 and A Ltd expects to recover nil.
- Aging structure of remaining trade receivables is as follows:

Past due days	Amount in CU	% of expected credit loss
Within maturity	390000	0.50
1-30 days	55000	10
31-90 days	27000	20
91-180 days	26000	35
Debtor B	2 000	100.00



Total	500 000	

Bad debt allowance is then calculated as:

(39000 x 0.5%) + (55000 x 10%) + (27000 x 20%) + (26000 x 35%) + (2000 x 100%) = 1950 + 5500 + 5400 + 9100 + 2000 = 23950.

However, banks cannot use simplified approach for the biggest group of their financial assets - loans, because the loans do not fall within the exception.

Banks need to apply 3-stage general model for recognizing loss allowances.

Stage 1: Performing Assets
Stage 2: Credit risk increased significantly
Stage 3: Credit impaired

Banks need to:

- Decide whether the individual financial assets will be monitored collectively (similar small volume loans) or individually (big loans)
- Carefully analyze the financial assets and assess to what stage does the financial asset belong:
    1. Performing, or
    2. With significantly increased credit risk, or
    3. Credit impaired.
- Based on the stage, bank must evaluate how to calculate loss allowance equal to:

o 12-month expected credit loss, as per para 5.5.5or
o Life-time expected credit loss for others

For the above calculation, bank must estimate:

o Probability of default within 12 months;
o Probability of default beyond 12 months;

o Credit losses in the case of default

Bank may need to categorize its loan into various portfolios and monitor relevant information for each portfolio separately.

Stage 1: Performing financial assets

Financial assets that are expected to perform normally in line with their contractual terms and there are no signs of increased credit risk.

Ind AS 9 requires recognizing impairment loss amounting to 12-month expected credit losses.

What is 12-month expected credit loss?

Appendix A defines 'The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.'

In this case, the interest revenue is recognized based on effective interest rate method on gross carrying amount, so no loss allowance is taken into account.

Stage 2: Financial assets with significantly increased credit risk

When the credit risk of certain financial asset significantly increased and the resulting credit quality is NOT low risk, then an entity needs to recognize full lifetime expected credit losses.

What are they?

Appendix A defines as The expected credit losses that result from all possible default events over the expected life of a financial instrument.

In fact, 12-month expected credit losses are just the portion of the life time expected credit losses.

Expected credit losses are in difference between:

- The present value of cash flows based on the contract of a financial instrument; and
- The present value of cash flows that an entity really expects to obtain from the financial instrument.

As a result, the timing of payments from the financial instrument directly affects their present value and thus the amount of an impairment loss.

If you expect that borrower will pay you in full, but later than in line with the contract, there is an impairment loss!

Interest revenue for stage 2 assets is calculated exactly in the same way as in stage 1 (on gross carrying amount).

Stage 3: Credit-impaired financial assets

When your financial asset has already become credit impaired (meaning that certain default events have occurred), then an entity still recognizes lifetime expected credit losses.

However, this time, interest revenue is calculated and recognized based on the amortized cost (that is gross carrying amount less loss allowance).

In this stage, financial assets might need to be individually assessed.

2 Classification and measurement of financial instruments

Financial assets make up most of banks' assets.

Ind AS 109 classifies the financial assets based on 2 tests:

- Contractual cash flows test, and
- Business model test.

Based on the assessment of these tests, the financial asset can be classified either as measured at:

- Amortized cost, or

- At fair value through profit or loss (FVTPL), or
- At fair value through other comprehensive income (FVOCI; and here, further accounting depends on the type of an asset).

Regardless analyzing the 2 tests above, every single financial asset and liability needs to be initially recognized at its fair value.

Here, the standard Ind AS 113 Fair Value Measurement sets principles for determining the fair value and therefore, it becomes very important in the financial reporting of any bank.

Distinguishing liabilities from equity

Banks enter into various contracts and transactions which might need to classify correctly whether the bank's instrument is equity or liability, or even a mixture of both.

The standard Ind AS 32 Presentation of financial instruments gives us more precise rules on how to correctly distinguish between these two types of instruments and this becomes particularly hot in banks.

Because incorrect identification of equity/liability/mix can lead to wrong presentation of bank's financial results including various rations assessing bank's capital and financial situation.

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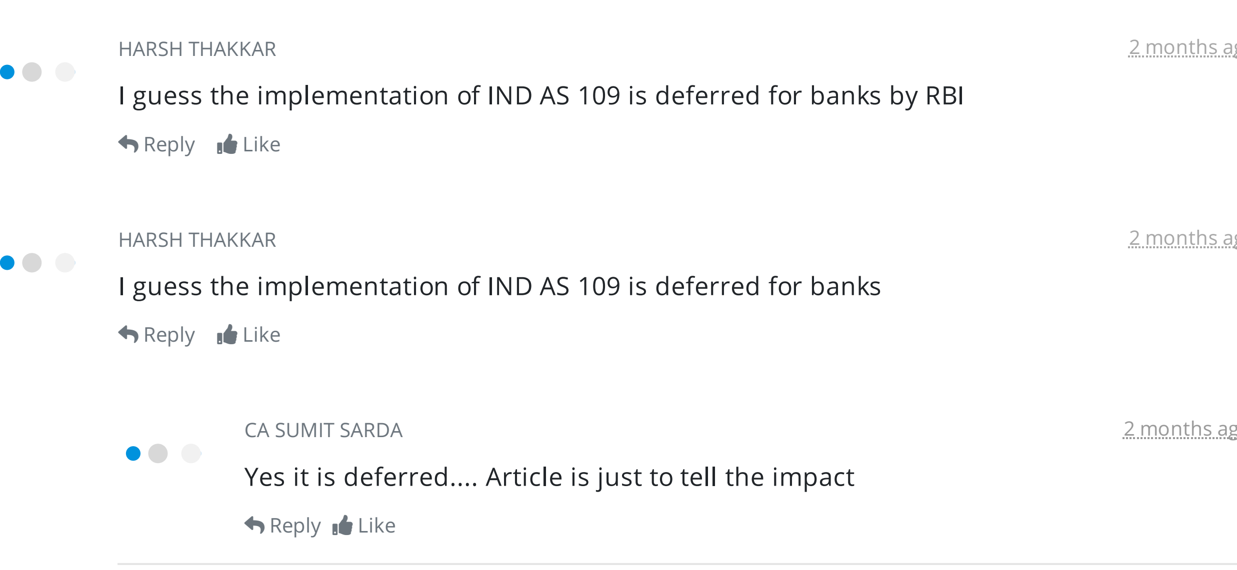

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