

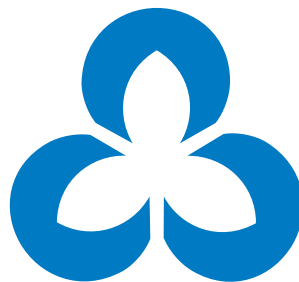


# APPLICATION GUIDE

## **DICO By-law No. 6**

Standards of Sound Business and Financial Practices

**Impaired Loans**



A publication of the  
**DEPOSIT INSURANCE CORPORATION OF ONTARIO**

**SPRING 2002**

*Ce document est également disponible en français*

**DEFINITION**

**Throughout this document, member institution means  
a credit union, a caisse populaire, or a league.**

*This Application Guide to DICO By-law No. 6  
is available on DICO's Web-site at:*

***[www.dico.com](http://www.dico.com)***

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# INTRODUCTION

DICO By-law No. 6 was amended in 1995 as a result of a new accounting standard, introduced by the Canadian Institute of Chartered Accountants (CICA).

The purpose of this application guide is to provide guidance and help to member institutions in complying with the requirements of the By-law and the accounting standard.

Under By-law No. 6:

- ❖ The conditions listed as evidence of impairment are minimum objective conditions. Management judgement must be applied in recognizing all situations where reasonable assurance of the timely and full collection of principle and interest is jeopardized;
- ❖ Income recognition for any impaired loan must cease after impairment is identified;
- ❖ Loans on which payments are significantly postponed are considered impaired;
- ❖ The allowance for impaired loans must include a non-specific provision on groups of loans whenever economic conditions or specific events suggest that the group's credit quality has deteriorated;
- ❖ Appropriate financial statement disclosure on impaired loans and the allowance for impaired loans is required.

## **IMPORTANT NOTE:**

Throughout the Guide

- ◆ **allowance** means allowance for impaired loans;
- ◆ **provision** means provision for impaired loans
- ◆ where examples are used, values indicated are for illustration purposes only.

# GLOSSARY

The following terms have been defined to aid understanding of this Application Guide. Refer also to the Definitions section of DICO's By-law No. 6, which complements this Glossary.

**Allowance for Impaired Loans :** The aggregate outstanding loan impairment recorded on the balance sheet includes the specific loan loss allowance and the non-specific provision.

**Carrying Amount of a Loan:** The outstanding balance of a loan plus accrued interest less any related allowance for impaired loans.

**Fair Value of Security ("FVS") Method:** This is based on 100% of the security deficiency using estimated current net realizable market values for security, excluding all legal, collection and disposition costs.

**Formally Restructured Loan:** A loan is considered formally restructured when the lender, due to the financial difficulties of the borrower, rewrites the loan to allow for economic concessions such as the forgiveness of principal or interest. A formally restructured loan is one which was at some time impaired, but is no longer considered impaired.

**Fully Secured:** A loan which is fully secured by charges on real property or security interests in personal property that have a fair security value, net of realization and legal costs, to discharge the outstanding principal and accrued interest in full.

**Homogeneous Loans:** Loans which are similar in credit purpose, general credit risk ranking and general exposure to industries or geographical locations facing similar credit risk.

**Loan Impairment:** It is the difference between the outstanding loan balance and the value of the realizable security.

**Loan Write-offs:** Loans where collection efforts are unlikely to lead to recovery in the foreseeable future.

**Material Value:** A dollar threshold which is considered important in order for financial statements to be presented fairly in accordance with Generally Accepted Accounting Principles (GAAP); this amount varies according to the size and nature of an organization.

**Provision for Impaired Loans:** The required change in the allowance for impaired loans which is charged to the income statement.

**Recorded Amount of a Loan:** The face or principal amount of a loan adjusted to reflect any principal repayments, accrued but uncollected interest, write-offs, unamortized premium or discount and unamortized loan fees and costs.

**Rewritten Loan:** A loan which may or may not be delinquent, whose terms and conditions have been formally revised (**without the loss of principal or interest**) to better accommodate the changed economic conditions of a borrower. Such loans are not considered impaired under By-law No. 6, unless the recovery of principal is significantly deferred beyond the loan's original term.

**Significantly Deferred Loan Postponement:** A deferral in the repayment term of a loan which is so significant that it causes doubt as to the ultimate collectibility of the loan. "Significantly deferred" relates to the broad GAAP concept of "timely" collection of full principal and interest found in Section 3025.03 of the CICA Handbook. Auditor consultations may be useful in the situational interpretation of this GAAP concept.

**Uncompensated Loan Deferral:** A loan whose schedule of payments has been interrupted without interest being applied (i.e. at the rate set out in the original terms of the loan) to compensate for the delay in receipt of loan payments.

**What is  
the objective  
of DICO  
By-law No. 6?**

Under Section 22 of Regulation 76/95, DICO has responsibility to prescribe how the allowance for impaired loans should be established, in accordance with Generally Accepted Accounting Principles (GAAP). The objective of By-law No. 6 is to provide a standard interpretation of GAAP, to ensure that similar economic events are accounted for in the same manner by DICO's member institutions.

DICO By-law No. 6 and this Application Guide will help member institutions to properly apply the accounting standard on impaired loans published in Section 3025 of the CICA Handbook on Generally Accepted Accounting Principles (GAAP).

Pursuant to Section 213 of the Credit Unions and Caisses Populaires Act (the Act), all member institutions must use GAAP to prepare their financial statements. Member institutions therefore need to be familiar with DICO's By-law No. 6 and Section 3025 of the CICA Handbook.

**By-law No. 6 uses the conventional method of valuing impaired loans by measuring underlying loan security. The allowance, using Fair Value of Security or FVS method must provide for 100% of the security deficiency of each impaired loan.**

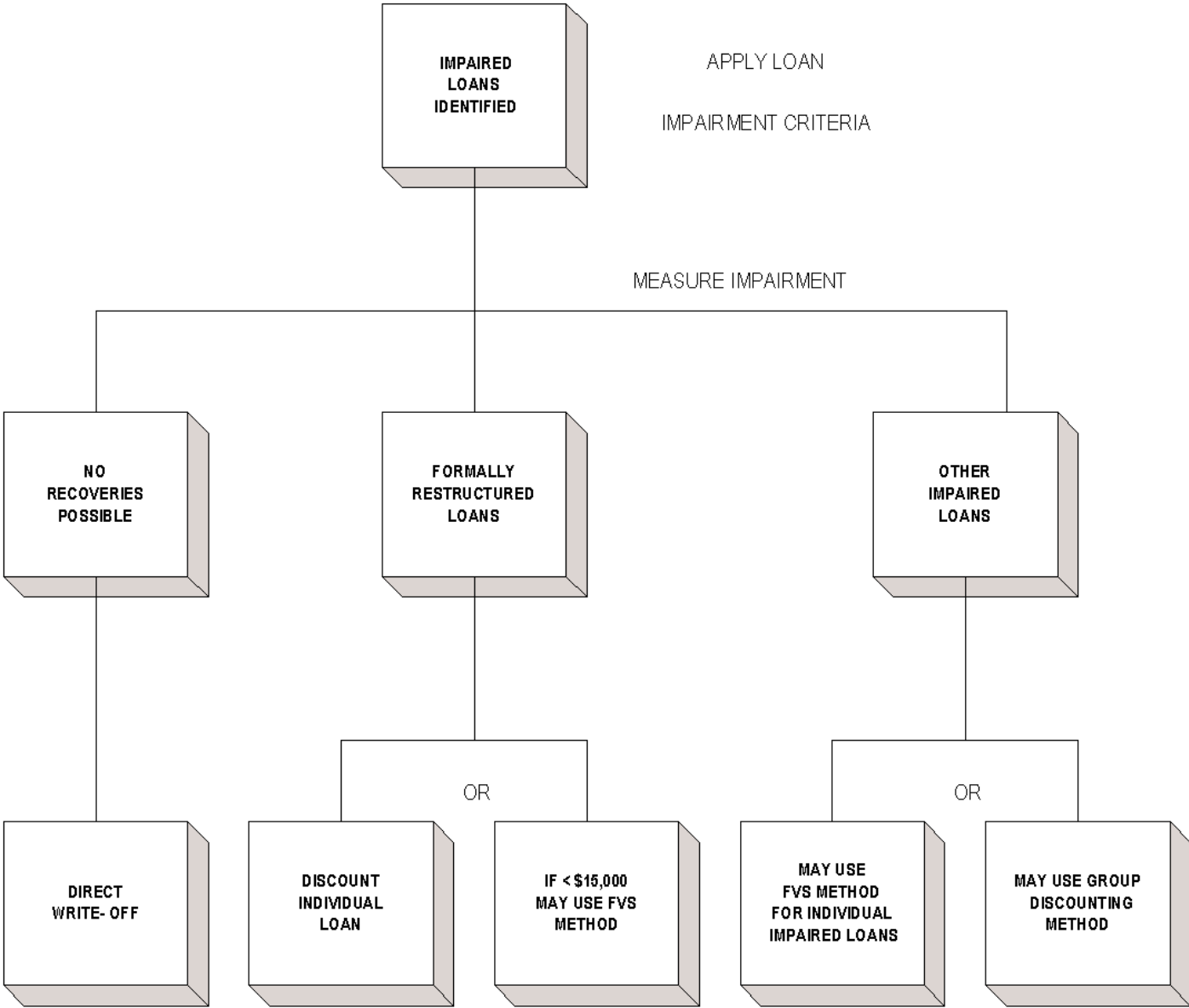
The GAAP requirement for discounting is limited under By-law No. 6 to those impaired loans, which are "formally restructured" (incorporating concessions such as the forgiveness of principal and/or interest). Once an impaired loan is formally restructured and subject to an accounting writedown, it is no longer considered impaired under GAAP.

**By-law No. 6 does not prohibit member institutions from electing to discount impaired loans under prescribed conditions.**

For example, where a member institution has a demonstrated recovery experience on loans which are not secured, By-law No. 6 permits member institutions to record some salvage value for these loans on a group discounted basis. For consumer loans, under \$15,000, which have been formally restructured, the FVS method may be used to measure the value of these loans.

**Refer to attached summary flowchart illustrating the various accounting options for impaired loans under By-law No. 6.**

# Summary Flowchart of Accounting Treatments for Impaired Loans



Note: FVS denotes fair value of security

**What are the requirements?**

By-law No. 6 lists the following conditions as evidence that a lender no longer has reasonable assurance of timely collection of the full amount of a loan's principal and interest, thus requiring such loan to be identified as impaired. The conditions listed below are minimum objective conditions (member institutions may elect to use additional criteria).

- ◆ FULLY SECURED LOANS - a payment is 180 days in arrears;
- ◆ OTHER LOANS, INCLUDING RESTRUCTURED LOANS - a payment is 90 days in arrears;
- ◆ a loan is assigned to a collection agency, is part of a bankruptcy proceeding/creditor proposal, or the debtor has absconded;
- ◆ a loan has been unrealistically postponed so that the recovery of principal is significantly deferred beyond the loan's original term.

In addition, management judgement must be applied in recognizing all situations where reasonable assurance of the timely and full collection of principal and interest is jeopardized and therefore loan impairment exists.

Loans which have any of the above specific characteristics listed above, or other characteristics that demonstrate untimely collection of principal and interest in full, must be tracked separately on internal loan reports and disclosed as impaired in the notes to the financial statements.

**What are the implications?**

Under By-law No. 6 the following loans would **not** be considered impaired:

- ◆ loans that are fully secured and collectible but delinquent less than 180 days;
- ◆ loans formally postponed or rewritten by a member institution after re-evaluating the borrower's credit worthiness and without projected loss of interest or principal;

**NOTE: In the case of a loan consolidation, loans to the same individual with different due dates may be renegotiated to a common date, which can substantially exceed the maturity date of one of the original loans. Lending policies should prescribe what conditions and maturities are considered acceptable for realistically amalgamating consumer loans.**

- ◆ loans which have been formally restructured (permitting economic concessions such as the forgiveness of principal and/or interest) for which the member institution has reduced on its books the value of the loan to its discounted amount (or to the fair value of the loan's underlying security if the loan is under \$15,000).

**NOTE: All formally restructured loans, although no longer considered impaired, should continue to be closely monitored, to ensure that they continue to be repaid as agreed. The status of these loans should be reviewed by management and by the board at each board meeting.**

**NOTE: Once a loan is impaired, it remains impaired until it is either:**

- ◆ **Brought contractually up to date or repaid**
- ◆ **Formally restructured**
- ◆ **Rewritten or formally postponed provided repayment is not *significantly deferred* beyond the original term of the loan**

#### **SITUATION 1**

*An unsecured loan guaranteed by a third party is 90 days in arrears. Is it impaired?*

Yes. This loan is considered impaired because it has no tangible security, and the guarantor has not brought the loan payments up to date. (See definition of “fully secured”.)

#### **SITUATION 2**

*A loan, fully secured by a mortgage, is 120 days in arrears. Is it impaired?*

No. If a loan is fully secured, it will not be considered impaired until it is 180 days delinquent. The value of the underlying security net of realization and legal costs, must be supported by current, documented appraisals on file. (See definitions)

#### **SITUATION 3**

*A fully secured loan, which was 179 days in arrears, is formally postponed for six months with interest. Is it impaired?*

No. As long as the loan has been postponed as a result of an objective re-evaluation of the borrower’s ability to meet his/her rescheduled obligations, and without loss of principal or interest. Member institutions should continue to monitor all postponed/rewritten loans in accordance with conventional loan monitoring practices to ensure that any future delinquency is immediately followed up.

#### **SITUATION 4**

*A large commercial loan, 200 days in arrears, has been subject to a settlement agreement whereby the borrower agrees to repay the outstanding principal over the next 36 months, but cannot afford to pay the outstanding interest. Is the loan impaired?*

No. If the loan has been formally restructured and the carrying value reduced to account for the loss in interest, with a mutually agreed repayment schedule, the loan is treated as a new loan and is no longer considered impaired.

#### **SITUATION 5**

*An agricultural loan which is not in arrears has suffered a significant deterioration in its security value (e.g. the security value has dropped below 75% of the loan's recorded value) and the borrower's overall financial condition has also weakened since the loan was originally granted. Is this loan impaired?*

Yes. A significant decline in the value of underlying security may indicate impairment when the financial condition of the borrower is weak and collection of the unsecured balance is in doubt. (Refer to Section 3025.08 of the CICA Handbook for further details on this specific GAAP application.)

#### **SITUATION 6**

*A borrower has two loans with a member institution, both of which are completely dependent on the cashflow of a family business. The first loan is a consumer loan and the second loan is a business loan. In this situation, should both the loans be considered impaired, if the business loan becomes 90 days delinquent?*

Yes. If a borrower's financial condition declines so that one of several loans becomes impaired, the entire borrower connection and all related loans should be identified as impaired. Where, however, it can be demonstrated that one or more of the loans is not at risk (e.g. the co-borrower's income is sufficient to service the loan for which he/she is a co-borrower), these loans could be exempted from impairment status.

# 3

# MEASURING LOAN IMPAIRMENT

## What are the requirements?

There are two measurement methods that may be used to measure loan impairment:

- (i) The conventional Fair Value of Security (FVS) Method
- (ii) The Discounting Method

### THE FVS METHOD

The FVS method for calculating loan impairment is generally used to determine the required loan allowance for individual loans.

### Examples

**NOTE: The carrying value of the loan will include any accrued interest up to the date of impairment.**

#### SITUATION 1

*What allowance is required for a \$10,000 impaired loan secured by a chattel whose fair value of security totals \$7,000?*

Calculated Answer:	Carrying value of loan	\$10,000
	FVS	\$ 7,000
	<u>Allowance Required</u>	<u>\$ 3,000</u>

#### SITUATION 2

*What allowance is required for a \$10,000 impaired loan with no underlying security?*

Calculated Answer:	Carrying value of loan	\$10,000
	FVS	0
	<u>Allowance Required</u>	<u>\$10,000</u>

#### SITUATION 3

*What allowance is required for a fully secured \$10,000 loan, which becomes impaired after 180 days delinquency, under By-law No. 6?*

Calculated Answer:	Carrying value of loan	\$10,000
	FVS	10,000
	<u>Allowance Required</u>	<u>\$ 0</u>

**When and how can the discounting method be used to estimate the allowance for impaired loans?**

**THE DISCOUNTING METHOD**

Under By-law No. 6, member institutions may only use the discounting method on impaired loans if the method is applied on a group basis. The projected cashflows of an individual impaired loan are considered to be too subjective under By-law No. 6, for discounting purposes. However, group discounting is considered acceptable because it is based on the objective, average historic recoveries of impaired loans of similar size and credit purpose. Group discounting requires calculation of a historic recovery percentage; an average outstanding impaired loan recovery period and an average group interest rate. (Refer to Appendix III for sample calculations for group discounting).

**Sample Allowance Calculations**

**SITUATION 1**

What allowance is required for a homogeneous group of impaired personal loans variously secured with an aggregate carrying value of \$300,000 to which the following applies:

- (i) the historic recovery percentage on such loans has been 75%,
- (ii) the average remaining recovery period is 24 months, and
- (iii) the weighted dollar average interest rate is 12%?

Calculated Answer:	Aggregate carrying value	\$300,000	(A)
	Expected nominal recoveries (75% of above)	\$225,000	
	Remaining recovery period	24 months	
	Average monthly recoveries ( $\$225,000 \div 24$ )	\$ 9,375	
	Weighted average interest	12%	
	Discounted amount ( $\$9,375 \times 21.243^*$ )	\$199,153	(B)
	<u>Allowance Required (A - B)</u>	<u>\$100,847</u>	

\* Monthly annuity factor for 12% interest rate for 24 months.

### SITUATION 2

What allowance is required for a homogeneous group of impaired, residential mortgages with an aggregate carrying value of \$900,000 to which the following applies:

- (i) the historic recovery percentage on such loans has been 85%,
- (ii) the remaining average loan recovery period is 36 months, and the weighted dollar average interest rate is 10%?

Calculated Answer:	Aggregate carrying value	\$900,000	(A)
	Expected nominal recoveries (85% of above)	\$765,000	
	Remaining recovery period	36 months	
	Average monthly recoveries ( $\$765,000 \div 36$ )	\$ 21,250	
	Weighted average interest	10%	
	Discounted amount ( $\$21,250 \times 30.991^*$ )	\$658,559	(B)
	<u>Allowance Required (A - B)</u>	<u>\$241,441</u>	

\* Monthly annuity factor for 10% interest rate for 36 months.

### SITUATION 3

What allowance is required for two impaired commercial loans (with a total carrying value of \$800,000 and total fair value of security of \$500,000) grouped together on the basis of large size and similarly high risk of loss, given the following:

- (i) weighted dollar average interest rate is 14%;
- (ii) historic recovery percentage is not known, as commercial lending is a new activity.

Under By-law No. 6 the allowance required for these two loans would have to be determined using the FVS method rather than the discounting method given the following constraints:

- ◆ The two loans, although similarly high risk, are unique in their industry concentration risk and credit profiles, and therefore would not warrant being put into one group and considered homogeneous;
- ◆ No accurate historic recovery percentage could be applied to discount these two loans as the member institution has no previous recovery experience on commercial loans.

The required allowance is \$300,000, which is the combined security deficiencies for the two loans using the FVS valuation method.

**How often should the value of security be re-measured for purposes of establishing the monthly allowance for impaired loans?**

Under By-law No. 6, the monthly provision and allowance for individual impaired loans must be based on current security valuations. Where the FVS method is used to measure the extent of impairment, the By-law defines what constitutes a current and acceptable valuation.

The By-law stipulates that once an appraisal has been obtained, and is objectively based upon either a published information source (e.g. the black book for consumer cars) or on the findings of a qualified appraiser, in accordance with the member institution's appraisal policy, such valuations are considered **current for up to one year**, assuming no contrary evidence about the condition of the loan security.

In the case of real estate, due to the cost of security valuations, By-law No. 6 allows appraisals which are older than one year provided:

- ♦ there has been no significant economic change since the last valuation, or
- ♦ if the current valuation reflects a low loan value to security value ratio (e.g. under 50%).

*In cases where there are material changes to security values from month to month, By-law No. 6 requires corresponding adjustments to the carrying value of the impaired loans measured by the FVS method.*

**How often should groups of impaired loans be rediscounted for purposes of establishing the monthly allowance for impaired loans?**

In the case of rediscounting groups of impaired loans for purposes of the monthly allowance, GAAP requires monthly re-valuations due to the following:

- ♦ The volume of outstanding cashflows in a group of discounted impaired loans will change from month to month due to cash receipts, loan write-offs or settlements and the addition of new impaired loans to the group;
- ♦ The group's remaining term to recovery and its average dollar interest rate will change from month to month; it therefore requires a new discount factor to be applied to the monthly rediscounting exercise.

*In cases where impaired loans are grouped for discounting, the total carrying costs should be adjusted monthly to equal the recalculated, discounted amount of these loans, by increasing or decreasing the allowance.*

# 4

# FORMALLY RESTRUCTURED LOANS

## What are formally restructured loans?

By-law No. 6 uses the GAAP definition of a formally restructured loan. That is a loan which is rewritten by a lender for a borrower in financial difficulty, offering one or more of the following concessions:

- ◆ a lower interest rate;
- ◆ **uncompensated** deferral or extension of principal repayments or interest repayments;
- ◆ forgiveness of some of the principal or accrued interest.

**Formally restructured loans represent a last resort collection strategy often used in:**

- ◆ **near bankruptcy situations;**
- ◆ **out-of-court settlements proposed by debtors.**

## Why and how are these loans treated differently from impaired loans?

A formally restructured loan is a loan that at one time was impaired due to the financial difficulty of the borrower but for which a compromise settlement has been negotiated. The compromise loan settlement usually results in some principal or interest being written off in exchange for the borrower's full cooperation to repay the residual debt without further collection difficulties.

Unlike impaired loans for which the FVS method may be used in all cases, formally restructured loans must generally be discounted. Once written down, in the accounting records, to the discounted amount, a formally restructured loan represents that part of a previously impaired loan which is considered still good and fully recoverable. For this reason, no continuing allowance is required on the recorded value of a formally restructured loan, since it is no longer considered impaired.

## How is the accounting writedown determined for a formally restructured loan?

Under GAAP, a formally restructured loan must be discounted and the difference between book value written off. However, under By-law No. 6, if the formally restructured loan is a **consumer loan** under \$15,000, a member institution may alternatively elect to write down such loan to the fair value of its tangible security.

**NOTE: Tangible security is limited to security for which fair values can be readily determined (i.e. automobiles, real estate, publicly traded stocks etc.).**

**Wage assignments are not considered tangible security.**

### SITUATION 1

What writedown is required for an impaired \$15,000 personal loan which is formally restructured, whereby monthly payments are reduced and the term extended without compensating interest?

Details of the restructuring are noted below:

	Original Loan	Restructured
Principal Balance	\$ 15,000	\$ 15,000
Monthly Amount	\$ 1,796	\$ 550
Term	12 months	24 months
Effective Interest Rate	14%	<14% (e.g. 12%)

Calculated Answer:

Using the discounting method, the size of the economic concession granted to the member (and therefore the amount of the loan writedown required) is determined by comparing the loan's carrying amount of \$15,000 to its discounted amount of \$ \$11,683, as calculated below:

New Monthly Payment	X 12%, 24 Month Factor	= Discounted Amount
\$550	X 21.243	= \$11,683

\$11,683 is the present value of the restructured loan. This is \$3,317 less than its recorded value of \$15,000. GAAP requires the recorded value of the restructured loan to be reduced to \$11,683 and \$3,317 to be expensed as a loan write-off.

### SITUATION 2

Using the FVS method, what writedown is required for the same loan which is secured by a \$12,000 chattel and is formally restructured? (with the same term and interest rate)

Under the FVS valuation method, the \$3,000 security deficiency relating to the consumer loan is the amount that must be written off the recorded value of the formally restructured loan, regardless of the newly negotiated loan principal. This writedown is a conservative alternative to discounting the loan, which is normally required under GAAP. The rationale for using the simpler FVS method, rather than discounting formally restructured consumer loans, is that consumer loans are generally secured by consumer products whose values depreciate over time. The drop in recovery value as a result of the passage of time reflects what discounting is all about. The FVS method, therefore, approximates the discounting method for consumer loans.

Impaired Loan	Security Deficiency	Recorded Loan Value	New Monthly Payment	Interest Rate
\$15,000	\$3,000	\$12,000	\$565	12%

### SITUATION 3

*If the \$15,000 formally restructured loan described above is a commercial loan, what writedown is required?*

Under By-law No. 6, the size exemption to discounting formally restructured loans (e.g. loans under \$15,000) applies only to consumer loans, given the rationale explained in Situation 2 above. The writedown for a commercial loan can, therefore, only be determined by discounting. Using the methodology in Situation 1 above, this would total \$3,317.

**Are monthly accounting adjustments required for formally restructured loans?**

As long as a formally restructured loan does not fall into arrears, its discounted value never needs to be recalculated.

Other monthly accounting adjustments, however, will be required whenever the recorded value of a formally restructured loan is reduced (to either its discounted or FVS value) and does not equal the loan's new contractual principal balance. For example, monthly accounting adjustments would be required if the rate of interest is lowered as part of the concession but the outstanding principle is left unchanged.

**Refer to Appendix IV for further details on required monthly accounting for formally restructured loans.**

**Can interest be accrued on impaired loans?**

**No.** Once a loan has been identified as impaired, using the description of impairment in By-law No. 6, no further interest income should be accrued in the financial statements. Any interest accrued up to the date of impairment, however, does not need to be reversed and is included in the calculations of the loan allowance, net of any tangible security.

Any accrued interest income, which the data processing system may continue to automatically calculate on impaired loans, must be reversed in accordance with GAAP. Two methods may be used to accomplish this:

- ◆ debit to interest income offset by a credit to accrued interest account;
- ◆ debit to interest income offset by a credit to the loan allowance.

**EXAMPLE**

*What amount of interest can be recognized on an impaired loan 90 days in arrears which has an outstanding principal of \$9,000 and accrued interest of \$500, assuming security value of \$2,000?*

At 90 days delinquency, the full \$500 of accrued interest on the loan may be included in the loan's recorded value, although no further interest can be accrued for financial statement purposes in accordance with GAAP. Since the value of security is \$2,000, the allowance (and the provision for impaired loans) must reflect a security deficiency of \$7,500 (which includes the \$500 of interest accrued during the first 90 days of delinquency).

**NOTE: If the loan was fully secured, interest up to 180 days delinquency could be included in the loan's recorded value, although no further interest can be accrued for financial statement purposes, in accordance with GAAP.**

**Can interest be accrued on restructured loans?**

**Yes.** A formally restructured loan is considered to be a new, unimpaired loan (once its recorded amount has been written down to account for the known concessions granted upon the loan's restructuring). Like any other new loan, interest may therefore accrue, in accordance with GAAP. Such interest must be accrued, however, using the new recorded principal amount and the original loan's interest rate. See examples in Appendix II, illustrating accounting for interest and principal payments on formally restructured loans.

# 6

# LOAN WRITE-OFFS AND RECOVERIES

**When and how should a loan be written-off?**

A loan should be written-off whenever collection efforts are unlikely to lead to recoveries in the near future. This may include situations where a member institution decides it will not pursue a borrower for funds due to his/her complete lack of resources or due to a negotiated settlement in which the lender forgives a portion of the debt.

GAAP permits loan write-offs to be debited either directly to the income statement or through the allowance. **By-law No. 6, however, requires all write-offs to be tracked through the allowance account** by first setting up a specific allowance and then reversing this allowance, and crediting the recorded investment to reflect the fact that the loan is no longer included in the doubtful loans but definitely written off.

**Examples**

**SITUATION 1**

*What accounting treatment should be given a \$10,000 impaired loan, which requires a 100% write-off?*

Required Accounting Entries:

(1) Provision for Impaired Loans	\$10,000 (DR)	
Allowance for Impaired Loans		\$ 10,000 (CR)

*To record the loan impairment through the allowance and charge the expense through the income statement.*

(2) Allowance for Impaired Loans	\$10,000 (DR)	
Loan Receivable		\$ 10,000 (CR)

*To record the write-off of the loan and adjust the total specific allowance on the balance sheet.*

**SITUATION 2**

*What accounting treatment should be given a \$10,000 impaired loan for which a \$3,000 allowance was originally established, but after security realization generates no recoveries and is written off?*

Required Accounting Entries:

(1) Provision for Impaired Loans	\$ 3,000 (DR)	
Allowance for Impaired Loans		\$ 3,000 (CR)

*To record the loan impairment through the allowance*

(2) Allowance for Impaired Loans	\$10,000 (DR)	
Provision for Impaired Loans	\$ 7,000 (DR)	
Loan Receivable		\$10,000 (CR)
Allowance for Impaired Loans		\$ 7,000 (CR)

*To record the write-off of the impaired loan through the allowance, after realization of security.*

**When and how are loan recoveries accounted for?**

Loan recoveries occur whenever cash is received on a loan which has already been written off and are considered to be “windfall” income in the year they are collected.

**By-law No. 6 requires that all recoveries be credited to the allowance** in the same way that all impaired loan write-offs are accounted for. In this way, the allowance tracks all the activity related to impaired loans. The required continuity schedule for the allowance under GAAP discloses each collection-related activity.

**Under By-law No. 6, payments received on impaired loans must be recorded as a reduction of recorded loan principal.**

**Examples**

**SITUATION 1 (A)**

Assume a Personal Impaired Loan has the following characteristics:

Principal	\$12,000
Accrued Interest	\$ 360
Delinquency	90 days
FVS	\$ 8,000
Interest Rate	12%

*The loan remains in arrears until it reaches 120 days delinquency, at which time the borrower starts to make monthly payments of \$200.*

Required Accounting Entries:

(1) Provision for Impaired Loans	\$ 4,360 (DR)	
Allowance for Impaired Loans		\$ 4,360 (CR)

*To record loan impairment after 90 days, and recognize 100% security deficiency, plus accrued interest (\$12,360 - \$8,000).*

(2) Cash	\$ 200 (DR)	
Loan Principal		\$ 200 (CR)

*To record interim receipt of cash on impaired loan (120 days).*

**SITUATION 1(B)**

*Assume that at 151 days the impaired loan is subsequently paid off in full.*

Required Accounting Entries:

Cash	\$12,400 (DR)	
Allowance for Impaired Loans	\$ 4,600 (DR)	
Interest Income (from date of impairment to payment)		\$ 240 (CR)
Loan Principal		\$11,800 (CR)
Provision for Impaired Loans		\$ 4,360 (CR)
Accrued Interest		\$ 600 (CR)
	<u>\$17,000 (DR)</u>	<u>\$17,000 (CR)</u>

*To reverse loan impairment and record collection of principal and interest in full.*

**SITUATION 1 (C)**

*Assume that the impaired loan has been written-off and a subsequent payment of \$500 has been received.*

Required Accounting Entries:

Allowance for Impaired Loans	\$ 4,360 (DR)	
Personal Loan Receivable		\$4,000 (CR)
Accrued Interest		\$ 360 (CR)
	<u>\$ 4,360 (DR)</u>	<u>\$4,360 (CR)</u>

To recover loan written-off:

Cash	\$ 500 (DR)	
Provision for Impaired Loans		\$ 500 (CR)

*To record recovery of \$500 through the income statement.*

**What is the purpose of a non-specific provision for impaired loans?**

The objective of including a non-specific provision in the allowance for impaired loans is to set aside reserves for anticipated loan losses. Such losses cannot be linked with particular loans, but are judged likely by management, given increasing credit risk in the loan portfolio and/or the economy at large.

Member institutions are required to document and establish a process to ascertain when a non-specific provision is required. This process should include monitoring economic conditions that may impact the quality of the loan portfolio on a monthly basis. (This is consistent with the requirement to calculate the “provision” on a monthly basis as outlined in Section 22, Ontario Regulation 76/95.)

**What is the income tax treatment of non-specific provisions?**

Questions concerning the income tax treatment of this GAAP requirement should be addressed to tax specialists.

**How should the non-specific provision be made?**

The non-specific provision should include an estimate of probable losses on any loan group for which specific events or recent changes in economic conditions suggest the group’s credit quality has deteriorated (although this may not yet be evident in individually impaired loans). Such a non-specific allowance should be set using management’s judgment and experience, excluding:

- ❖ loans in the group for which specific provisions have been made, and
- ❖ insured or government-guaranteed loans.

In accordance with CICA Handbook, Sections 3025.09 and 3025.10, the following examples of specific events are:

- ◆ A higher than normal level of unemployment;
- ◆ A depressed real estate market.

Other examples include:

- ◆ Strikes or production cutbacks that are likely to impact a measurable portion of the membership;
- ◆ Changes in terms of employment contracts that increase the likelihood of industry or employer job losses;
- ◆ Poor weather conditions that are likely to result in lower crop yields and cash flows.

Examples provided of recent changes in economic conditions are:

- ◆ A sharp decline in the price of a commodity;
- ◆ A significant and rapid increase in the general level of interest rates.

When determining “groups” of loans, it is necessary to segregate the loan portfolio into homogeneous groups within each loan class that share the same risk characteristics (e.g. employment type, loan purpose, etc.). In some cases, a “group” may be limited to a specific loan class (i.e. mortgages, personal loans, agricultural loans, etc.) or the total portfolio.

Classes of loans are outlined in Ontario Regulations 76/95, sections 51-57 and include:

- ◆ Agricultural loans
- ◆ Bridge loans
- ◆ Commercial loans
- ◆ Institutional loans
- ◆ Personal loans
- ◆ Residential mortgage loans
- ◆ Syndicated loans
- ◆ Unincorporated Association loans

Groups of loans may also be based on branch location, region or market (e.g. rural, urban etc.)

There are a variety of methods which may be helpful when calculating a non-specific provision. These include consideration of:

1. Impaired loan coverage;
2. Historical loan loss experience;
3. High-risk (Watchlist);
4. Concentration risk;
5. Delinquency.

An overview of these methods is provided below. In certain circumstances, it may be appropriate to use a combination of these methods.

**Examples of methods to calculate non-specific loan loss provision for specific groups of loans.**

**1. The Impaired Loan Coverage Ratio**

The coverage ratio is based on the level of allowances relative to the total gross impaired loans. A higher ratio provides additional protection if recovery is lower than anticipated due to specific events or economic conditions. It may be reasonable to assume that this same ratio can be applied to those loans for which a non-specific provision is required.

<b>BASED ON IMPAIRED LOAN COVERAGE</b>		
Total Specific Allowance	\$ 85,000	(A)
Total Gross Impaired Loans	<u>\$750,000</u>	(B)
Coverage ratio on impaired loans (A ÷ B)	11.33%	(C)
Total loans in this group (as determined by management)	\$586,000	(D)
<b>Non-Specific Provision required (C x D)</b>	<u><b>\$ 66,394</b></u>	

## 2. Historical Loan Loss Experience

The non-specific provision may be estimated by using historic knowledge of a member institution's actual loan loss experience for certain types of loans over past periods of similar events or economic conditions. These actual losses, compared to the specific provisions originally made for these loan categories, should highlight what extra allowance would have been appropriate. For example, bankruptcies may arise without prior impairment or delinquency.

### BASED ON HISTORICAL LOAN LOSS EXPERIENCE

Actual Loan Loss Experience during similar events or economic conditions	\$33,000	(A)
Original specific provisions for these loans	<u>\$27,000</u>	(B)
Change required	\$ 6,000	(C)
Percentage change required (C ÷ B)	22.2%	(D)
Current specific provision for group of similar loans	<u>\$12,000</u>	(E)
Non-specific provision required (D x E)	<u>\$ 2,664</u>	

## 3. High-Risk (Watchlist)

In some cases, high risk loans, that are not yet impaired, are identified and monitored on a "Watchlist" (e.g. mortgage loans where security values have decreased, loans to borrowers in poorly performing industries, etc). Experience may indicate probable losses on loans with similar risk profiles which have been identified on this Watchlist and can be used to calculate any non-specific provision deemed appropriate.

### BASED ON HIGH-RISK (WATCHLIST)

Watchlist (does not include impaired loans where a specific allowance has been established):

Personal Loans	\$ 65,000	A
Commercial Loans	\$750,000	B
Agricultural Loans	<u>\$100,000</u>	C
Total Watchlist	<u>\$915,000</u>	D

The example assumes that the Non-Specific Provision is 5% for Personal Loans and 10% for Commercial and Agricultural Loans :

Personal Loans (A x 5%)	\$ 3,250	E
Commercial Loans (B x 10%)	\$ 75,000	F
Agricultural Loans (C x 10%)	<u>\$10,000</u>	G
Non-Specific Provision Required (E + F +G)	<u>\$ 88,250</u>	

**NOTE: Actual experience will help determine the appropriate percentage to use for each loan group.**

#### 4. Concentration Risk

Different industries or loan types have different levels of inherent risk. Evidence may be available to help determine an appropriate “default rate” for specific industries or types of agricultural loans which can be used to determine the adequacy of the loan loss allowance and any additional non-specific provision required.

<b>BASED ON INDUSTRY OR AGRICULTURAL CONCENTRATION / RISK</b>				
	<b>% of Loan Portfolio (A)</b>	<b>Default Rate (B)</b>	<b>Portfolio Risk (A x B)</b>	
Industry (1)	20%	5%	1%	
Industry (2)	20%	10%	2%	
Industry (3)	10%	20%	2%	
<b>Total</b>			<u>5%</u>	<b>(C)</b>
Total Loans (Industry 1,2 and 3)			<u>\$4,500,000</u>	(D)
Non-specific provision required for this group of loans (C x D)			<u>\$ 225,000</u>	(E)

#### 5. Delinquency Ratio

Delinquency is an indicator of probable future impairment. Historical evidence may indicate a relationship between delinquency and impairment that may be used to determine the adequacy of the allowance and any additional non-specific provision required for a group of loans.

<b>BASED ON DELINQUENCY</b>			
Total Delinquent Loans (over 30 days)		\$ 980,000	
Total Impaired Loans		<u>\$ 25,000</u>	
Total non-impaired Delinquent Loans		\$ 965,000	(A)
This example assumes the Non-Specific Provision is to be based on historical loan delinquency of 3%		<u>3%</u>	(B)
Non-specific Provision (A x B)		<u>\$ 28,950</u>	

Please refer to Appendix II for sample calculation schedules for non-specific loan loss provisions.

**SAMPLE NOTES TO THE FINANCIAL STATEMENTS:**

The following sample notes are illustrations of the type of information that must be disclosed in financial statements.

**Note 1: Loans to Members****SAMPLE CALCULATIONS WHEN DISCOUNTING****ALLOWANCE FOR IMPAIRED LOANS**

Loan Category	Impaired Loans	Allowance for Impaired Loans		
		Current Year	Previous Year	
Residential Mortgages	\$ 35,000,000	\$ 1,625,000	\$ 60,000	\$ 70,000
Commercial Loans	7,500,000	425,000	245,000	200,000
Personal Loans	10,000,000	217,000	85,000	60,000
	<u>\$ 52,500,000</u>	<u>\$ 2,267,000</u>	<u>\$ 390,000</u>	<u>\$ 330,000</u>

*Note: \$200,000 of commercial loans and \$150,000 of personal loans were grouped together to establish specific allowances totalling \$100,000 and \$40,000 respectively. The allowance also includes a \$50,000 non-specific provision for commercial loans.*

**FORMALLY RESTRUCTURED LOANS\***

	Current Year	# Loans	Previous Year	# Loans
Mortgages	\$ 125,000	2	\$ 95,000	1
Commercial Loans	405,000	5	100,000	2
Personal Loans	70,000	14	30,000	8
	<u>\$ 600,000</u>	<u>21</u>	<u>\$ 225,000</u>	<u>11</u>

*Note: Formally restructured loans are no longer considered impaired.*

\*Total represent cumulative outstanding balances.

**CONTINUITY SCHEDULE: ALLOWANCE FOR IMPAIRED LOANS**

	Current Year	Previous Year
Allowance (beginning of year)	\$ 320,000	\$ 330,000
Write-offs	(280,000)	(200,000)
Loan Recoveries	60,000	80,000
Net Provision for Impaired Loans	290,000	120,000
Allowance (end of year)	<u>\$ 390,000</u>	<u>\$ 320,000</u>

The allowance for impaired loans herein disclosed is in accordance with DICO's By-law No. 6.

*Note: Where a member institution continues to include accrued interest in the recorded amounts of its impaired loans and offsets these accruals with a higher allowance, the amount of increased allowance, as a result of this practice, must be separately disclosed.*

# APPENDIX I

## SAMPLE SPECIFIC ALLOWANCE CALCULATION SCHEDULE FOR A PORTFOLIO OF LOANS\* Allowance for Impaired Loans as Required under DICO By-law No. 6

Loans Category	1 Month Start Net Impaired Loans (Contractual Principal plus Interest less Allowance)	2 Loans Becoming Impaired During Month (Contractual Principal plus Interest)	3 Month End Net Impaired Loans = 1 + 2	4 Net Security Valuation**	5 Discounted Amount of Future Receipts	6 Charge to Loan Impairment = 3-4-5	7 Month Start Allowance for Impaired Loans	8 Month End Allowance for Impaired Loans 6+7
Personal								
Residential Mortgages								
Commercial								
Agricultural								
Institutional								
Unincorporated Associations								
Other								
TOTALS								

\*Note that the Board should review this schedule monthly as well as support documentation listing individual impaired loan balances, individual supporting security valuations for each loan and any application group discounted amounts. Additionally, the Board should be advised of all written-off and formally restructured loans arranged during the month and any provision for non-specific loan impairment.

\*\*Note that Net Security Valuation must be determined on a loan-by-loan basis. Any excess of security pertaining to one borrower may not be applied against the impairment of another borrower.

# APPENDIX II

## SAMPLE CALCULATION OF NON-SPECIFIC LOAN LOSS PROVISIONS Based on Coverage Ratio

### EXAMPLE 1

	Non-Specific Loan Loss Provision	Personal Loans	Residential Mortgage Loans	Commercial Loans	Institutional Loans	Unincorporated Loans	Agricultural Loans	Total
A	Total Specific Allowance							
B	Total Gross Impaired Loans							
C	Coverage Ratio (A ÷ B)							
D	Group of Loans Requiring Non-Specific Provision							
E	% of Non-Specific Provision required (C)							
F	\$ Non-Specific Provision required (D x E)							
G	Current Non-Specific Provision							
H	Additional Provision Required (F - G)							

**SAMPLE CALCULATION OF NON-SPECIFIC LOAN LOSS PROVISIONS**  
**Based on Historical Loan Loss Experience**

**EXAMPLE 2**

	Non-Specific Loan Loss Provision	Personal Loans	Residential Mortgage Loans	Commercial Loans	Institutional Loans	Unincorporated Loans	Agricultural Loans	Total
A	Actual Loan Loss Experience during similar events or economic conditions							
B	Original specific loan loss provision for these loans							
C	Change required (A - B)							
D	% change (C ÷ B)							
E	Current Specific Allowance							
F	Non-Specific Provision Required (D x E)							

**SAMPLE CALCULATION OF NON-SPECIFIC LOAN LOSS PROVISIONS**  
**Based on High Risk (Watchlist) Loans**

**EXAMPLE 3**

	Non-Specific Loan Loss Provision	Personal Loans	Residential Mortgage Loans	Commercial Loans	Institutional Loans	Unincorporated Loans	Agricultural Loans	Total
A	Group of Loans Identified as Requiring Non-Specific Provision (i.e. Watchlist)							
B	% of Non-Specific Provision required based on risk profile							
C	Non-Specific Provision required (A x B)							
D	Current Non-Specific Provision							
E	Additional Non-Specific Provision Required (D - C)							

**SAMPLE CALCULATION OF NON-SPECIFIC LOAN LOSS PROVISIONS**  
**Based on Industry Concentration/Risk**

**EXAMPLE 4**

	Non-Specific Loan Loss Provision	Industry (1)	Industry (2)	Industry (3)	Industry (4)	Industry (5)	Industry (6)	TOTAL
A	Total Loans							
B	% of Loan Portfolio							
C	Industry Risk Rating %							
D	Weighted Risk (B x C) %							
E	Non-Specific Provision required (D x A)							
F	Current Non-Specific Provision							
G	Additional Non-Specific Provision (E - F)							

**SAMPLE CALCULATION OF NON-SPECIFIC LOAN LOSS PROVISIONS**  
**Based on Loan Delinquency**

**EXAMPLE 5**

	Non-Specific Loan Loss Provision	Personal Loans	Residential Mortgage Loans	Commercial Loans	Institutional Loans	Unincorporated Loans	Agricultural Loans	Total
A	Delinquent Loans Identified Requiring Non-Specific Provision							
B	Gross Impaired Loans in (A)							
C	Non-Impaired Delinquent Loans (A - B)							
D	% of Non-Specific Provision required							
E	\$ Non-Specific Provision required (C x D)							
F	Current Non-Specific Provision							
G	Additional Non-Specific Provision Required (E - F)							

# APPENDIX III

## SAMPLE CALCULATIONS WHEN DISCOUNTING GROUPS OF LOANS

The following formulae are required to "group discount" impaired loans. The objective of these calculations is to establish the average percentage recovery for a member institution, based on a history of collecting past impaired loans, and the average length of time it took to obtain these recoveries.

The information is then applied to the current portfolio of impaired loans, after determining the weighted-average interest rate of this group of loans. The weighted-average interest rate is needed in order to appropriately discount the group's expected dollar recoveries over an average remaining collection period. For example, if it is established that on average 27 months were needed to collect recoveries on a past group of impaired loans, and a present group of loans has been impaired, on average, for three months, then the required discounting period for the present group of impaired loans is 24 months (27 months - 3 months).

### Formulae

**A: HISTORIC AVERAGE RECOVERY PERIOD FOR IMPAIRED LOANS** = Number of days required to finalize collection of each impaired loan in a homogeneous group weighted by the dollar size of each loan relative to the group.

**B: HISTORIC PERCENTAGE RECOVERY ON IMPAIRED LOANS** = Sum of dollars collected from a group of impaired loans in a homogeneous group, divided by the amount outstanding on these loans when they became impaired.

Obtaining the data for the formulae requires research into the historical collection experience of a member institution. A recommended approach would be to identify in the most recent fiscal year, or beyond as necessary, all impaired loans for which collection activity ceased as a result of a final payout or otherwise.

These loans should be traced back to their original date of impairment to find the total number of days required to resolve them. **A sample size of at least 30 loans is required to statistically validate a member institution's ability to make recoveries on impaired loans.** (If a sample size of 30 loans is not available, a smaller sample size may be used if the results are adjusted by the standard deviation of such samples. Detailed knowledge of statistics and standard deviation techniques would be required for using samples smaller than 30 to group discount loans for purposes of By-law No. 6.)

#### IMPAIRED LOAN 1

Day 1	\$8,000 Principal
Day 120	Impaired, \$7,600 balance
Day 1100	Paid off
Recovery Period	1100 - 120 = 980 days
Recoveries	\$7,600

#### IMPAIRED LOAN 2

Day 1	\$5,000 Principal
Day 60	Impaired, \$4,000 balance
Day 850	Borrower declares bankruptcy
Recovery Period	850 - 60 = 790 days
Recoveries	\$1,500

#### IMPAIRED LOAN 3

Day 1	\$3,000 Principal
Day 160	Impaired, \$1,500 balance
Day 610	Borrower absconded
Recovery Period	610 - 160 = 450 days
Recoveries	\$800

### Formula A

#### HISTORIC AVERAGE RECOVERY PERIOD FOR IMPAIRED LOANS

Loans in Historic Group	Recovery Days	Weighted Average Days*
1. \$ 8,000	980 x 8/16	= 490
2. \$ 5,000	790 x 5/16	= 247
3. \$ 3,000	450 x 3/16	= 84
\$16,000		821 days ÷ 30
		27 months*

\*Approximate to closest month

### Formula B

#### AVERAGE PERCENTAGE RECOVERY ON IMPAIRED LOANS

Balance at Impairment	Dollars Subsequently Recovered
Loan:	
1. \$ 7,600	\$ 7,600
2. \$ 4,000	\$ 1,500
3. \$ 1,500	\$ 800
\$13,100 (A)	\$ 9,900 ÷ (A) = 75%

### Formula C

REMAINING RECOVERY PERIOD FOR CURRENT GROUP OF IMPAIRED LOANS = Historic Average Recovery Period less Weighted Average Age of Currently Impaired Loans.

$$717 \text{ days} = 821 \text{ days} - 104 \text{ days} \\ (24 \text{ mo.})^*$$

The average age of currently impaired loans should be weighted by size of loan to group size as follows:

New Impaired Loans	Days of Impairment	Weighted Average Age
Loan: 4. \$ 7,000	100 x 7/13	= 53
5. \$ 4,000	120 x 4/13	= 37
6. \$ 2,000	90 x 2/13	= 14
\$13,000		104 days

\*Approximate to closest month

### Formula D

WEIGHTED AVERAGE GROUP INTEREST RATE = Sum of Interest Rates **Weighted** by Loan Size to Total Loans.

New Impaired Loans	Interest Rate*	Weighted Average Rate
Loan: 4.	10% x 7/13	= 5.38%
5.	13% x 4/13	= 4.00%
6.	18% x 2/13	= 2.77%
		12% approx.

\*Weighted by individual loan dollar size to total dollars of impaired loan group.

# APPENDIX IV

## MONTHLY ACCOUNTING FOR FORMALLY RESTRUCTURED LOANS

Generally, for formally restructured loans, the contracted principal balance would differ from the recorded principal balance. As a result, loan payments over time would not match the loan amortization that is recorded on the accounting books. GAAP requires that such monthly cash discrepancies (both interest and principal payments) be posted to loan principal as a reconciling accounting entry.

To avoid monthly accounting reconciliations, a member institution can, when restructuring loans, recognize all loan concessions granted as the forgiveness of principal, not interest. Then the renegotiated principal and interest will match the accounting records and none of the following, reconciling entries would be required.

### SITUATION 1

A formally restructured loan with an outstanding principal of \$20,000 and a 15% interest rate, is renegotiated to require a new \$650 monthly payment over a new term of 36 months. Its discounted amount in the accounting records is \$18,750 ( $\$650 \times 28.847$ ). The member institution, however, restructures the loan contract so that the stated principal remains at \$20,000 but interest is lowered. What month end accounting adjustments are required?

Calculated Answer:

	<b>Restructured Contract Amounts</b>	<b>Accounting Record Amounts</b>
Principal	\$20,000.00	\$18,750.00
Monthly Payment	\$ 650.00	\$ 650.00
Interest Rate	10.5%	15%
Interest Portion	\$ 175.00*	\$ 234.38*
Principal Portion	\$ 475.00*	\$ 415.62*

\*first month payment

Accounting Entries and Explanations:

	Debit	Credit
Accrued Interest	\$234.38	
Interest Income		\$234.38
<i>To record monthly accrued interest on the \$18,750 loan receivable at original interest rate of 15%</i>		
Cash - Interest Portion	\$175.00	
Accrued Interest		\$234.38
Loan Principal	\$ 59.38	
<i>To record receipt of contractual cash interest and reversal of interest accrual, and to record reconciling entry to loan principal</i>		
Cash - Principal Portion	\$475.00	
Loan Receivable		\$475.00
<i>To record receipt of contractual cash principal and appropriate reduction of loan receivable per monthly amortization</i>		

Note: This end principal balance equals the "Accounting Record Amounts" of starting principal \$18,750 minus \$415.62.

## SITUATION 2

A restructured consumer loan with an original principal of \$10,000 and a 12% interest rate is renegotiated to require a new monthly payment of \$460 over a new term of 24 months. For accounting purposes the loan is to be valued using FVS, which totals \$5,000. The member institution, however, restructures the loan contract so that interest not principal is forgiven. What month end accounting adjustments are required?

Calculated answer:

	<b>Restructured Contract Amounts</b>	<b>Accounting Record Amounts</b>
Principal	\$10,000.00	\$5,000.00
Monthly Payment	\$460.00	\$460.00
Interest Rate	9.5%	12%
Interest Portion	\$79.17*	\$50.00*
Principal Portion	\$380.83*	\$410.00*
*first month payment		

Accounting Entries and Explanations:

	Debit	Credit
Accrued Interest	\$50.00	
Interest Income		\$50.00

*To record accrued interest on the \$5,000 loan receivable at 12%*

Cash - Interest Portion	\$79.17	
Accrued Interest		\$50.00
Loan Principal		\$29.17

*To record receipt of contractual cash interest and reversal of interest accrual, and to record reconciling entry to loan principal*

Cash - Principal Portion	\$380.83	
Loan Principal		\$380.83

*To record receipt of contractual cash principal*

**NOTE: Using the FVS method, the recorded principal of \$5,000 will be fully amortized after 12 months. All additional cash receipts will therefore have to be credited to loan recoveries. This will allow the member institution to take back into income in the second year, its overly conservative write-off booked in the first year. In contrast, the discounting method would only have required a small writedown, reducing the loan's recorded amount to \$9,770 (\$460 x 24 months 12% annuity factor of 21.243) versus \$5,000 under FVS, which was highly conservative.**

# NOTES



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