Ind AS for NBFCs – Not Just an Accounting Challenge...

Non-Banking Finance Companies ('NBFCs') having net worth of ₹500 crore or more as at 31st March 2016 or thereafter are required to comply with Ind AS for accounting periods beginning on or after 1st April 2018 with the date of transition of 1st April 2017 or thereafter. As a result, NBFCs have started reporting the first set of financial results (for Q1 - 2019) prepared under Indian Accounting Standards ('Ind AS'). It is pertinent to note that while the Reserve Bank of India ('RBI') deferred the implementation of Ind AS by one year for scheduled commercial banks i.e. 2019-20 would be the first year of Ind AS with 2018-19 as the comparative year, the transition date for NBFCs remains unchanged. Read on…

Transition to Ind AS is more than just an accounting change and may have a significant impact on the businesses, systems and processes and people, making this change as much a focus area for the CEO as it is for the CFO/ Controllers.

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One of the particular challenges for NBFCs has been the relative lack of preparation and external communication of the impact / likely impact of Ind AS on their financial statements and results. Given how significant the impact of these standards can be for such entities, most stakeholders have been concerned about a number of aspects relating to the transition to these new standards. For example, hitherto, the accounting related to classification

and recognition of Non-Performing Loans ('NPL'), securitisation transactions, investment classification and valuation etc. are primarily driven by RBI regulations. These prudential norms are prescriptive in nature and provided little discretion to the companies in application. As the date of transition to Ind AS for NBFCs in India was announced some time back, many NBFCs did not begin application efforts early in anticipation of some sort of implementation guidance by regulators. However, as things stand, no such implementation guidance has been issued and as a result there is a certain lack of clarity on some key matters in how Ind AS may impact the way businesses are conducted and how peer group comparisons will emerge.

For example, the decision of whether to enter into a securitisation arrangement or a direct assignment could impact balance sheet management and a requirement to fair value loans and consequently the extent of capital required. The classification of funding instruments in the financial statements as a liability or equity could also impact an NBFC's fund raising ability.

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Some of the significant potential changes in practices that are expected are as follows:

Potential Changes in Business Practices in the Near Term

Credit appraisals and covenant setting

NBFCs are a significant source of funding to corporates, especially mid-sized corporates. Ind AS may also be applicable to some of these borrowers while others may need to follow Accounting Standards (erstwhile Indian GAAP). This may raise a practical issue of comparing the financial performance of borrowers for credit assessment. Moreover, setting and monitoring of covenants would also be challenging in such a multi-GAAP environment. For NBFCs that use an internal credit rating model, the model may also need to be updated on account of changes in rating parameters.

Credit ratings

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One of the indicators of significant increase in credit risk, a key factor that differentiates between 12 month ECL and lifetime ECL, is the change in credit rating of a borrower. NBFCs may now need a periodic ratings refresh and system enhancement to capture the credit rating history of borrowers. This is expected to help assess and compute the life time expected credit losses better.

Insourcing vs. outsourcing arrangements

NBFCs incur significant costs to originate loans by way of commission and incentives to internal and external distribution channels. Ind AS requires amortization of such directly attributable and incremental origination costs. Generally, greater proportion of costs that are incurred in-house tend to be fixed in nature and hence not eligible for amortization under Ind AS; whereas those paid for outsourced services may be variable in nature and hence eligible for amortization. The operating model chosen by the entities would play a crucial role in the way these costs get accounted in the statement of profit and loss.

Potential Changes in Business Practices Over Long Term

Impact on loan pricing

NBFCs often consider measures like Risk Adjusted Return on Capital (RAROC) or Return on Risk Adjusted Capital (RORAC) for pricing of loans. One of the key inputs to these computations is the consideration of 'expected loss'. In case NBFCs do

not consider the ECL in the computation, there may be a significant impact in the statement of profit and loss of companies as the loan pricing may not have appropriately captured the charge on account of ECL.

Cliff effect of provision requirements

For assets where the credit risk has increased significantly since origination, i.e. when the account is more than 30 days overdue, Ind AS requires the lifetime ECL to be recognized. This brings forward the recognition of the expected losses over the entire lifetime in one accounting period thereby creating a cliff effect on recognition of the ECL provisions.

These may have far reaching impacts on the business processes as well as customer behaviour. NBFCs may now need to make greater effort on early collections than under the erstwhile Indian GAAP regime so as to avoid recognition of life time provisions when the accounts become more than 30 days past due. Moreover, this change would also force NBFCs and banks to educate customers of this change in order to bring in more discipline in borrowers.

Employee compensation

NBFCs used stock options as an important tool in order to link the performance of the companies to the compensation paid to employees and also to encourage retention. As long as the exercise price of the options was the prevailing market price of the share on the date of granting the award, companies could opt for the intrinsic value method and not recognise any charge to the statement of profit and loss. Ind AS, however, mandates the fair value of these options to be recognised as a charge in the profit and loss account. The allowability of such costs as a deduction under the tax laws would also be an important determinant to continue such compensation plans.

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Further, several companies provide concessional or interest free loans to employees. As such, Ind AS would require the economics of the transaction to be reflected, i.e. recognition of both interest income as well as employee benefit expense.

Key Elements of the Transition Plan

As NBFCs gear up to embrace the impacts of Ind AS, the key elements of the transition plan should focus on stakeholder communication and identification of changes in business practices.

Stakeholder communication

Transition to Ind AS is expected to significantly alter the key performance indicators or business ratios. Different entities would be impacted differently based on their business or operating model, and capital structure amongst others. For example, the cost to income ratio, interest margin, leverage, Gross NPA ratios and provision coverage ratios could be significantly different from those communicated to investors under erstwhile Indian GAAP. NBFCs would be well advised to proactively reach out to stake holders like analysts, bankers and investors to highlight to them the key changes brought about by the new reporting framework.

Timely communication of first time adoption choices would also be critical, as the choices adopted on first time adoption may vary from NBFC to NBFC and may have a bearing on the profitability in future years.

In the absence of any implementation guidance the accounting of certain transactions will have to be on the basis of the Ind AS framework which exists today. This may have far reaching consequences. Certain examples are set out below :

— ***Securitisation related transactions***

Securitisation and direct assignment transactions are an important source for generating liquidity, managing credit concentration, amongst others for an NBFC. Under the erstwhile Indian GAAP, the de-recognition of assets was largely driven by the 'true sale' criteria. The guidance on de-recognition of assets under Ind AS is significantly different and focuses on whether significantly all the risks and rewards related to the asset have been transferred. This may result into some of the existing structures not being eligible for de-recognition under Ind

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AS resulting into a grossing up of the balance sheet of NBFCs. Consequently, the computation of the capital adequacy ratio may not be fully aligned with the accounting requirements under Ind AS.

NBFCs may also need to consider the impact of the securitization and direct assignment transactions on their business model assessment and in cases where the loans are eligible for de-recognition, the NBFCs may need to consider fair valuation of the said portfolio.

— ***Inter-company funding arrangements***

Some of the popular instruments that are used as a funding tool include Compulsorily Convertible Preference Shares ('CCCPS'). The advantage of using such instruments is that the issuer of the instrument is permitted to consider certain CCCPS as part of Tier 1 capital under the RBI regulations. These instruments also get considered as capital under the erstwhile Indian GAAP. The classification of an instrument as an equity instrument or a liability instrument, however, is dependent on certain features such as the terms of conversion. In instances where conversion ratio is not fixed at inception, such instruments would not be eligible to be considered as equity instruments in the financial statements prepared under Ind AS. NBFCs would need to carefully consider whether these instruments would be eligible to be treated as part of Tier 1 capital for regulatory reporting purposes as well as for compliance with the capital adequacy norms.

— ***Capital adequacy and regulatory reporting***

All NBFCs are required to submit periodic returns to the RBI which includes key parameters related to capital adequacy, Non-Performing Assets (NPAs), advances, amongst others. Substantial data that is reported to the RBI is compiled from the accounting records of the NBFCs, i.e. records maintained under the erstwhile Indian GAAP and the fields to be populated in the regulatory submissions are not based on Ind AS. For example, there is no separate field to capture fair value changes recognised in OCI or re-measurements or actuarial gains and losses recognised in OCI. Accordingly, suitable changes to the fields in the returns would also be required to be made to operationalise regulatory reporting by NBFCs. Further, in the cases where loans are fair valued under Ind AS, while the risk weighted assets reflect the fair value, the treatment of the fair value gains for the purposes of considering as part of capital is unclear. This could potentially have a dual impact on companies, i.e. on one hand the Risk Weighted Assets (RWA) increases required greater capital to be maintained while on the other hand, if the fair value change is not considered as part of capital, the capital adequacy ratio could worsen.

All measurement differences arising between the erstwhile Indian GAAP and Ind AS upon transition to Ind AS are required to be recognised in retained earnings. Certain Ind AS adjustments may have a material impact on the retained earnings on transition, which may in turn impact the Tier 1 capital of the NBFCs.

Therefore, it will be important to get regulatory guidance on such matters in respect of NBFCs.

It is interesting to note, that housing finance companies have been mandated by the National Housing Bank to consider the existing norms (i.e. guidance under the erstwhile Indian GAAP) for the purposes of regulatory reporting.

In summary, Ind AS aims to align the reporting by entities in India to that of global companies facilitating better comparability of financial statements globally and providing easier access to capital markets. Certain differences between Ind AS and the erstwhile Indian GAAP may have a potential business impact making decision-making a challenging job for CEOs and CFOs / Controllers. Clarifications or implementation guidance from the regulators on important areas would be welcomed by the NBFCs and the other stakeholders involved in the financial and regulatory reporting. ■