



# Ind AS impact analysis for non-banking financial companies

An analysis of published results of NBFCs  
for the year ended 31 March 2019



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# Contents

# Overview

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Phase 1 Non-banking financial companies (NBFCs) including housing finance companies (HFCs) made a mammoth journey in transitioning to the International Financial Reporting Standards (IFRS) convergent Indian Accounting Standards (Ind AS) for the year ended 31 March 2019. Also, the Ministry of Corporate Affairs (MCA) notified Division III to Schedule III of the Companies Act 2013 on 11 October 2018, which stated that every NBFC to

which Ind AS applies, shall prepare its financial statements in accordance with the prescribed schedule or with such modification as may be required under certain circumstances. These NBFCs have published their financial results for the year ended 31 March 2019. The results provided useful insights on how the adoption of Ind AS impacted NBFCs and proved to be a testament to their readiness to adopt a significant change in financial reporting.

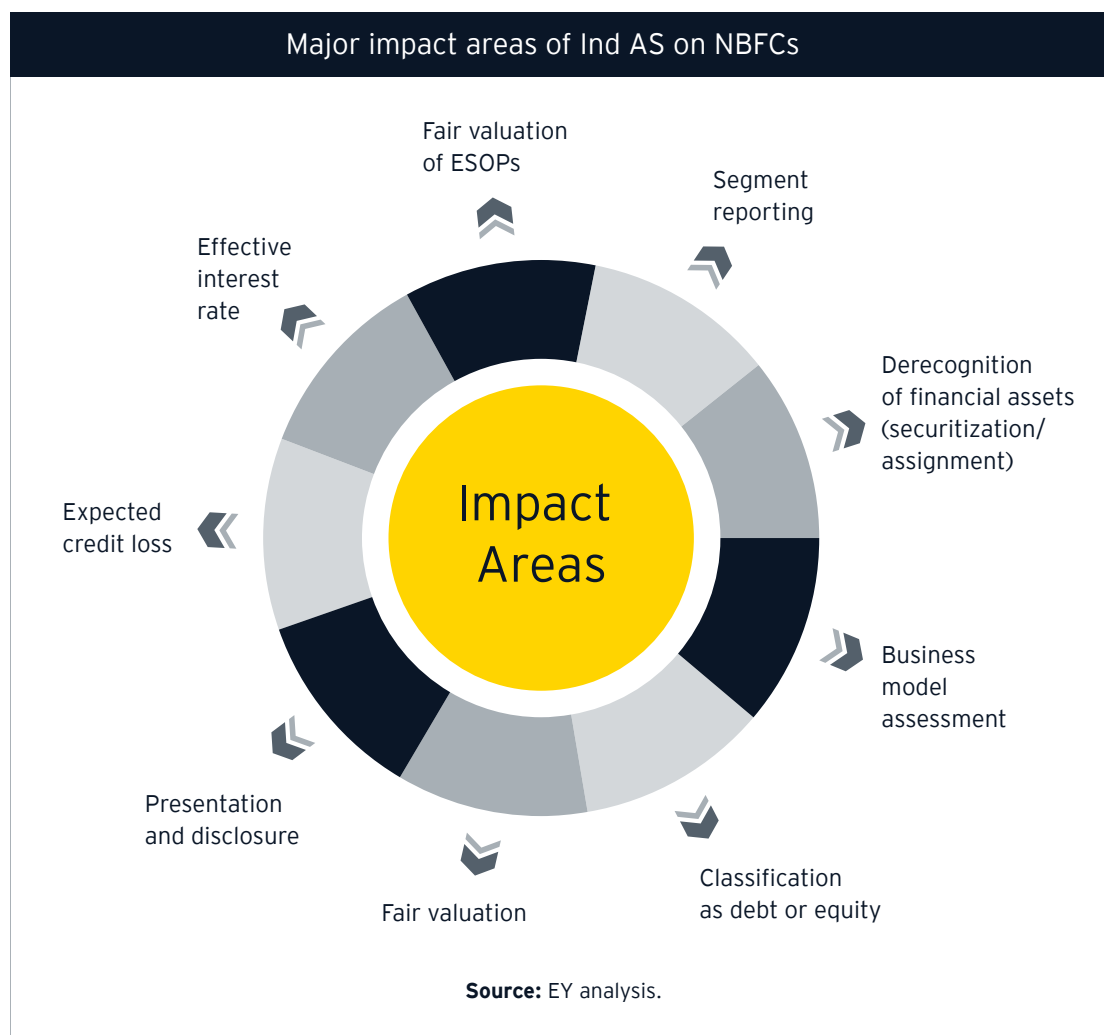
#### The major impact of Ind AS on these NBFCs were due to:

- ▶ the 'expected credit loss' model (ECL) which replaced the erstwhile incurred loss model
- ▶ the application of 'effective interest rate' (EIR)
- ▶ Fair valuation of financial instruments

The other impact areas include fair valuation of employee stock option plan (ESOPs), securitization and assignment arrangements, and taxation. We have explained the key GAAP differences, analysis from the published

financial statements and key observations and implementation experiences, wherever possible, for impact areas in relevant sections below.

#### Major impact areas of Ind AS on NBFCs



The instructions issued by the Reserve Bank of India vide its circular dated 13th March 2020 on Implementation of Indian Accounting Standards by Non-Banking Financial Companies is a positive move and has addressed certain issues faced by these companies while preparing their financial statements.

It has brought in relevant controls by putting additional responsibility on the audit committee and the Board of Directors of these companies of approving certain decisions which were generally taken by the management of the Companies. For example, the requirement for any changes in the parameters, assumptions and other aspects of their ECL model to be approved by the Board will put increased controls on the way assumptions and other aspects of the ECL model are determined.

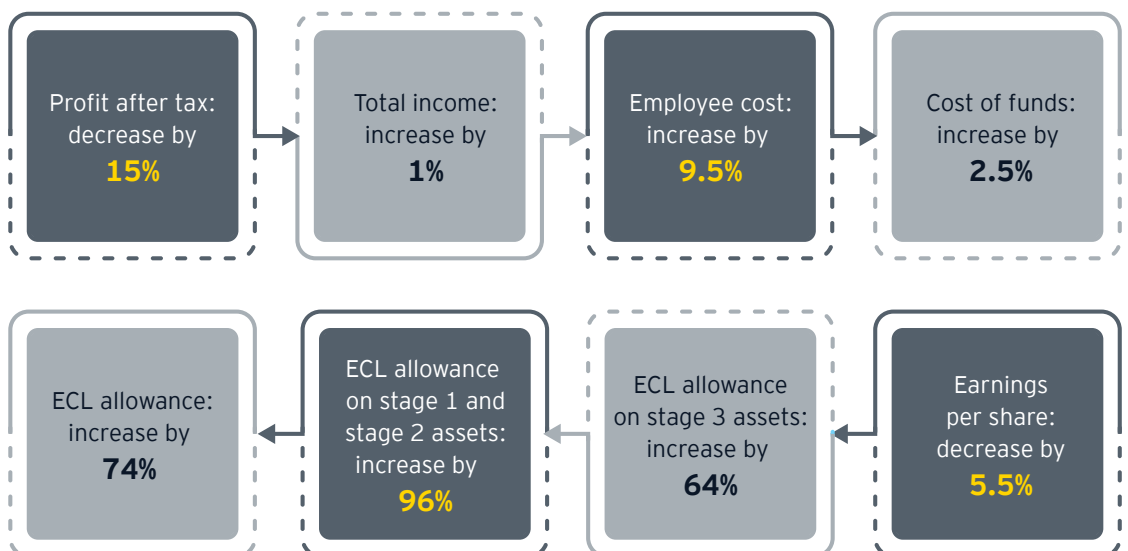
The creation of the impairment reserve (provisions as per IRACP less provisions as per the expected credit loss model) would offer some cushioning to the NBFC in the long run and at the same time giving them a realistic profit and loss account.

However, these instructions have been silent on the treatment and determination of macro-economic factors and the provisioning under the expected credit loss method for investments in government securities and loans secured by guarantees from government entities.

NBFCs faced significant implementation challenges for transition to Ind AS specifically in relation to data availability and systems and processes. Our analysis indicated that there was scope for improvement in providing explanation for transition to Ind AS and disclosures, specifically those relating to financial instruments.

Also, NBFCs need to consider the impact of the ongoing COVID-19 outbreak and regulatory reliefs by RBI vide circular dated 27th March 2020 when preparing their Ind AS financial statements. As Phase 2 NBFCs get ready to publish their first set of financial results under Ind AS, this publication focuses on the major impact areas relating to the sector by analyzing these financial results. Considering the impact and complexities of Ind AS, accounting teams would have to be well prepared to navigate the change.

## Impact on key performance indicators\*



\*for the year ended/as at 31 March 2018

# Study Methodology

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In this publication, we analyze the results as per the separate financial statements of 51 NBFCs (34 NBFCs and 17 HFCs) unless specified otherwise. We have excluded core investment companies and asset management companies from our analysis. We have compared the reported financial results for the year ended 31 March 2018 under the erstwhile Indian GAAP with the restated financial results for the same period under Ind AS, that have been published as comparatives for the year ended 31 March 2019.

The comparative analysis is based on the profit and equity reconciliations presented for the year ended 31 March 2018 under erstwhile Indian GAAP with the restated results for the same period under Ind AS published in the separate financial statements for the year ended 31 March 2019 on an aggregated basis.

Stage wise provision coverage rates are calculated by dividing stage wise provisions by stage wise gross advances. Average gross and net NPAs are calculated by dividing gross NPA advances and net NPA advances by total gross advances and total net advances respectively. The averages calculated are simple averages for all the NBFCs and HFCs covered in our analysis.

As necessary explanations/notes to the profit and equity reconciliations have not been provided in a narrative form by all the covered NBFCs, we have determined the nature of adjustments to profit regarding a particular Ind AS on the basis of descriptions available in the reconciliations and our analysis of those descriptions. This publication has been prepared for general guidance on matters of interest only and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. In absence of detailed information and due to significant estimation, approximation and assumptions involved, this study has attempted to quantify the impact of Ind AS on various impact areas.

This information should not be used or relied for any decision-making. Further, certain values and percentages referred to in this publication should be considered as indicative and may change if computed differently and/or on use of different set of assumptions. Additionally, standard-wise/adjustment-wise Ind AS impact analysis on profitability is based on absolute values of adjustments disclosed in the reconciliations. The analysis done should not be considered as an accounting or legal opinion or any form of assurance or concurrence with a specific entity's accounting matters, financial statements, any financial or other information or internal controls. EY can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with EY or other professional advisors familiar with your particular situation for advice concerning specific audit, tax or other matters before making any decisions. EY did not conclude on the appropriate accounting treatment based on specific facts or recommend which accounting policy/treatment a specific entity should select or adopt. The views we express in this publication represent our perspectives as of April 2020. We may identify additional issues as we analyze the standard and entities continue to interpret it, and our views may evolve during that process. We expect to periodically update our guidance to provide the latest implementation insights.

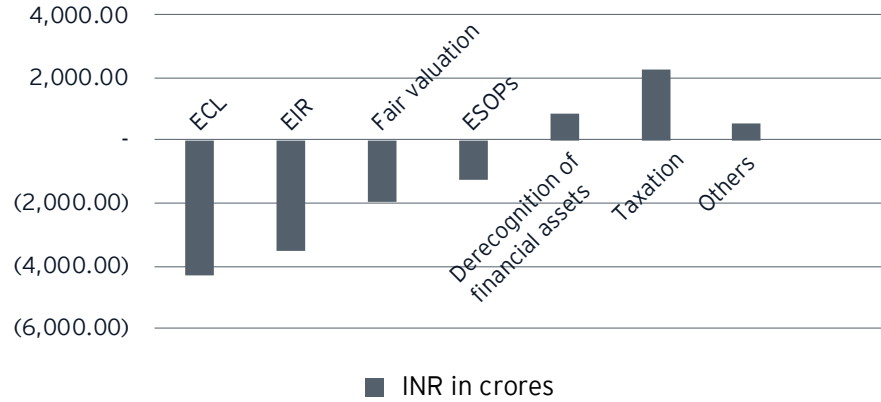


# Key GAAP differences, analysis and implementation experiences

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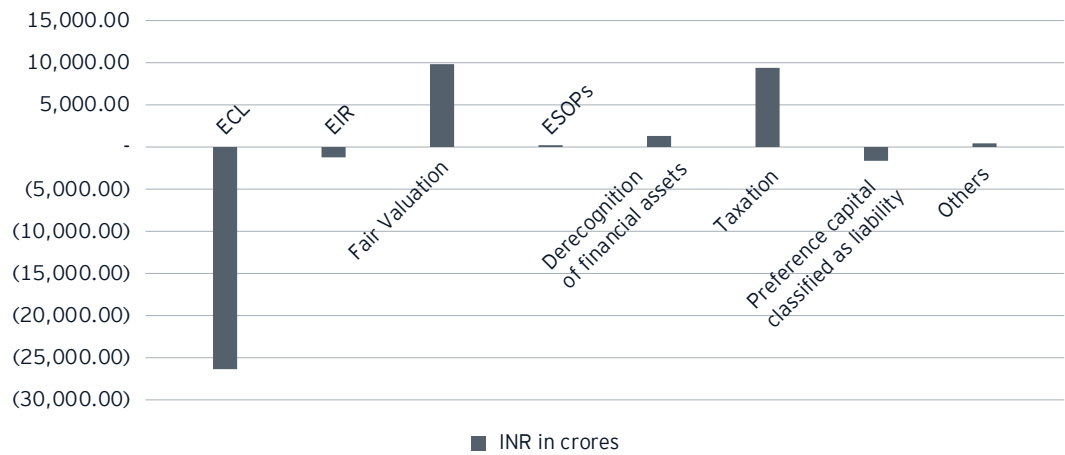
## Profit after tax as at 31st March 2018: bridge between Indian GAAP to Ind AS



<b>Indian GAAP Profit After Tax</b>	<b>48,213</b>
ECL	-4,278
EIR	-3,547
Fair Value of financial instruments	-1,933
ESOPs	-1,235
Derecognition of financial assets	829
Taxation	2,220
Others	556
<b>Total Adjustments</b>	<b>-7,388</b>
<b>Ind AS Profit After Tax</b>	<b>40,825</b>

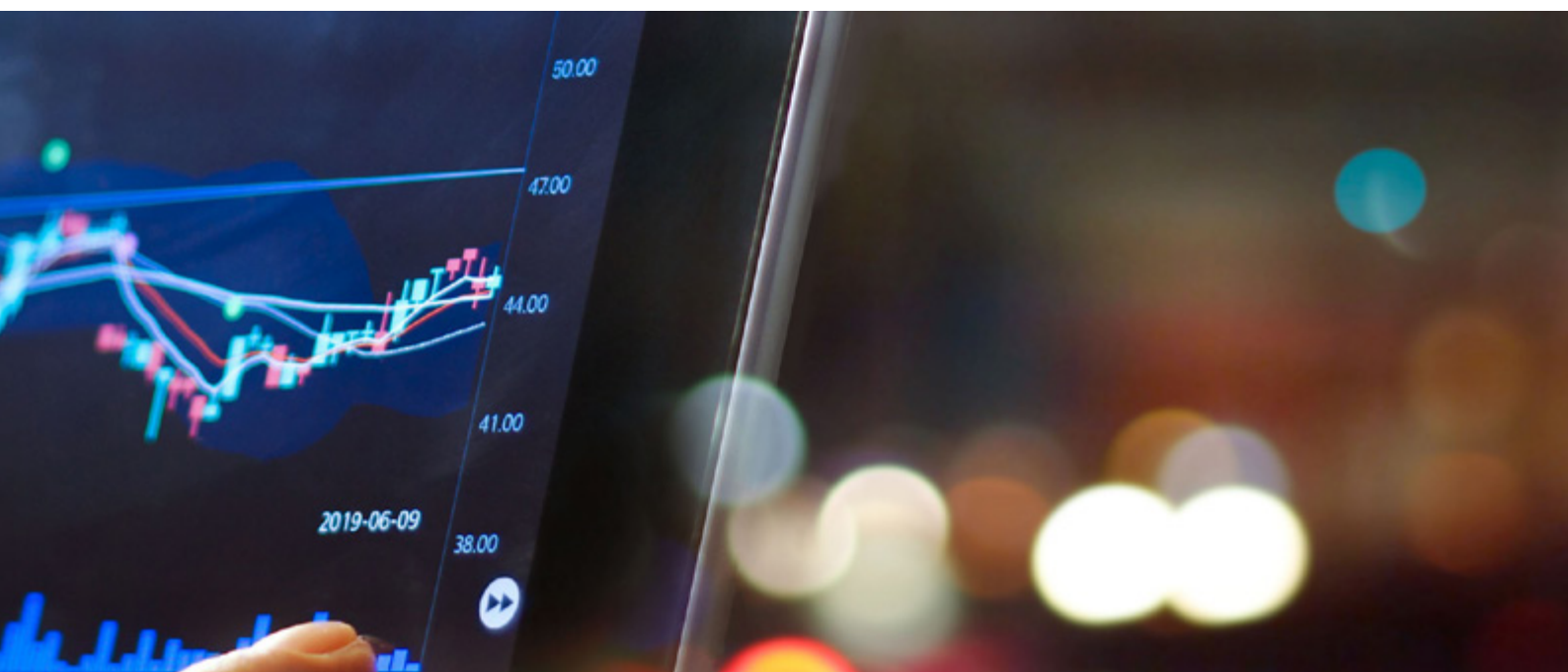


## Net worth as at 31st March 2018: bridge between Indian GAAP to Ind AS<sup>1</sup>



Indian GAAP Equity	2,15,916
ECL	-27,359
EIR	-1,130
Fair Value of financial instruments	9,532
ESOPs	22
Derecognition of financial assets	1,349
Taxation	9,082
Preference capital classified as liability	-1,726
Others	397
<b>Total Adjustments</b>	<b>-9,833</b>
<b>Ind AS Equity</b>	<b>2,06,083</b>

<sup>1</sup> Based on net worth reconciliation of 28 NBFCs and 8 HFCs



## Expected credit loss (ECL)

### Key differences between erstwhile Indian GAAP and Ind AS

#### Background

Under the erstwhile IGAAP, no detailed guidance is provided on recognition of provision on loans and advances. However, the provisioning norms were governed by RBI master circular - Non-Banking Financial Company (NBFC) - Systemically important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016. Similarly, housing finance companies followed the prudential guidelines under the Housing Finance Companies (NHB) Directions, 2010 for recognizing loan provisions.

On adopting Ind AS, NBFCs transitioned from the extant provision norms as per these guidelines to an 'expected credit loss' model in which the NBFC measures the provision using any of the three approaches viz. general approach, simplified approach and purchase or originated credit impaired approach.

#### Scope

The scope of impairment requirements of Ind AS covers debt instruments measured at Amortised cost or Fair Value Through Other Comprehensive Income, a lease receivable, contract asset, a loan commitment or financial guarantee contracts.

IGAAP on the other hand covers only loans given under provisioning requirements.

Under IGAAP, no provision is required to be maintained for off-balance sheet exposure like loan commitments or financial guarantee contracts.

Under Ind AS, NBFCs provide for expected credit losses on such exposures on the basis of the credit assessment of the underlying borrower.

#### Asset classification

Under existing norms, loans are classified under 2 categories viz. Standard assets and Non-Performing Assets (NPA). NPA is further sub-classified as Substandard assets, Doubtful assets and Loss assets.

Under Ind AS, advances are generally classified under Stage 1, 2 and 3 on evaluation of the following criteria:

- ▶ Stage 1 - Advances with low credit risk and where there is no significant increase in credit risk.
- ▶ Stage 2 - Advances with significant increase in credit risk.
- ▶ Stage 3 - Credit impaired advances.

The standard also provides a rebuttable presumption of 30 days past due (DPD) as a backstop indicator to assess significant increase in credit risk. NBFCs can rebut the presumption when it has reasonable and supportable information available that demonstrates that even if contractual payments become more than 30 DPD, this does not represent a significant increase in the credit risk of a financial instrument.

Also, the standard provides a rebuttable presumption that default does not occur later than 90 days past due (DPD) unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate.

However, there are a lot of qualitative as well as quantitative factors such as change in ratings, change in the risk of a default, change in payment pattern, and operating results of the borrower that needs to be considered by NBFCs for assessing whether there is a significant increase in credit risk.

For such assessment of significant increase in credit risk, if information at borrower level can be made available without undue cost or effort then the assessment is done at an individual level. However, NBFCs are allowed to do the assessment at pool level where the pools are required to be made on the basis of homogenous risk characteristics or collective assessment in case the information at borrower level is not available without undue cost or effort.

Accordingly, NBFCs provide for 12-month ECL where there is no significant increase in credit risk since initial recognition.

**Interest on credit impaired assets**

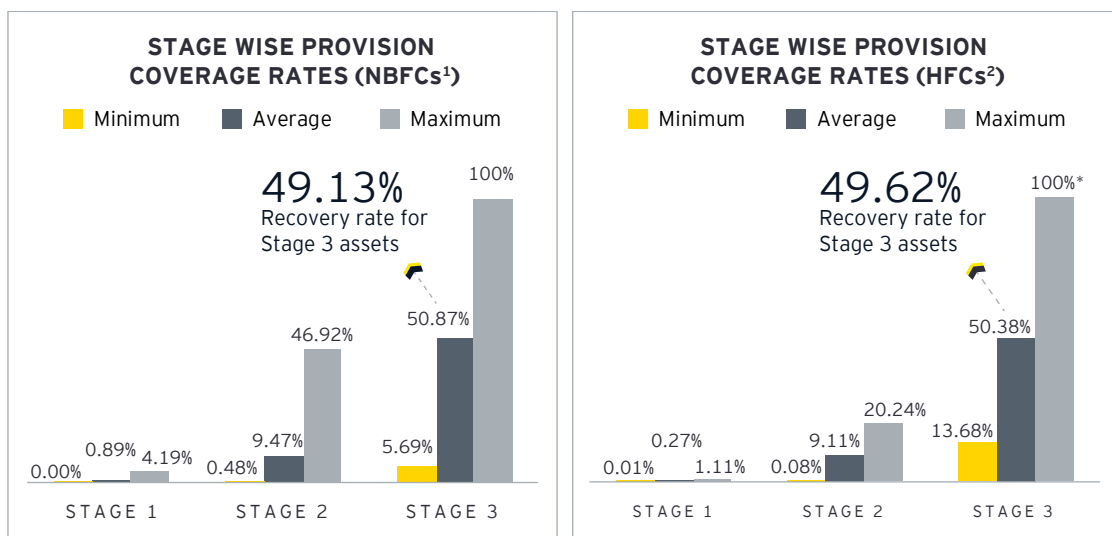
Under IGAAP, interest on Non-Performing Assets (NPA) is recognized on receipt basis.

However, under Ind AS interest on credit

impaired assets is recognized as income in statement of profit and loss on the amortized cost of the asset which is the gross carrying amount reduced by the loss allowance recognized on that asset.

**Analysis**

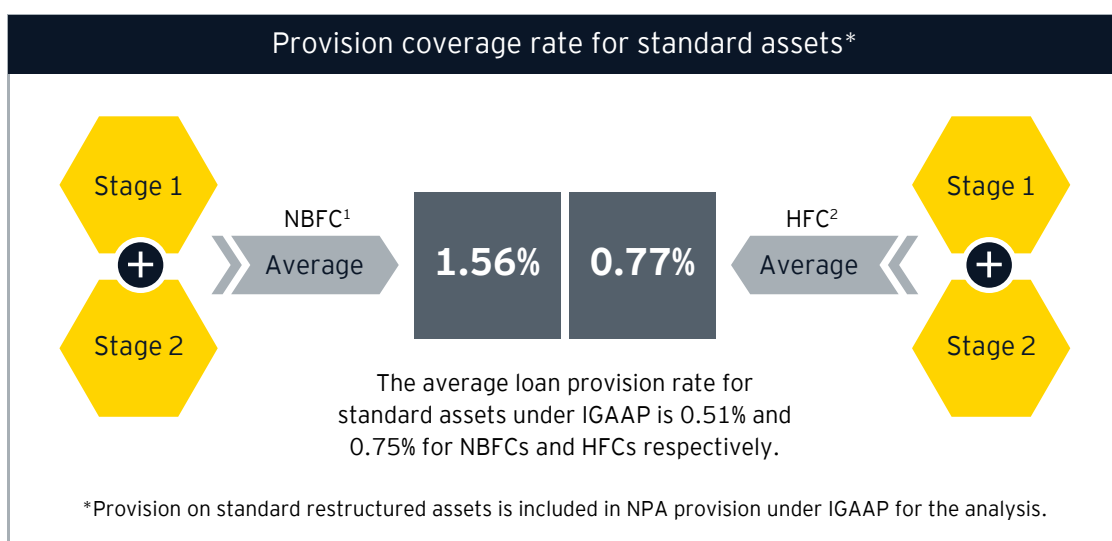
**Overview of provision coverage**



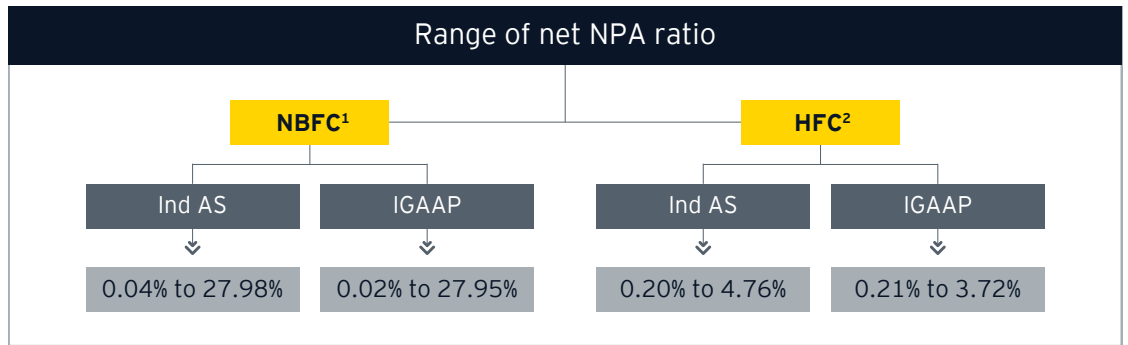
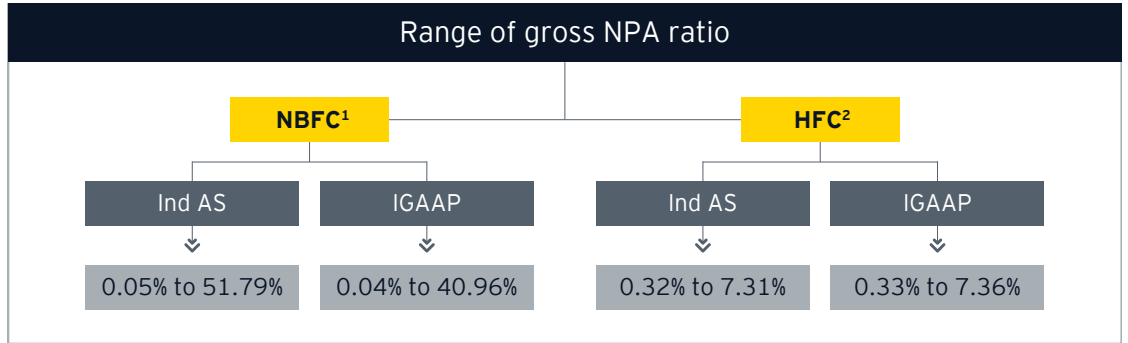
<sup>1</sup> Based on analysis of 32 NBFCs, as 2 NBFCs have not reported stage wise disclosures.

<sup>2</sup> Based on analysis of 16 HFCs, as 1 HFC has not reported stage wise disclosures.

\*In 1 HFC, the provision coverage rate for Stage 3 Assets is 150%. We have not considered this for the purpose of the above analysis.



**Range of gross and net NPA ratio**



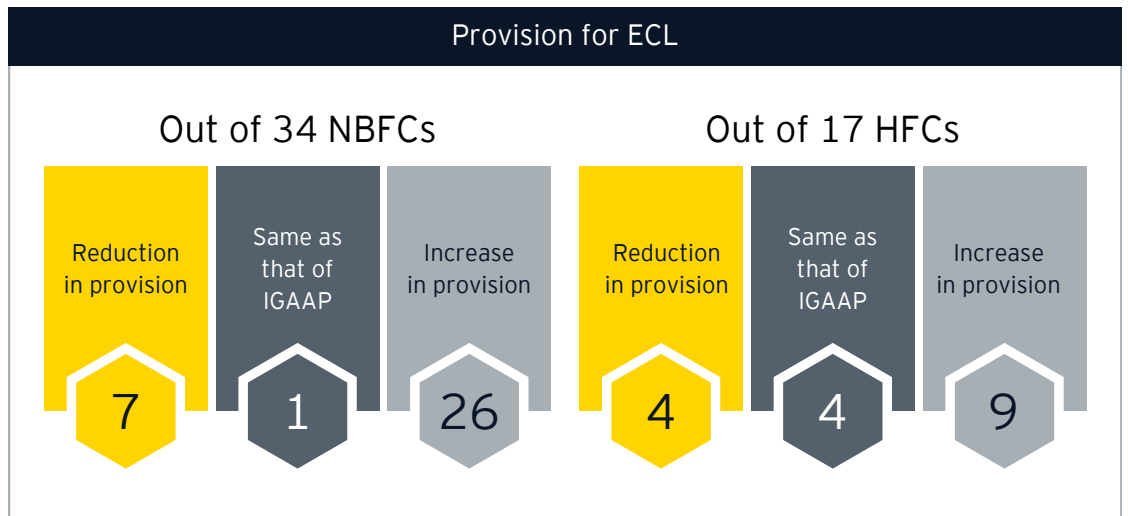
<sup>1</sup> Based on analysis of 32 NBFCs, as 2 NBFCs have not reported stage wise disclosures.

<sup>2</sup> Based on analysis of 16 HFCs, as 1 HFC has not reported stage wise disclosures.

Above figures are derived from NPA gross advances and NPA provision available in the annual reports.

On an average, the gross NPA% for NBFCs is 6.68% under IGAAP and 8.47% under Ind AS; whereas for HFCs, the same is 1.31% under IGAAP and 1.53% under Ind AS.

Similarly, on an average, the net NPA% for NBFCs is 4.15% under IGAAP and 4.35% under Ind AS; whereas for HFCs, the same is 0.70% under IGAAP and 0.76% under Ind AS.



**NBFCs**

On an average the loan loss provisions have increased by 93.41%.

Out of the 26 NBFCs where an increase has been witnessed, 12 of them reported an increase of more than 100%.

**HFCs:**

On an average the loan loss provisions have increased by 16.23%.

Out of the 9 HFCs where an increase has been witnessed, 1 has reported an increase of more than 100%.

**Impact of ECL provision on the statement of profit and loss****NBFCs**

On an average there has been an increase in the ECL provision under Ind AS by 19.44% as

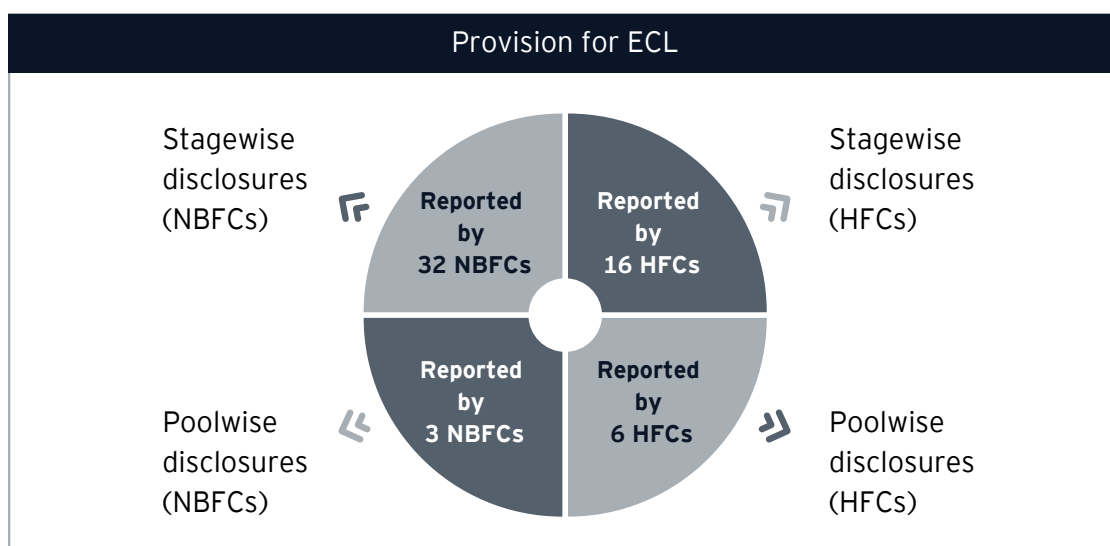
compared to impairment expense under Indian GAAP.

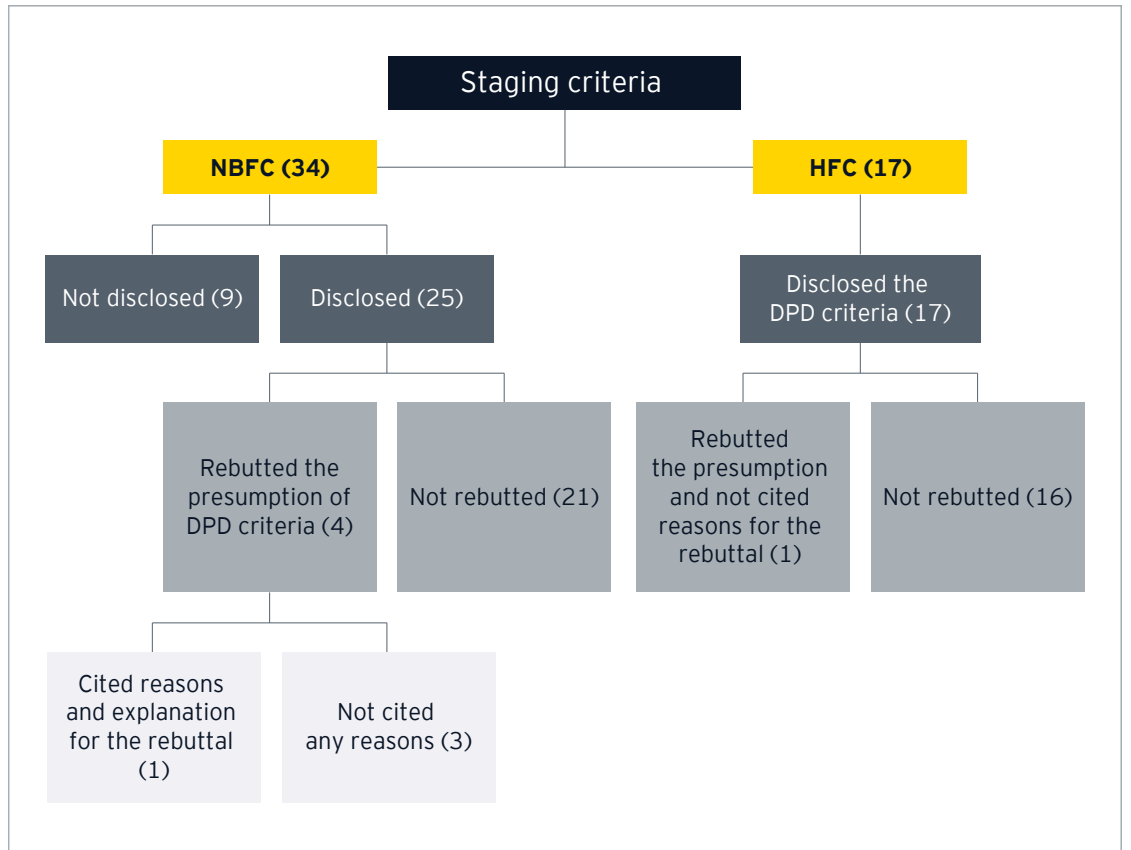
**HFCs:**

On an average there has been an increase in the ECL provision under Ind AS by 9.51% as compared to impairment expense under Indian GAAP.

**IGAAP based provisioning**

2 NBFCs and 1 HFC out of the entire population have adopted and disclosed an approach wherein loss allowance is considered as ECL or IGAAP provision, whichever is higher.

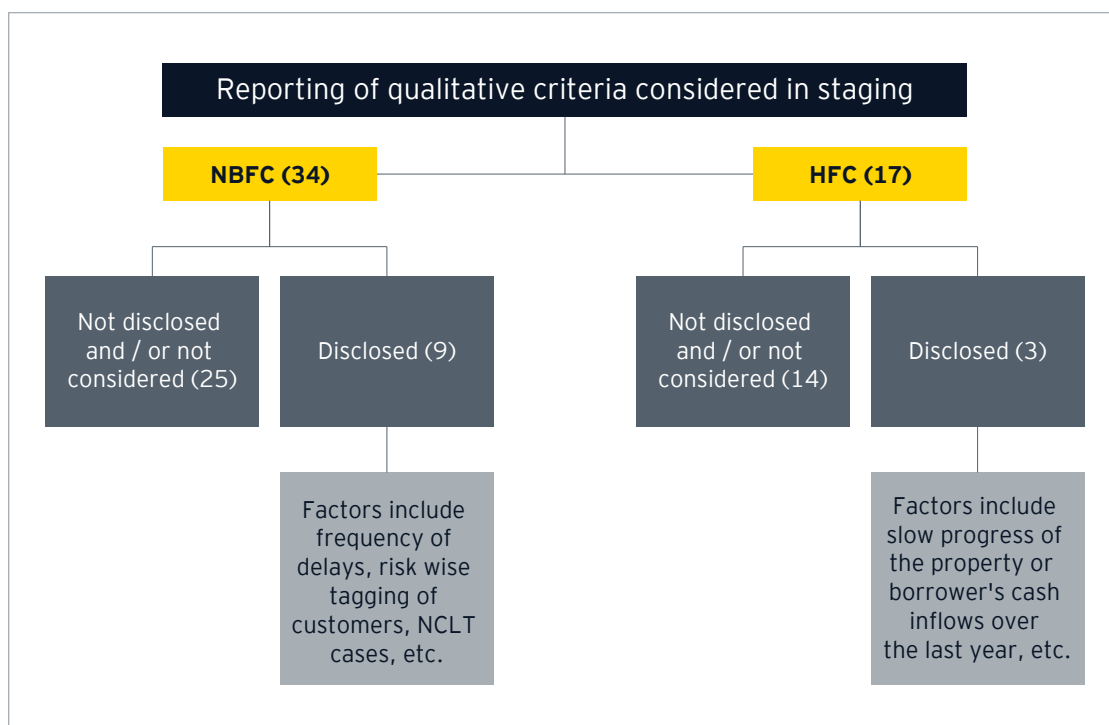
**Disclosures****Quantitative disclosures**

**Policy disclosures****Staging criteria**

Hence, some entities have disclosed the staging criteria as a part of their Impairment requirements policy while some have not. Also, majority of them have not rebutted the days past due presumption while others have rebutted the presumption.



### Qualitative criteria for staging



Thus, majority of the entities are following only DPD criteria for staging of borrowers; it seems that qualitative criterion for staging are considered and/or disclosed only by few NBFCs.

### Recent development

The RBI has issued a notification<sup>1</sup> on 13th March 2020 stating the following:

#### Prudential Floor for ECL

NBFCs should simultaneously maintain asset classification and compute provisions as per extant prudential norms on Income Recognition, Asset Classification and Provisioning (IRACP), including borrower/beneficiary wise classification, provisioning for standard and restructured assets, and NPA ageing. Where impairment allowance under Ind AS 109 is lower than the provisions required as per IRACP, the difference should be appropriated from net profit or loss after tax to a separate 'impairment reserve' The balance in

the 'impairment reserve' shall not be reckoned for regulatory capital. Further, no withdrawals shall be permitted from this reserve without prior permission from the Department of Supervision, RBI. The requirement for 'impairment reserve' shall be reviewed, going forward.

A comparison, as per the prescribed template between provisions required under IRACP and impairment allowances made under Ind AS 109 should be disclosed by NBFCs in the notes to their financial statements to provide a benchmark to their Boards, RBI supervisors and other stakeholders, on the adequacy of provisioning for credit losses.

<sup>1</sup>The RBI guidelines are applicable to NBFCs for preparing their financial statements from financial year 2019-2020 onwards.

**Other points of the RBI notification:**

- 1. Methodologies for computing ECL:** The Board of Directors should approve sound methodologies for computation of ECL commensurate with the size, complexity and risk profile of the NBFC.
- 2. Parameters and assumptions of ECL model:** Documentation required for the parameters, assumptions, and their sensitivity to ECL output, which should not be changed for profit smoothing. The rationale for any change in the model to be documented.
- 3. Changes in parameters, assumptions and ECL model and management overlays:** Any adjustments to the model output to be approved by the Audit Committee of the Board (ACB) by documenting its basis and rationale.
- 4. Default:** The ACB should approve the classification of accounts that are beyond 90 DPD but not treated as impaired, with the rationale for the same clearly documented. Also, the number of such accounts and the total amount outstanding and the overdue amounts should be disclosed in the notes to the financial statements.
- 5. Rebutting the presumption for significant increase in credit risk:** In limited circumstances, where NBFCs do rebut the 30 DPD presumption, it should be done only with clear documentation of the justification for doing so. All such cases shall be placed before the ACB. NBFCs shall not defer the recognition of significant increase in credit risk for any exposure that is overdue beyond 60 days.

The assessment of the impact of COVID-19 outbreak on ECL will require significant judgement, especially as it is not directly comparable with any recent similar events. Entities will have to update their macroeconomic scenarios and consider the use of top-down 'management overlays' to embed in the ECL risks not yet fully captured by their models. Given the level of uncertainty and the sensitivity of judgements and estimates, disclosures of the key assumptions used and judgements made in estimating ECL, as well as the impact of any relief measures, is going to be critical.

### Key observations and implementation experiences

- a. The application of the ECL model has generally resulted in an earlier recognition of credit losses and consequently a higher impairment charge being recognized upfront. This also resulted in a significant impact on the equity, regulatory capital and key performance indicators of the NBFCs.
- b. Conceptual design of ECL computation framework including Ind AS 109 compliant risk parameters involved significant efforts.
- c. Significant judgement was required to be applied for the pooling of the loan portfolio taking into consideration homogenous characteristics such as sector, product category, and geography.
- d. Significant judgement was also involved in the determination of stage of loans and transfer criteria.
- e. Assessment of 'significant increase in credit risk' (SICR) based on qualitative and quantitative factors. Availability of external data, such as ratings, was also a challenge in some cases specifically for individual borrowers.
- f. For some NBFCs (specifically those which have been in operation for less than 3 years) determination of probability of default (PD) and loss given default (LGD) was challenging in the absence of historical data.
- g. Other challenges
  - ▶ Availability of data for macroeconomic forecasts.
  - ▶ Obtaining data relating to collateral value.
  - ▶ Determination of Credit Conversion factor for off-balance sheet exposures.
  - ▶ Determination of expected tenure of the loan rather than the contractual tenure.

## Effective interest rate

### Key differences between erstwhile Indian GAAP and Ind AS

Under the erstwhile Indian GAAP, processing fees on loans and borrowings are recognized upfront in the profit and loss account. Similarly direct origination costs, like DMA costs are accounted for as and when they are incurred.

Under Ind AS, direct loan origination fees, net of direct loan origination costs need to be amortized over the life of the loan using the "effective interest rate" method.

As per Ind AS 109, interest income and expenses are required to be recognized applying the 'Effective interest rate' method. Effective interest rate is the rate that discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross

carrying amount of a financial asset or to the amortized cost of a financial liability. When calculating the effective interest rate, an entity should estimate the expected cash flow by considering all the contractual terms of the financial instrument (for example prepayment, extension, call and similar options)

Under Indian GAAP, service charges, fees (other than processing fees) and commission income are generally recognized on due basis. However, under Ind AS, fees that are an integral part of the effective interest rate of a financial instrument are treated as an adjustment to the effective interest rate, unless the financial instrument is measured at fair value through profit and loss.

### Analysis

Ind AS 109 requires the interest income and expense in respect of financial instruments classified and subsequently measured at amortized cost to be recognized applying the 'Effective interest rate' method. Effective interest rate is the rate that discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortized cost of a financial liability.

Revenue recognized under Ind AS increased by 1.09% whereas finance cost increased by 2.5% as compared to erstwhile Indian GAAP.



**Increase in  
revenue:  
1.09%**



**Increase in  
finance cost:  
2.5%**

### Key observations and implementation experiences

- a. The accounting for interest income on an effective interest rate basis impacted the net interest income and the corresponding interest spreads and margins.
- b. Judgement was involved in the assessment of costs (external as well as internal) that can be considered directly attributable and incremental for calculating the effective interest rate.
- c. Considering the huge volume of data and with the existing IT systems, many NBFCs faced challenges in extracting and capturing the information relating to processing fees and other charges at a loan/borrower level. This also resulted in changes to the chart of accounts in many instances.
- d. NBFCs such as housing finance companies had to estimate the tenure of the loans because of the likelihood of prepayment of such loans.

## Fair valuation - measurement

### Key differences between erstwhile Indian GAAP and Ind AS

Under Indian GAAP, all investments are measured at cost on initial recognition. Investments, which are readily realizable and intended to be held for not more than one year from the date on which such investments are made, are classified as 'current investments'. All other investments are classified as 'long term investments'. 'Long term investments' are carried at acquisition/ amortized cost. A provision is made for diminution other than temporary on an individual basis. 'Current Investments' are carried at the lower of cost or fair value on an individual basis.

Ind AS 109 has prescribed 3 classification models for financial assets: Amortized cost, Fair Value through Profit and Loss (FVTPL), and Fair Value through Other Comprehensive Income (FVOCI).

**Amortised cost:** The asset is measured at the amount recognized at initial recognition minus principal repayments, plus or minus the cumulative amortization of any difference between that initial amount and the maturity

amount, and any loss allowance. Interest income is calculated using the effective interest method and is recognized in the statement of profit and loss. Changes in fair value are recognized in the statement of profit and loss when the asset is derecognized or reclassified.

**FVTPL:** The asset is measured at fair value. Changes in fair value are recognized in profit and loss as they arise.

**FVOCI:** Changes in fair value are recognized initially in Other Comprehensive Income (OCI). When the asset is derecognized or reclassified, changes in fair value previously recognized in OCI and accumulated in equity are reclassified to profit and loss on a basis that always results in an asset measured at FVOCI having the same effect on profit and loss as if it were measured at Amortised Cost. However, in case of equity instruments irrevocably designated at FVOCI, dividends are recognized in profit and loss. Changes in fair value are recognized in OCI and are never recycled to profit and loss, even if the asset is sold or impaired.

### Analysis

As per Ind AS 109, when an asset is measured at FVTPL, the financial asset is measured at fair value, and any changes in fair value are

recognized in profit or loss as they arise.

Due to this, the Ind AS PAT decreased by 4% as compared to erstwhile Indian GAAP PAT.

### Key observations and implementation experiences

- a. Fair value measurement led to more volatility in the statement of profit and loss.
- b. It also led to new and complex disclosure requirements, which significantly impacted the need for new systems and processes to collect the necessary data.
- c. The determination of fair value in case of unquoted FVTPL and FVOCI securities involved application of significant management judgements and estimates.

## Share based payments (ESOPs)

### Key differences between erstwhile Indian GAAP and Ind AS

The erstwhile Indian GAAP allows an option of using either the intrinsic value method or the fair value method.

In contrast, under Ind AS, employee share-based payments should be accounted for using the fair value method. Intrinsic Value is allowed only in rare case wherein the entity is unable to estimate reliably the fair value of equity instruments granted.

Under the intrinsic value method, the compensation cost, accounted for in the statement of profit and loss account, is the difference between the market price of the

underlying share on the grant date and the exercise price of the option.

The fair value method is based on the fair value of the option at the date of the grant. The fair value is estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current price in the market of the underlying stock and its expected volatility, expected dividends on the stock, and the risk-free interest rate for the expected term of the option.

### Analysis

Out of the analysis of 51 NBFCs,

- a. 17 NBFCs do not have ESOP Scheme. Hence these are excluded from analysis as there is no impact.
- b. Remaining 34 NBFCs have recorded ESOP expense in the erstwhile Indian GAAP as per intrinsic value method. However out of 34 NBFCs, only 9 NBFCs have ESOP expense

as per the financial statements and balance 25 NBFCs have NIL expense with respect to ESOP as exercise price is greater or equal to market price on grant date.

As stated above, under Ind AS, the ESOP expense needs to be recorded at fair value. Due to this, the total ESOP expense has increased by about 49 times as compared to erstwhile Indian GAAP.

### Key observations and implementation experiences

- a. Most Indian entities preferred to adopt intrinsic value method under Indian GAAP. Since the accounting for ESOP had to be remeasured using fair value under Ind AS, this resulted in increased charges for ESOPs for various entities, and has had a significant impact on key indicators such as earnings per share.
- b. Additional liabilities arising from the adoption of Ind AS 102 have negatively impacted financial results and ratios.
- c. Compliance with Ind AS required determination of fair valuation of such ESOPs using complex options pricing models which required assistance from experts.

## Derecognition of financial assets

### Key differences between erstwhile Indian GAAP and Ind AS

Under Indian GAAP, derecognition of financial assets was based on the extant RBI guidelines which required 'true sale' criteria to be met for removal of assets transferred from the balance sheet of the originator. The illustrative list of conditions included immediate legal separation, effective transfer of all risks/rewards and rights/ obligations, cessation of originator's economic interest, no obligation to remit funds to SPV/investors until received from the borrowers, sale shall be only on cash basis etc.

As per Ind AS 109, a financial asset is derecognized when and only when either the contractual rights to the asset's cash flows expire, or the asset is transferred,

and the transfer qualifies for derecognition. This decision of whether a transferred asset qualifies for derecognition is made by applying a combination of risk and rewards and controls tests. Derecognition cannot be achieved by only a legal transfer. The transfer must happen in substance which is evaluated by using a risk and rewards and a control model.

As a result, in many cases, the NBFCs would need to bring back securitized assets in their books and record them as collateralized borrowings. On assignment transactions, the excess interest spread retained by the NBFCs would be recorded as upfront gains rather than on a deferred basis.

### Analysis

On transition to Ind AS, the NBFCs had to reassess whether the derecognition criteria was met as per Ind AS 109.

This impacted 14 NBFCs, the impact of which ranged from 0.03% to 8.10% of the previously reported net worth under erstwhile Indian GAAP as at 31 March 2018.

Range of impact for derecognition of financial assets



**0.03%**

**8.10%**



### Key observations and implementation experiences

- a. Securitization transaction for loans which met the true sale criteria as per RBI guidelines did not meet the derecognition criteria as per Ind AS since risks and rewards relating to such loans were not transferred mainly because of credit enhancements. Hence, in most cases, NBFCs were required to reinstate such loans in the books and recognize a corresponding liability for the amounts received from the investors. However, on transition, most entities opted for grandfathering the assets that were derecognized under Indian GAAP even if they would not meet the derecognition criteria under Ind AS.
- b. Significant judgement was involved in assessing whether the derecognition criteria have been met or not under Ind AS 109 and appropriate disclosures were required to be provided.
- c. In cases where the derecognition criteria were met, all the losses/gains on such derecognition were recognized upfront as required by Ind AS. Under Indian GAAP, loss arising on derecognition is recognized upfront whereas gain is deferred over the remaining tenure of the asset transferred.
- d. Reinstatement of securitized assets also had impact on the computation of capital adequacy ratio or capital to risk asset ratio.

## Deferred tax on special reserve

### Key differences between erstwhile Indian GAAP and Ind AS

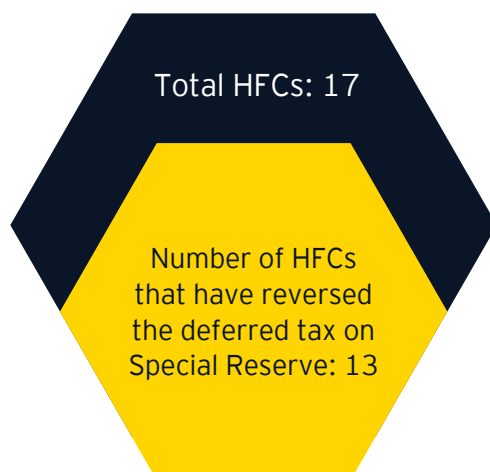
Under the erstwhile Indian GAAP, NBFCs created Deferred Tax Liability (DTL) on special reserve created under Section 36(1) (viii) of Income Tax Act, 1961.

Under the erstwhile Indian GAAP, the recognition of deferred tax assets or liabilities is based on the income statement method, which focuses on timing differences. While, under Ind AS, the same is based on balance sheet

approach, i.e. comparing the Ind AS carrying value of the asset or liability to its tax base.

Certain HFCs have considered special reserve as non-withdrawable reserve, and it was not construed as a temporary difference under Ind AS. Thus, DTL was not created under Ind AS and any DTL created under the erstwhile Indian GAAP was reversed.

### Analysis



It has been observed that there is a mixed practice followed by HFCs regarding reversal of deferred tax on special reserve. The entities should exercise judgement in evaluating whether to create a DTL on a special reserve based on the facts and circumstances in each case.

Of the 17 Housing Finance Companies (HFCs) covered in the analysis, 13 HFCs have reversed the deferred tax liability recognized in respect of the special reserves upon transition to Ind AS.

## Segment reporting

### Key differences between erstwhile Indian GAAP and Ind AS

Ind AS 108 requires that the amount of each segment item reported is the measure reported to the chief operating decision maker (CODM) in internal management reports, even if this information is not prepared in accordance with the Ind AS accounting policies of the entity. In contrast, AS 17 requires the segment information to be prepared in conformity with

the entity's accounting policies for preparing its financial statements.

Ind AS 108 adopts a management reporting approach to identify operating segments. It is likely that in many cases, the structure of operating segments will be the same under Ind AS 108 as under AS 17 Segment Reporting.

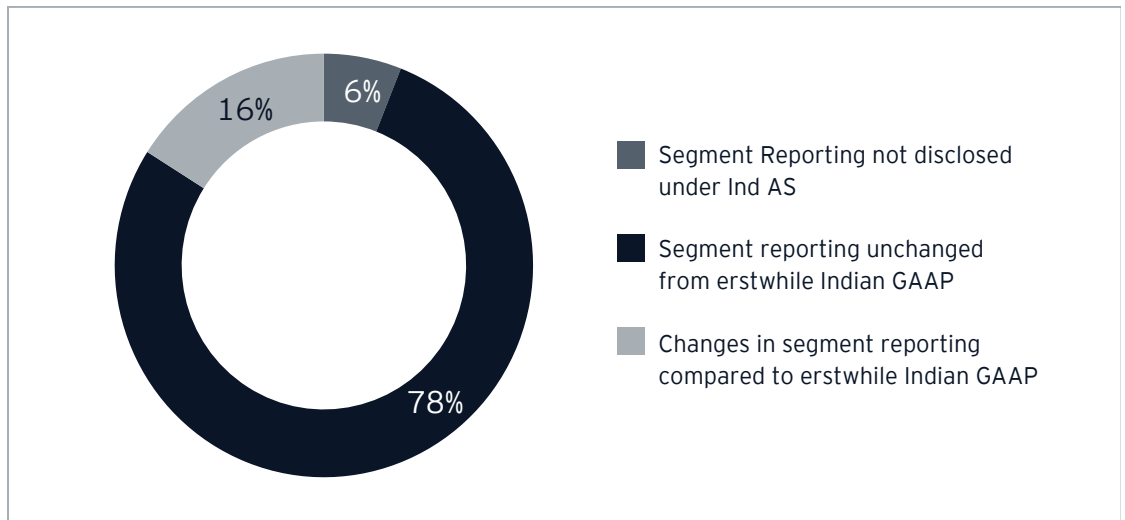
## Analysis

Ind AS 108 requires segment disclosure based on the components of the entity that the management monitors while making decisions about operating matters (the management approach). Such components (operating segments) are identified based on internal reports that the Chief Operating Decision Maker

(CODM) of the entity reviews regularly when allocating resources to segments and assessing their performance.

Out of 51 NBFCs selected under the analysis, the operating segments of 8 NBFCs have changed under Ind AS as compared to erstwhile Indian GAAP.

3 NBFCs have not disclosed segment reporting as per the Ind AS 108 "Operating Segments".



## Key observations and implementation experiences

- Reconciliations were required to be made if the policies followed for computing information for management information system did not match with those used in financial statements, thus involving more time and effort. Entities had to devise or upgrade systems to prepare reconciliation between the MIS and the accounting system.
- Reporting under Ind AS is based on the information furnished to the CODM. Entities were required to review their management structure to identify the CODM.
- Comparative information had to be restated for changes in reportable segments.



# Other impact areas

## Business model assessment

### Key differences between erstwhile Indian GAAP and Ind AS

Ind AS 109 Financial Instruments contains three classification categories of financial assets i.e. Amortised Cost, Fair Value through Other Comprehensive Income (FVOCI) and Fair Value through profit and loss (FVTPL)

The classification is based on Business Model Assessment and Solely Payment of Principal and Interest (SPPI) tests. The assets are classified and measured as follows:

Business Model	SPPI Test Pass/Fail	Classification Category
Hold to collect contractual cash flow till maturity	Pass*	Amortised Cost
Hold to collect contractual flow and sell the financial asset	Pass*	FVOCI
Held for Trading		FVTPL

\* If SPPI Test fails then classification category is FVTPL

### Recent development

As per the RBI Notification<sup>1</sup> issued on 13 March 2020, considering the criticality of the nature of business model in determining classification of financial assets and restrictions in subsequent reclassifications, NBFCs are advised to put in place:

- ▶ Board approved policies that clearly articulate and document business models and portfolio.
- ▶ Objectives for managing each portfolio.
- ▶ Policy for sales out of amortised cost business model portfolios and disclose the same in their notes to financial statements.

### Key observations and implementation experiences

- a. NBFCs were required to ensure that appropriate policies and procedures as approved by the key management personnel are in place for determining the business model.
- b. Significant judgement was involved in the assessment of 'infrequent number of sales' and 'insignificant in value' in the context of Ind AS 109 for assessing the hold to collect contractual cash flows criteria.
- c. Transactions such as assignment of loans also affected the business model assessment for the loan portfolio.
- d. NBFCs, based on the business model, had to modify or develop data-capture systems for classification of their loans and investments portfolio.

<sup>1</sup>The RBI guidelines are applicable to NBFCs for preparing their financial statements from financial year 2019-2020 onwards.

## Classification as debt or equity

### Key differences between erstwhile Indian GAAP and Ind AS

Ind AS 32 requires the issuer of a financial instrument to classify the instrument as liability or equity on initial recognition, in accordance with its substance and the definitions of the terms. The application of this principle may require certain instruments that have the form of equity to be classified as liability.

For example:

- ▶ Mandatorily redeemable preference shares on which a fixed dividend is payable are treated as a financial liability
- ▶ Convertible bonds/debentures may need to be split between liability and equity

### Analysis

Ind AS 32 requires the issuer of a financial instrument to classify the instrument as liability or equity on initial recognition, in accordance with its substance based on the contractual terms.

The impact of reclassification from equity to debt was observed in 4 NBFCs. Due to reclassification of financial instruments from equity to debt, the equity reported under Ind AS for these NBFCs has reduced by 13%.

### Key observations and implementation experiences

a. NBFCs had to assess and change the classification of certain instruments such as compulsorily convertible preference shares issued as part of tier I and tier II capital. Similarly, there were issues around assessing whether any equity

component of compound financial instruments (e.g. compound debentures) will be considered as being eligible for Tier 1/Tier 2 capital.

b. There was an impact on the capital adequacy and debt to equity ratios.

## Fair valuation - disclosures

### Key differences between erstwhile Indian GAAP and Ind AS

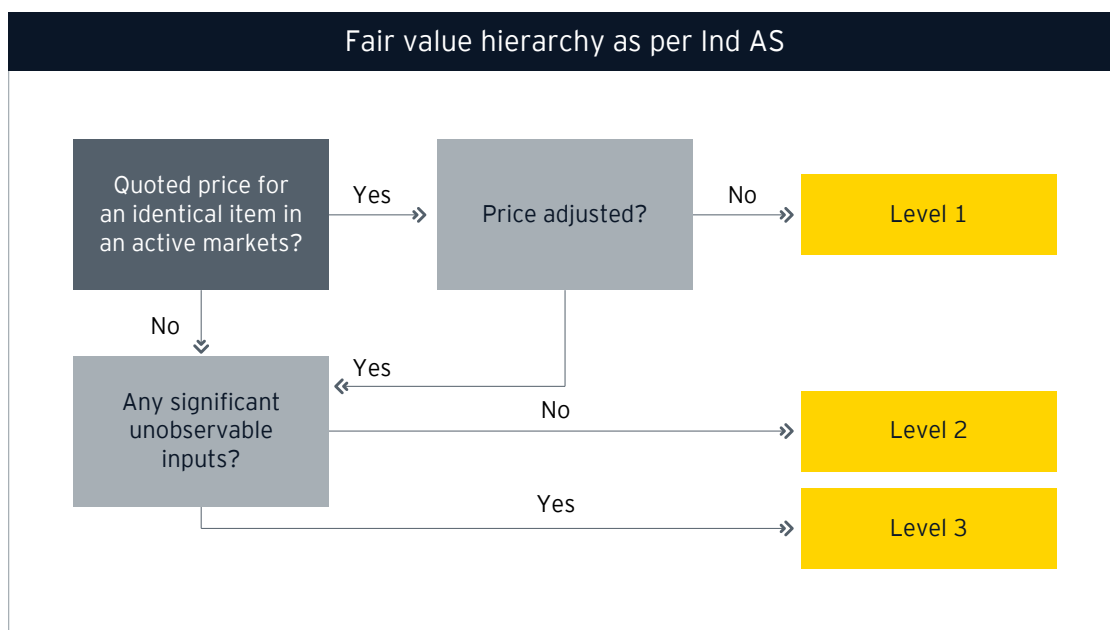
Ind AS 113 Fair Value Measurement provides principles on how to measure fair value. It applies to all assets and liabilities that are required or permitted to be measured at fair value.

Entities need to classify and disclose fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy is made up of 3 levels, with Level 1 being the highest level.

Level 1 inputs: Unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.

Level 2 inputs: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3 inputs: Unobservable inputs for the asset or liability.



As per Ind AS 113, the disclosures relating to fair value measurement include:

1. Fair value at the end of the reporting period, indicating Level 1, 2 or 3, and their valuation techniques.
2. Valuation adjustments and other inputs and considerations.
3. Reconciliations of opening and closing balance (including information on transfers in and out).
4. Quantitative analysis of significant unobservable inputs.
5. Sensitivity of fair value measurements to changes in unobservable inputs.
6. Fair value of financial instruments not measured at fair value, indicating Level 1, 2 or 3 along with their valuation techniques.

### Key observations and implementation experiences

- a. Fair valuation of certain instruments such as loans and security receipts posed challenges including estimation of a discount rate that market participants would use to determine the interest rate to be charged on a similar instrument with similar terms, including risks.
- b. Valuation of financial instruments for disclosure purposes also posed a challenge. It required the valuer to understand the contractual terms of

the instrument in detail and thereafter choose the right method and build the appropriate model. This was specifically a challenge for loans and investments in unlisted equity shares.

- c. Significant judgement was involved in the classification of financial instruments in the appropriate fair value hierarchy based on the inputs used in making the measurements.

## Consolidated financial statements

### Key differences between erstwhile Indian GAAP and Ind AS

Ind AS 110 establishes a single control model for all entities (including special purpose entities, structured entities and variable interest entities). This standard requires managements to exercise significant judgment to determine which entities are controlled and therefore are required to be consolidated.

It changes the assessment of whether an entity is to be consolidated, by revising the definition

of control. Further proportionate consolidation can be used only in limited cases of joint operations, while joint ventures would have to be consolidated using the equity method.

This is a radical change in the Indian environment, because applying the new "control" definition have changed the gamut of entities included within a group.

### Key observations and implementation experiences

a. Securitization transactions through a trust/special purpose vehicle (SPV) are common in case of NBFCs. In such cases, the loans/receivables are transferred to a trust generally sponsored by the NBFC. Significant judgement was required to be exercised to assess whether the NBFC controls such trust/SPV considering the design and purpose of the SPV, investment in securities issued by the trust, activities of the SPV which significantly affects the returns, credit

enhancements and hence is required to consolidate the trust.

b. Many NBFCs have investment in funds such as Alternate Investment Funds. Significant judgement was required in assessing whether NBFCs have control over such fund considering the purpose of the fund, ownership interest in such fund, power over the relevant activities, whether the NBFC acts as a fund manager for the fund, and remuneration that the NBFC receives.

## Presentation and disclosure

### Key differences between erstwhile Indian GAAP and Ind AS

The MCA vide its notification dated 11 October 2018 introduced Division III to Schedule III of the Companies Act, 2013 which provides guidelines for preparation of financial statements of a NBFC that is required to comply with Ind AS. The key requirements of Division III are as follows:

- a. Classification of items of the balance sheet into financial and non-financial assets and liabilities.
- b. Specific requirements of disclosure of derivative financial instruments and subordinated debt on the face of balance sheet.

c. Presentation of 'revenue from operations' and 'other comprehensive income' on the face of statement of profit and loss.

d. Presentation of all transactions with equity holders in their capacity as equity holders in the statement of changes in equity.

NBFCs had to modify their systems and processes to ensure compliance with the revised format and other presentation and disclosures required by Division III on transition to Ind AS.

Under Ind AS, disclosures required have increased significantly as compared to Indian

GAAP. NBFCs are significantly impacted by disclosure requirements of Ind AS 107- Financial Instruments Disclosures.

Ind AS 107 requires very comprehensive

disclosures regarding financial instruments including qualitative and quantitative disclosures regarding the risks to which an entity is exposed, as well as the policy of managing such risks.

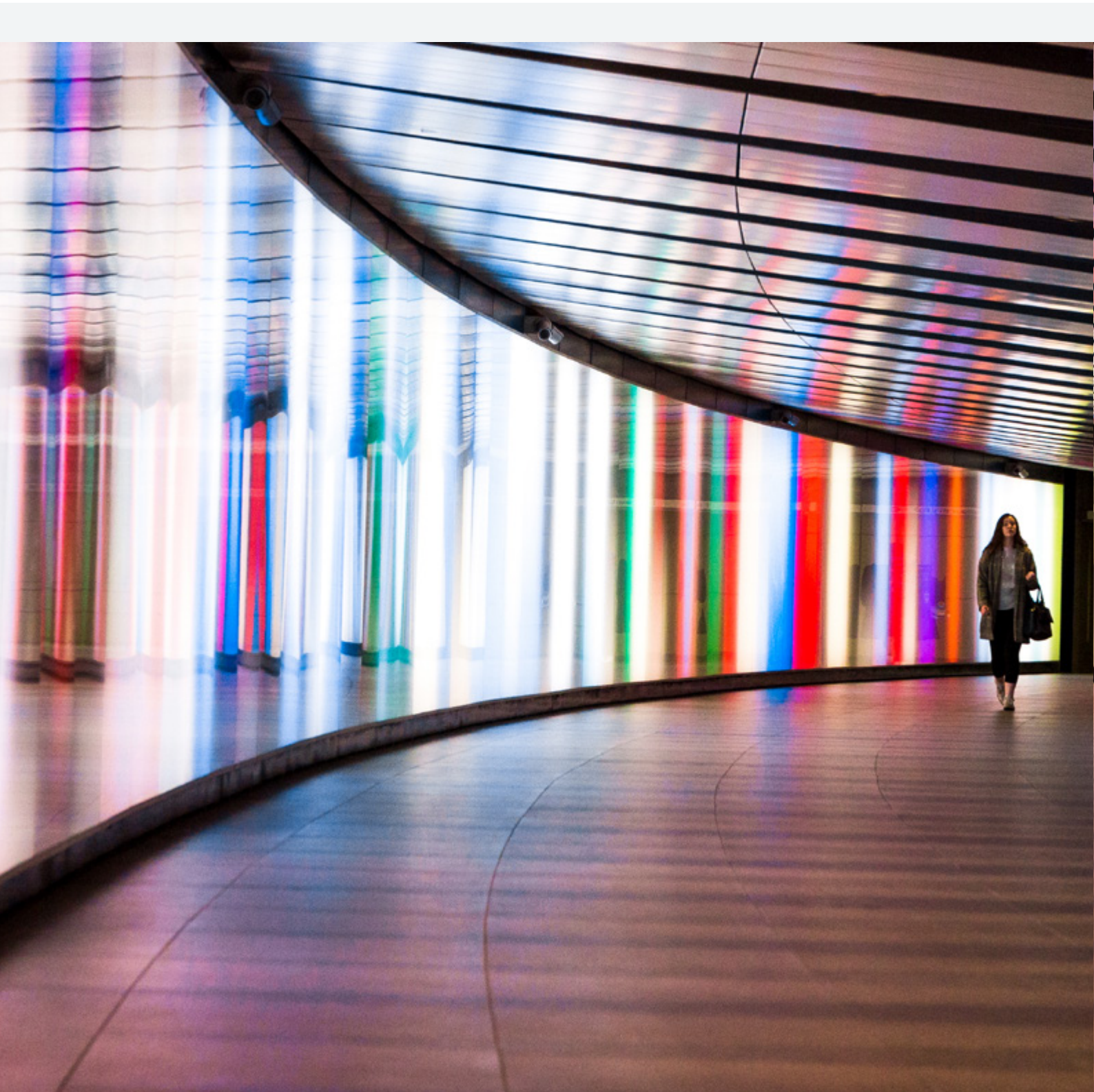
### Key observations and implementation experiences

- a. Systems were not geared up for providing the necessary information and functions within the organization providing such information had to be identified (such as finance, treasury, and risk management).
- b. NBFCs were required to consider how various financial instruments were affected by movements in credit, liquidity and market risks and determine their objectives, policies and processes to manage such risks.
- c. NBFCs were also required to exercise appropriate judgements and apply estimates for performing sensitivity calculations. Data availability for such calculations also posed a challenge for some NBFCs.
- d. Significant challenge was faced in providing disclosures relating to impairment which involved tracking of data for determining whether the credit risk of financial instruments has increased significantly since initial recognition, determining how much detail to disclose, and appropriate level of aggregation and disaggregation.



# Way forward

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Below are some of the key considerations for NBFCs going forward:

1. NBFCs that used manual workarounds for certain impact areas such as ECL and EIR to meet short deadlines should consider redesigning processes and augmenting their systems to eliminate the inefficiencies these workarounds created.
2. While carrying out business model assessment and re-assessment, NBFCs will have to consider whether assumptions made prior to COVID-19 are still relevant, considering deterioration in asset quality and liquidity.
3. NBFCs should focus on strengthening their risk management framework and building reliable loss estimates. Changes should be made in the ECL model to factor in the COVID-19 and moratorium impact.
4. NBFCs should focus on taking more strategic initiatives like re-calibration of PD/LGD/macro-economic overlay models as well as recovery and collection management towards optimization of resources and reduced LGD.
5. Reduce reporting time, achieve a more robust and well-documented process. Deploy solutions to automate the financial reporting including preparation of financial statements including disclosures and calculation of deferred taxes.
6. Ensure quality of data specifically for computing ECL, EIR and disclosures relating to fair values and ECL.
7. High-quality training to improve performance and ensure teams are well equipped with technical accounting knowledge, best practices and industry trends.
8. Well documented accounting policy and process manual for harmonization of accounting policies, improvement in understanding of policies and processes for finance teams across the organization and strengthening internal controls.
9. Streamline the audit process by identifying possible bottlenecks early, reduce audit preparation time and meet tight reporting deadlines.

## End notes

The journey that started with inhibitions and fear is now complete for NBFCs required to transition to Ind AS in Phase 1. The level of preparedness and focus on transition were two key success factors. The immediate focus for these NBFCs now is assessing and disclosing the impact of COVID-19 in their financial statements for the year ended March 2020. Also, they need to focus on automation of the financial reporting process, gearing up IT systems and enhancing the quality of disclosures. It would be interesting to see how the regulators, bankers and analysts respond to the information disclosed and presented under Ind AS. There exist certain grey areas in the form of tax positions and regulatory over-laps. NBFCs, however, believe that they now understand those expectations better. Phase 2 NBFCs which are ready to publish their first set of financial results under Ind AS have a lot to learn from the experiences of large NBFCs and they need to show the same rigor and enthusiasm as those who have already transitioned.

# Appendix A:

roadmap for implementation of  
Indian Accounting Standards  
(Ind AS) for NBFCs: a snapshot

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In January 2016, the Ministry of Corporate Affairs (MCA) announced the Indian Accounting Standards (Ind AS) roadmap for scheduled commercial banks (excluding regional rural banks [RRBs]), insurers/insurance companies and non-banking financial companies (NBFCs).

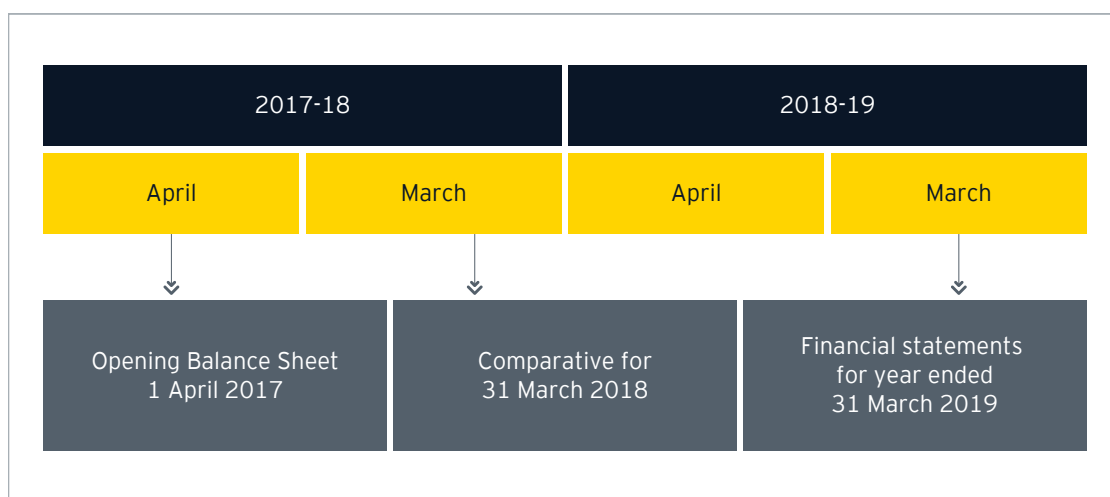
The initial plan of MCA was to implement Ind AS for banks, insurance companies and NBFCs from 1 April 2018 onwards. However,

in early 2018, the Ind AS implementation date was deferred for banks by one year and for insurance entities by two years. Further, in March 2019, the RBI again deferred the implementation of Ind AS by banks till further notice.

NBFCs are required to prepare both consolidated and separate financial statements based on Ind AS in the following two Phases.

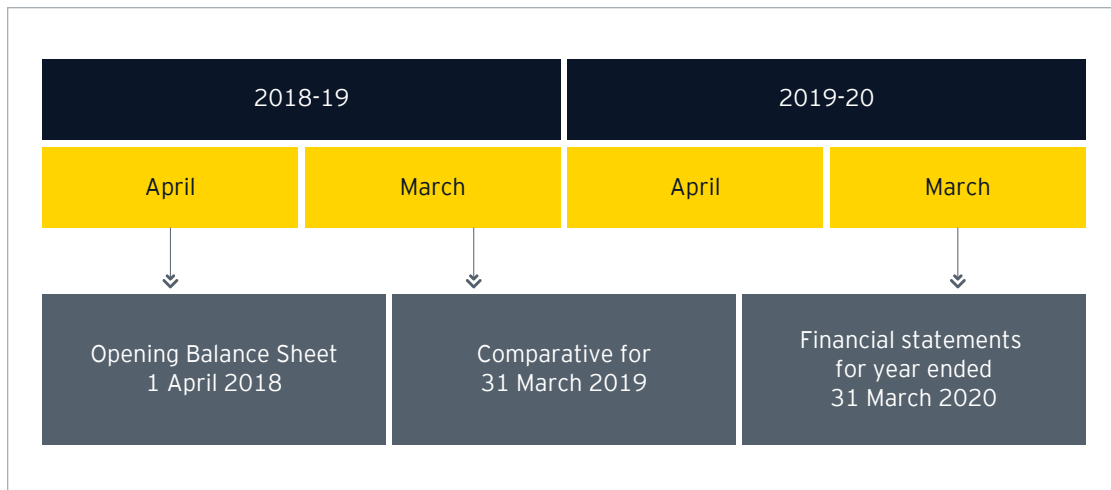
### Phase I: From 1st April 2018 (with comparatives)

- ▶ Date of transition: 01 April 2017.
- ▶ First Ind AS financial statements: 2018-19 (Comparative year 2017-18)
- ▶ **Applicable to:**
  - ▶ NBFCs (whether listed or unlisted) having net worth of INR 500 crore or more
  - ▶ Holding, subsidiary, JV and associate companies of above NBFC other than those already covered under corporate roadmap shall also apply from said date



### Phase II: From 1st April 2019 (with comparatives)

- ▶ Date of transition: 01 April 2018.
- ▶ First Ind AS financial statements: 2019-20 (comparative year 2018-19)
- ▶ **Applicable to:**
  - ▶ NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth less than 500 crore
  - ▶ NBFCs that are unlisted having net worth of INR 250 crore or more but less than 500 crore
  - ▶ Holding, Subsidiary, JV and Associate companies of above other than those already covered under corporate roadmap shall also apply from said date
  - ▶ Applicable for both Consolidated and Separate Financial Statements
  - ▶ NBFC having net worth below 250 crore shall not apply Ind AS.
  - ▶ Adoption of Ind AS is allowed only when required as per the roadmap.
  - ▶ Voluntary adoption of Ind AS is not allowed.



Reference date for computing net worth: In order to determine if an NBFC is covered by the notification, the net worth is to be calculated in accordance with the separate financial statements of the NBFC as on 31 March 2016 or the first audited financial statements ending after that date.

On 11th October 2018, the MCA through its notification has amended Schedule III to the Companies Act, 2013. The amendments, inter alia, have incorporated a new division

to Schedule III i.e. Division III which provides general instructions for presentation of financial statements of Non-Banking Financial Company (NBFC).

The financial year 2018-19 marked the first year of financial results under Ind AS for NBFCs covered under Phase 1 of the roadmap. The adoption of Ind AS is a significant change in the financial reporting framework used by NBFCs to report their financial results.

# List of Abbreviations

NBFC	Non-Banking Financial Company
HFC	Housing Finance Company
IGAAP	Generally accepted accounting principles in India
ECL	Expected Credit Loss
EIR	Effective Interest Rate
ESOP	Employee Stock Option Plan
PAT	Profit After Tax
SICR	Significant increase in credit risk
PD	Probability of default
LGD	Loss given default
DPD	Days past due
NPA	Non-Performing Asset
DMA	Direct Marketing Associates
FVTPL	Fair Value through Profit and Loss
FVOCI	Fair Value through Other Comprehensive Income
DTL	Deferred Tax Liability
CODM	Chief operating decision maker
SPV	Special purpose vehicle
MCA	Ministry of Corporate Affairs
IRACP	Income Recognition, Asset Classification and Provisioning
ACB	Audit Committee of the Board



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