Non - Recognition of Interest Income in Small Financial Institutions

P.G.K.H. Dharmadasa& U.L.T.P. Gunasekara
hansamalikpd@gmail.com & thamarag@kln.ac.lk

Introduction

LMD Ltd is a company which provides micro credit in remote areas; however the company does not take deposits. The loan portfolio includes variety of loan categories such as business development, consumption, dairy, etc.

Discussion of the Issue

The disbursement of loans are handled by the Micro Finance Officers (MFOs) and loan installments are settled by customers as direct deposits to the bank other than paying in the cluster meetings. Since the actual loan due dates and the cluster dates are different, the company considers recent cluster date of the client as the applicable due date of the loan of that customer.

Therefore the company recognizes interest income at the point where it receives from cash which is the cluster meeting date or direct deposit date. Therefore when the due date comes, an interest receivable account will not be created, rather the company identifies interest income which is the operating income of the company on cash basis as follows.

Assume that interest received on a certain day was Rs.6, 000. It recognizes by the company as follows.

Cash/Bank a/c	Dr	Rs.6, 000		
Relevant Interest Income a/c		Cr	Rs.6, 000	

Since the company renders services, as per the paragraph 30 of LKAS 18 – Revenue; the interest income of the company can be recognized as stated below.

The outcome of the transaction can be estimated reliably when all the following conditions are satisfied:

a) *It is probable that the economic benefits associated with the transaction will flow to the entity; and*
b) *The amount of the revenue can be measured reliably*

Since the company receives interest income of loans throughout the loan period, criteria *a)* get satisfies.

The interest income can be recognized through effective interest method which demonstrates in paragraph 30 in LKAS 18 as, "*interest shall be recognized using the effective interest method as set out in LKAS 39 paragraphs 9 and AG5-AG8*". In accordance with LKAS 39 – Financial Instruments: Recognition and Measurement, the effective interest rate has defined as, "*the effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocation the interest income or interest income over the relevant period*". This definition get satisfies criteria *b)*, because the revenue amount for each period can be measured reliably through the effective interest method. Through effective interest method, future cash receipts will be discounted through the expected life of the loan. Future cash receipts can be estimated including all the contractual terms (all fees and points received) without considering the future credit losses.

Since company recognizes interest income on cash basis and most of the expenses in accrual basis, the matching concept also get violated as per the paragraph 4.40 of the Conceptual Framework for Financial Reporting.

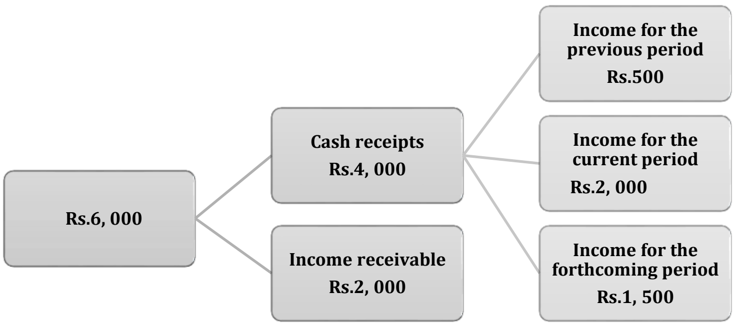
Implications of the Issue

If the company does not recognize the income properly for a particular period, the financial statements will not demonstrate an accurate image. Based on the cash basis, the income will include the income for the previous period of time, income for the forthcoming period of time, income for the present period or any combination of them. This can either undervalue or overvalue the actual income of the period. Since the recognition is not according to LKAS 39, it will affect the provisions made for loan losses as well.

The Statement of Financial Position also will be inaccurate, since there will be no interest income receivable or interest income received in advance. This will reduce the assets, liabilities or either both.

Conclusion and Recommendations

Interest income need to be identified for the relevant period of time as per LKAS 18 and LKAS 39.



The above income need to be recognized as follows.

Cash/Bank	Dr	Rs.4, 000		
Interest Income Receivable	Dr	Rs.2, 000		
Interest Income Receivable			Cr	Rs. 500
Interest Income			Cr	Rs.4, 000
Interest received in advance			Cr	Rs.1, 500

Since the income needs to be recognized for the relevant period, an account for interest income receivable will be created. Thus the Statement of Comprehensive Income and Statement of Financial Position will indicate accurate information.

The interest income receivable and interest income received in advance can demonstrate in notes of the Statement of Financial Position as a maturity analysis as the practice in the industry. This includes remaining contractual period to maturity as at the date of Statement of Financial Position of the assets employed.

Maturity analysis can include different time periods such as,1 -3 months, 3 – 12 months, 1 – 3 years, 3 – 5 years and more than 5 years. This can be different from company to company based on their loan portfolio. Maturity analysis will make the user of the financial statements to understand the non-current assets/liabilities and current assets/liabilities relating to the interest income.