Impairment of Financial Assets

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Introduction

ABC Ltd was established with the purpose of offering a range of financial services for their diverse market groups ranging from large corporate, SME’s, self-employed, professionals and executives. Further, they also facilitate entrepreneurs among the business community with a variety of financial solutions. The principle activities of the company are leasing, hire purchase, micro leasing, personal, short-term and corporate loans, trade finance loans to import traders, debt factoring, fixed deposits and savings accounts.

Discussion of the issue

The company doesn’t provide collective impairment for trade finance loans and debt factoring segments. However, it was identified that, when filing CBSL (Central Bank of Sri Lanka) returns, the company has submitted the aging details to CBSL and also that information has been included in the financial risk management section.

In addition to that, for other financial assets apart from trade finance and debt factoring customer segments, the company has computed the collective impairment by using the Probability of Default (PD) rate based on the net flow rate method. PD can be described as the likelihood of default over a particular time period. However, they have discounted the derived impairment amount by a percentage called, “security cover” without any particular basis and as a result of this arbitrary method, the collective impairment has reduced by a significant amount as shown below,
<table>
<thead>
<tr>
<th>Loan Category</th>
<th>Cover (%)</th>
<th>Collective Impairment without Security Cover</th>
<th>Collective Impairment with Security Cover</th>
<th>Reductions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hire Purchase</td>
<td>60%</td>
<td>629,494</td>
<td>251,797</td>
<td>(377,696)</td>
</tr>
<tr>
<td>Leases</td>
<td>60%-70%</td>
<td>67,215,479</td>
<td>20,396,874</td>
<td>(46,818,604)</td>
</tr>
<tr>
<td>Secured Loans</td>
<td>55%</td>
<td>44,741,222</td>
<td>20,133,550</td>
<td>(24,607,672)</td>
</tr>
</tbody>
</table>

As per paragraph 59 of LKAS 39, the underlying rule for impairment is that,

“A financial asset or a group of financial assets is impaired and impairment loss are incurred is, and only if, there is an 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’

With regards to ABC Ltd, the records indicate that the company has computed impairment for individually large financial assets except for trade finance, loans and debt factoring due to the absence of accurate aging details. However, as further explained in paragraph 64 of LKAS 39,

“An entity first assesses whether objective evidence of impairment exists individually for financial assets that that are individually significant and individually or collectively for financial assets that are not individually significant”

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”

Hence, based on this, it can be said that ABC Ltd has violated LKAS 39 as it has not considered trade finance loans and factoring receivables, which are individually assessed but no evidence of impairment has been specifically identified on an individual basis
As per the standard, financial assets with the similar risk characteristics which indicate the debtor’s ability to pay, such as asset type, industry, geographical region, internal rating, product type, collateral type, past-due status and other relevant factors can be collectively evaluated for impairment.

Therefore, trade finance, loans and factoring must be evaluated collectively for impairment to reflect the cumulative collective impairment losses incurred at the statement of financial position date.

**Implication**

Any impairment loss on a loan taken to the Statement of Profit or Loss and Comprehensive Income has a direct impact on the profits of the firm. With regards to ABC Ltd, arbitrary method used in computing impairment resulted in low impairment amount recognized in financial statements, consequently over stated the current year net profits. In addition to that, non-assessment of trade finance, loans and debt factoring will also lead to understate the collective impairment provision and thus, overstate the profit.

**Conclusion and Recommendation**

It was recommended to adhere LKAS 39 and collectively assess impairment allowances for financial assets which are not impaired individually by grouping them together according to their credit risk characteristics. Further, it was advised to properly use PD rule based on net flow rate method, by using the aging submitted to CBSL and also it is advised to observe the industry practices on impairment of trade finance loans and factoring receivables.

In conclusion, as per paragraph 64 of LKAS 39, once assets have been segmented will be assessed individually and portfolio basis, the individually significant items are assessed either individually or on the portfolio basis. This group assessment of financial assets needs to be done based on the degree of homogeneity of exposures. The next step after the segmentation will be to identify the financial asset or group of financial asset where a loss event has occurred in order to book the impairment provision. But when it comes to assets which qualify for individual assessment, but no impairment evidence was found at the individual level, those needs to be grouped and collectively impaired.