

Query No. 16

Subject: Classification of loan assets and collateral repossessed under SARFAESI Act, 2002 as 'Non-current Assets Held for Sale' as per Ind AS 105.¹

A. Facts of the Case

1. A company (hereinafter referred to as 'the Company') is registered with the National Housing Bank (NHB) in February 2009 to carry on the business of housing finance. The financial statements of the Company are prepared in accordance with Indian Accounting Standards (Ind AS) notified under section 133 of Companies Act, 2013 (hereinafter referred to as 'the Act'), as amended from time to time, the guidelines issued by the NHB and Reserve Bank of India (RBI) to the extent applicable and the relevant provisions of the Act. The financials of the Company for the year ended March 31, 2019 were the first financial statements prepared in compliance with Ind AS along with restated comparatives.

2. The Company offers to its borrowers, a range of mortgage-related loan products, which include housing loans, secured business loans, and affordable housing project loans which are secured through mortgage of residential or commercial properties. In the normal course of its business, the Company follows the applicable collection mechanism process for recovery of dues from the borrowers, which involves invoking provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), actual/physical repossession of assets after eviction and subsequent sale of repossessed assets via auction process in case of default by the borrowers.

3. The Company is empowered to take necessary action in case of default under the provisions of the SARFAESI Act, which includes taking possession of the secured assets in lieu of the loan outstanding. The Company's endeavour will be to sell the assets so repossessed, in a public auction and realise the sale proceeds to recover the loan amount outstanding at the earliest. The customer has all opportunity to repay the loan amount before finalisation of sale of the property and take back the possession. Further, any excess amount received from sale of the property during auction process, i.e., sale value less all the dues pertaining to the case is required to be passed on to the customer. Shortfall, if any, will have to be debited to the Statement of Profit and Loss as a write-off and other legal recourse for recovery of short-fall (i.e., balance loan amount outstanding) will be continued. The Company may participate in auction/sale proceedings and itself retain the repossessed assets, after auction failures due to adverse market conditions, with intent to sell the same when the market conditions are favorable. It is possible that even after initiating auction process, the Company may not be able to sell the property due to various circumstances, such as, borrower initiated litigations or adverse market conditions.

4. As per the querist, the stages of recovery mechanism initiated under SARFAESI Act are as follows:

1. Loan classified as non-performing asset (NPA)
2. Demand notice under Section 13(2) of SARFAESI Act issued
3. Possession notice under Section 13(4) of SARFAESI Act issued
4. Applied for order under Section 14 of SARFAESI Act for physical possession of the property
5. Eviction and physical possession of the property

¹ Opinion finalised by the Committee on 23.8.2022.

6. Auction for sale initiated
7. Multiple auction attempts are made in case the auction is not successful for the first time.

5. The querist has provided the extracts from Indian Accounting Standard (Ind AS) 105, 'Non-current Assets Held for Sale and Discontinued Operations' and Ind AS 1, 'Presentation of Financial Statements' and the relevance of the same to the facts of the extant case as follows:

Paragraph no. of Ind AS 105	Extracts from relevant paragraph of Ind AS 105	Facts of the extant case
1	<p>“The objective of this Indian Accounting Standard (Ind AS) is to specify the accounting for assets held for sale, and the presentation and disclosure of <i>discontinued operations</i>. ...”</p> <p><u>[Paragraph 66 of Ind AS 1</u></p> <p>“An entity shall classify an asset as current when:</p> <p>(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;</p> <p>(b) it holds the asset primarily for the purpose of trading;</p> <p>(c) it expects to realise the asset within twelve months after the reporting period; or</p> <p>(d) the asset is cash or a cash equivalent (as defined in Ind AS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.</p> <p>An entity shall classify all other assets as non-current.”]</p>	<p>The Company takes possession of collateral property at Stage No. 5 above for the loan asset classified under amortised category. If the customer defaults in loan repayments, the Company initiates SARFAESI Act proceedings against the borrower and, by virtue of Court Order, physically possesses the property which was pledged with the Company against the borrowings.</p> <p>Alternatively, the Company may purchase/acquire property at the auctions in case there are no buyers for the property or failure of the auctions due to non-availability of better market demand.</p> <p>The property so acquired may either be used by the Company for its own use (which is either classified as Property Plant and Equipment or Investment property) or may be held with an intent to sell the same when the market conditions are favorable.</p>
2	<p>“The classification and presentation requirements of this Ind AS apply to all recognised <i>non-current assets</i> and all <i>disposal groups</i> of an entity. ...”</p>	
6	<p>“An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally</p>	<p>The primary intent of the Company is to earn interest on loan provided to borrowers and to recover the dues on a timely basis.</p>

	through a sale transaction rather than through continuing use.”	The Company’s right to repossession of collateral property in respect of non performing loans is one such step in the recovery processes and its disposal via auction depends on fulfillment of various conditions.
7	“For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be <i>highly probable</i> . Thus, an asset (or disposal group) cannot be classified as a non-current asset (or disposal group) held for sale, if the entity intends to sell it in a distant future.”	Assets acquired under SARFAESI Act and where the auction process is initiated are available for immediate sale. However, intent of the Company is to recover the amount from customers for loan outstanding. If the customer pays the due amount before sale of property is committed, then, the sale is stopped and the property is handed over to customer or loan is regularised. In certain cases, sale under auction is hampered due to legal action taken by customer.
8	“For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, except as permitted by paragraph 9, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. ...”	
11	“When an entity acquires a non-current asset (or disposal group) exclusively with a view to its subsequent disposal, it shall classify the non-current asset (or disposal group) as held for sale at the acquisition date only if the one-year requirement in paragraph 8 is met...and it is highly probable that any other criteria in paragraphs 7 and 8 that are not met at that date will be met within a short period following the acquisition (usually within 3 months)”	

5	<p>“The measurement provisions of this Ind AS do not apply to the following assets, which are covered by the Ind ASs listed, either as individual assets or as part of a disposal group:</p> <p>(a) ...</p> <p>(b) ...</p> <p>(c) financial assets within the scope of Ind AS 109, <i>Financial Instruments</i>.</p> <p>(d) ...</p> <p>(e) ...</p> <p>(f) ...”</p>	<p>The Company provides loans to the borrowers which are covered by Ind AS 109. The company carries a provision on such loan assets in accordance with Expected Credit Loss methodology.</p> <p>The Company acquires the collateral assets in event of failure of the auctions due to non-availability of better market demand.</p>
15	<p>“An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.”</p>	
16	<p>“If a newly acquired asset (or disposal group) meets the criteria to be classified as held for sale (see paragraph 11), applying paragraph 15 will result in the asset (or disposal group) being measured on initial recognition at the lower of its carrying amount had it not been so classified (for example, cost) and fair value less costs to sell ...”</p>	
5B	<p>“This Ind AS specifies the disclosures required in respect of non-current assets (or disposal groups) classified as held for sale or discontinued operations ...”</p>	<p>The disclosure of loan assets is done in accordance with Ind AS 109.</p>
30	<p>“An entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposal of non-current assets (or disposal groups).”</p>	

6. With reference to paragraphs 6 and 7 of Ind AS 105, the querist has stated that the Company, while pursuing recovery process under SARFAESI Act, repossesses the asset “as on where is basis” and further goes for sale through auction process with the primary intent to recover amount from customer. If during the said recovery process but before sale is committed, the customer clears the dues, the loan account is regularised or closed as the case may be. In case the property is sold through auction process, loss is booked and further legal recourse is followed for recovery and, gain, if any, is returned to customer after setting off all dues. After repossession, recourse available for the Company is selling the property and the Company cannot utilise it or earn any income from it. In some cases, the property could not

be sold under auction due to distressed market situation. In such cases, the Company acquires/purchases the asset in the final auction process and the sale is executed in the Company's favour. Post acquisition, the Company intends to sell the property at the fair price.

7. As per paragraph 5 of the Ind AS 105, the measurement provisions of the Ind AS do not apply to financial assets within the scope of Ind AS 109. As a measure for recovering amount from customer, the Company repossesses/acquires the asset under SARFAESI Act for loans which are classified as loan assets within the scope of Ind AS 109.

B. Query

8. The querist has sought the opinion of the Expert Advisory Committee on the following issues:

- (i) At stage 5 mentioned in paragraph 4 above, the Company repossesses the property for recovery of the dues through auction and after stage 7 mentioned in paragraph 4 above, the Company acquires/purchases property under last auction due to distressed market situation. To comply with Ind AS 105, at which stage the Company should classify the asset as 'Asset held for sale' from 'Loan assets under amortised cost' category?
- (ii) As the Company's loan assets are in the nature of financial assets covered by Ind AS 109, at which stage the measurement criteria as per Ind AS 105 will be applicable i.e., at auction stage or acquisition of assets by the Company on failure of the auction? Whether the physical property possessed in lieu of amounts outstanding or as a settlement option can continue to be classified as a financial asset. If it is concluded that the same is not a financial asset, then, whether such property possessed with the intention of selling should be classified as Asset Held for Sale and carried at the lower of cost and its fair value less costs to sell as per Ind AS 105.

C. Points considered by the Committee

9. The Committee notes that the basic issues raised by the querist relate to timing of classification of loan assets and the repossessed collateral in case of default by customer as 'held for sale' and timing of applicability of measurement provisions of Indian Accounting Standard (Ind AS) 105, 'Non-current Assets Held for Sale and Discontinued Operations' to the same. The Committee has, therefore, considered only these issues and has not examined any other issue that may be contained in the Facts of the Case, such as, accounting for loan or collateral asset before the default by customer, provision for credit loss on loan assets as per expected credit loss methodology under Ind AS 109, derecognition of loan asset including timing thereof, etc. The Committee expresses its views in the context of the Companies (Indian Accounting Standards) Rules, 2015, as amended till date. Further, it appears from the Facts of the Case that the Company is a non-banking financial company and, hence, Division III of Schedule III to the Companies Act, 2013 is applicable to the Company. The Committee notes that as per the querist, the borrower can take back the possession of the collateral by repaying the amount due before the sale of the collateral is committed. The Committee expresses its views only for this particular situation presented in the Facts of the Case. Further, though paragraph 8(ii) above refers to possession of physical property "in lieu of amounts outstanding or as a settlement option", as per the Facts of the Case, the collateral can only be sold in auction (in which the Company may also participate in some situations) and

the disposal proceeds alone can be adjusted against the loan. The Committee expresses its views for this fact pattern only.

10. As far as reclassification of loan asset is concerned, the Committee notes that the mortgaged asset (i.e., mortgaged residential or commercial property) repossessed by the Company on default by the borrower is a collateral for the loan given. Since the collateral is repossessed not in satisfaction or settlement of the loan asset, the repossessed collateral cannot be directly adjusted against the outstanding loan amount. It can only be sold in public auction and the disposal proceeds can be adjusted against the outstanding loan amount (though the Company itself can acquire/purchase the asset in the final auction in case of failure of the auction due to distressed market conditions). The loan asset is, thus, held by the Company for collecting contractual cash flows and not for selling. Hence, the Committee is of the view that in the extant case, the loan asset cannot be classified as held for sale at any stage. Further, as per paragraph 3.2.3 of Ind AS 109, 'Financial Instruments', unless the contractual rights to the cash flows from the loan asset expire or the loan asset is transferred and the transfer meets certain conditions as per the derecognition requirements of Ind AS 109, the loan asset cannot be derecognised. Consequently, the loan asset cannot be transferred to repossessed collateral held for sale at any stage. (In any case, measurement requirements of Ind AS 105 are not applicable to loan assets within the scope of Ind AS 109 in view of paragraph 5 of Ind AS 105).

11. With regard to classification of repossessed collateral as an asset, the Committee notes paragraph 3.2.23 of Ind AS 109, reproduced below:

“3.2.23 If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:

- (a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its balance sheet (eg as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.**
- (b) If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.**
- (c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.**
- (d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.”**

The Committee notes from paragraph 3.2.23(c) of Ind AS 109 (reproduced above) that the transferee shall recognise the collateral as its asset only after expiry of right of redemption of the transferor who has defaulted under the terms of the contract, provided the collateral has not been not sold by that time.

12. With regard to right of redemption of collateral, the Committee notes that the querist has specifically stated that on default by the customer, the Company, while pursuing recovery process under SARFAESI Act goes for sale of the repossessed collateral through auction process with the primary intent to recover amount from customer and if during the said recovery process but before sale is committed, the customer clears the dues, the loan account is regularised or closed. The customer has all opportunity to repay the loan amount before finalisation of sale of the property and take back the possession of the collateral. Further, any excess amount received from sale of the property during auction process i.e., sale value less all the dues pertaining to the case is required to be passed on to the customer. Thus, apparently, in the extant case, the borrower has the right of redemption of the collateral till the sale of the collateral is committed. Therefore, the collateral cannot be recognised as an asset by the Company either on default by the borrower or on repossession of the collateral in the extant case except in the situation covered under paragraph 13 below. Since the collateral cannot be recognised as an asset at any stage by the Company, except that covered in paragraph 13 below, the question of timing of classification of the repossessed collateral as 'Non-current Asset Held for Sale' and application of measurement provisions of Ind AS 105 to the same does not arise at all.

13. The Committee now considers the situation where the Company acquires/ purchases the collateral in the final auction process. The Committee notes from the Facts of the Case that such a situation arises where the property could not be sold under auction due to distressed market situation. The property so acquired may either be used by the Company for its own use or may be held with an intent to sell it when the market conditions are favorable. Therefore, the Committee is of the view that if the acquired/purchased asset is to be used by the Company for its own use and qualifies for recognition under a specific Ind AS (e.g., Ind AS 16, 'Property, Plant and Equipment'), the same should be accounted for in accordance with the relevant Ind AS. In case the asset acquired/purchased is not to be used by the Company for its own use and is held for sale till favorable market conditions arise and is expected to be recovered more than twelve months after the reporting period, it will be a non-current asset in view of footnote 1 appended to paragraph 2 of Ind AS 105 which provides that "For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the reporting period ...". (This is because current/non-current presentation is not applicable for balance sheet purposes for the Company in the extant case, for which Division III of Schedule III to the Act is relevant as pointed out in paragraph 9 above). If the asset acquired/purchased is a non-current asset, then, the same should be classified as held for sale, only if all the criteria for such classification prescribed in Ind AS 105 are fulfilled. The Company should assess the stage at which the said criteria are met, which, in any case, cannot be before the acquisition/purchase date. From the time the said criteria are met, measurement criteria prescribed in Ind AS 105 would be applicable.

D. Opinion

14. On the basis of the above, the Committee is of the following opinion on the issues raised by the querist in paragraph 8 above:

- (i) Loan assets classified under amortised cost category should neither be reclassified as 'Held for Sale' nor be transferred to repossessed collateral held for sale at any stage. If the collateral is acquired/purchased by the Company in the final auction stage, the treatment should be as explained in paragraph 13 above.

- (ii) In view of (i) above and also because of paragraph 5 of Ind AS 105, measurement requirements of Ind AS 105 are not applicable for loan assets within the scope of Ind AS 109. The collateral cannot be recognised as an asset at any stage, except when acquired by the Company in the final auction process and, consequently, the question of classification of the collateral as a financial asset or the question of applying measurement criteria prescribed in Ind AS 105 to the collateral does not arise. If the non-financial collateral is acquired/purchased by the Company at the final auction stage, the treatment should be as explained in paragraph 13 above.
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