Income recognition of a loan with increasing rentals (Stepping up Loans): A case study on a selected Sri Lankan company

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In consequence to introduction of Sri Lanka Accounting Standards (SLFRS and LKAS) compatible with International Financial Reporting Standards (IFRS), by the Institute of Chartered Accountants of Sri Lanka with effect from 1st January 2012, The Company being a registered finance company with public accountability, is required to apply provisions of the full set of accounting standards and in the preparation of the financial statements in compatible with these new accounting standards, company has encountered numerous issues regarding the deviations from the requirements of the accounting standards. Out of them, this case study discuses in detailed one of the main issues that was identified during the preparation of financial statements of this company. This company provides range of different types of loans to its customers and among them it was identified a loan category with a specific feature. This loan type is called as "Stepping Up" loans and the special feature in this loan is its monthly installment changes (increases) in every 12 months. Therefore the monthly installments in first few years are relatively lower than the monthly installments of the final years of the loan agreement. In the interest income recognition of these types of loans company has encountered a problem because Sri Lanka Accounting Standard (LKAS) 39 – 'Financial Instruments: Recognition and Measurement' requires recognizing the interest income of loans using effective interest method where in the first two years of the loan agreements the monthly rental is not even enough to recover the interest of these loans which is calculated using effective interest method.

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