Chapter 3

Ind AS: Practical perspectives (NBFCs)

This article aims to:

Capture emerging trends and practices by analysing year end annual reports of NBFCs for the year ended 31 March 2019.

Introduction

The financial year 2018-19 marked a new beginning on the financial reporting horizon for financial services sector as Non-Banking Financial Companies (NBFCs) in India reported their financial statements in line with the requirements of Ind AS. The annual reports for the period ended 31 March 2019 provide the first opportunity to understand the choices made by the covered companies, their key accounting policies and the qualitative disclosures as required by the Ind AS.

Non-Banking Financial Companies (NBFCs) have adopted Ind AS from 1 April 2018. These companies have published their annual reports for the year ended 31 March 2019. These annual reports contain first full set of financial statements presented by NBFCs as per Ind AS framework.

As NBFCs embrace Ind AS, KPMG in India, through its analysis, 'Ind AS: Practical perspectives (NBFCs)' aims to capture emerging trends and practices by analysing their annual reports.

Basis of our analysis

We have analysed the annual reports of 48 NBFCs (top 15 NBFCs (based on loan funds) that have their debt securities listed on BSE and 33 equity listed NBFCs (on BSE 500) as on 1 April 2019.

Of the 15 debt listed companies analysed in this article, three companies are Housing Finance Companies (HFCs) while 12 companies are other NBFCs, and of the 33 equity listed companies analysed, 10 are HFCs while the balance 23 are other NBFCs. Out of 48 covered NBFCs, 38 reported consolidated financial statements while balance 10 reported standalone financial statements.

The analysis is based on the disclosures provided by NBFCs in their financial statements prepared in accordance with Ind AS included in the annual reports for the year ended 31 March 2019.

Analysis of impact of key standards

Ind AS 109, *Financial Instruments*, Ind AS 32, *Financial Instruments: Presentation* and Ind AS 107, *Financial Instruments: Disclosures* prescribe the principles for classification, recognition and measurement of financial instruments. These standards have introduced several new accounting concepts as well as extensive disclosure requirements for companies that apply Ind AS. In our experience, the NBFCs that have transitioned to Ind AS in the Financial Year (FY) 2018-19 faced complexity relating to accounting and preparation of disclosures as per new requirements applicable to financial services sector.

As a result of the new accounting and disclosure requirements, investors, analysts, lenders and other stakeholders would be able to obtain an enhanced understanding of a company's dealings in financial instruments. These disclosures are designed to provide more insights into the objective of transacting in the instruments as well as how they are managed by the company.

The impact of complying with the requirements of the new standards has been pervasive. The NBFCs have reported significant adjustments relating to classification and measurement of financial instruments, recognition and derecognition and relating to consolidation.

Analysis of key disclosures provided by NBFCs

First-time adoption exemption

Ind AS 101, *First-time Adoption of Ind AS* provides certain exemptions and exceptions to facilitate smooth transition from Indian GAAP to Ind AS. These exceptions/exemptions are classified under mandatory exceptions and optional exemptions.

While these exemptions facilitate a smooth transition to Ind AS, certain exemptions may also be chosen with a particular financial reporting objective in mind. For example, restatement of past business combinations may normally result in lower amount of goodwill as compared to Indian GAAP. The quantum of reduction may have been partly or entirely amortised to retained earnings depending on the timing of the acquisition.

A variety of first-time adoption choices have been made by the NBFCs. The section below provides a summary of key transition options which had impact for NBFCs.

Derecognition of financial assets

As per Ind AS 101, an entity should apply the derecognition requirements of Ind AS 109 prospectively for transactions occurring on or after the date of transition to Ind AS. However, an entity may apply the derecognition requirements retrospectively from a date chosen by, it if the information needed to apply Ind AS 109 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Of the 32 NBFCs that provided disclosures on this choice, 8 NBFCs have applied derecognition principles on a retrospective basis and the balance 24 have elected to apply derecognition provisions on a prospective basis. NBFCs applying principles retrospectively have in most instances stated that reliable information was available at the time of initially accounting for these transactions.

Investment in subsidiaries

25 NBFCs have disclosed that they account for investment in subsidiaries at cost and two NBFCs account for at Fair Value through Other Comprehensive Income (FVOCI).

Significant judgements and estimates

Under Ind AS, an entity should disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

The disclosure of the most important judgements is likely to enable users of financial statements to understand better how the accounting policies are applied and to make comparisons between entities regarding the basis on which managements make these judgements.

Following table depicts the trend of some of the key judgements provided by the NBFCs:

Key judgements	Presented		Not presented	
	Equity	Debt	Equity	Debt
Impairment of financial assets (ECL)	32	14	1	1
Measurement and recognition of provisions and contingencies	27	14	6	1
Fair value measurement of financial instruments	30	14	3	1
Effective Interest Rate (EIR)	27	13	6	2
Business model assessment	28	13	5	2

Impairment of financial instruments was identified by all the entities as a significant judgement/estimate, irrespective of whether these entities were NBFCs, HFCs, broking or similar companies. The items such as fair value measurements, Effective Interest Rate (EIR) and business model assessment also were the other key areas of significant judgement and estimates identified by the companies.

Expected Credit Loss (ECL)

Ind AS 109 provides a new ECL model for impairment which may lead to earlier recognition of impairment allowance. Under the new approach entities are required to consider information from the perspective of historic, current and forward-looking data elements.

Whilst Ind AS 109 is required to be applied for ECL measurement, 6 NBFCs have retained loan loss provisions in line with prudential norms of the Reserve Bank of India (RBI) i.e. the provision amounts under the prudential norms are higher than the Ind AS based ECL provisions.

Ind AS 101 requires an entity to assess and determine the impairment allowance on financial assets as per Ind AS 109 using the reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that financial instruments were initially recognised and compare it to the credit risk at the date of transition to Ind AS. Only one NBFC has applied this exception prospectively. Rest have applied ECL principles at transition date on a retrospective basis.

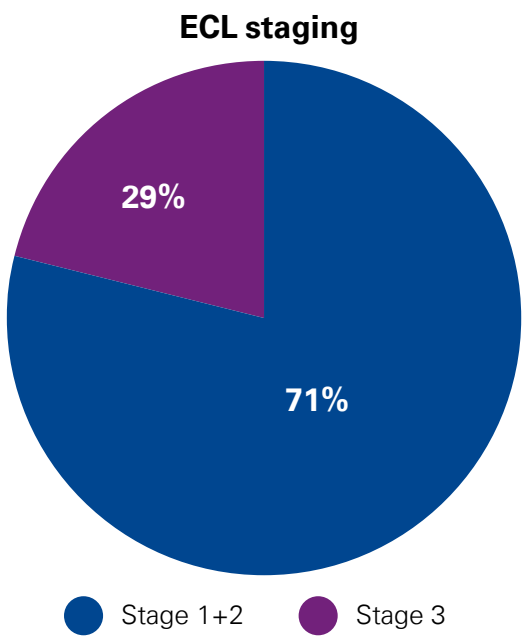
Description	Amount
Gross loans	INR3,013,012 crore
Impairment allowance	INR97,024 crore
Percentage to gross loans	3%

Out of 48 companies, four companies do not have loss allowance provision. Further, the percentage of provision ranges from 0.5 per cent to 39 per cent. There appear to be large variations in impairment percentage.

Classification and measurement of loans (including securitisation)

- More than 95 per cent of the aggregate loan exposure disclosed by the covered companies have been classified as amortised cost. This is reflective of the nature of the loan products offered by the covered companies and also the business model of holding these loans till maturity to collect substantial portions of the contractual cash flows.
- It is pertinent to note that while of the 48 companies covered in the analysis, 29 companies have undertaken securitisation arrangements. Under Ind AS, the criteria for derecognition of loans are far more detailed and stringent to meet the derecognition criteria. This is reflected in the fact that of these 29 companies, only five companies have been able to meet the derecognition criteria. The remaining 24 companies have therefore, reflected the proceeds arising from securitisation as borrowings.
- In terms of securitisation arrangements entered into by the covered companies, assignment transactions appear to be far more popular form of securitisation as compared to the traditional securitisation transaction involving transfer to a Special Purpose Vehicle (SPV) which in turn issues pass through certificates. The disclosures around securitisation arrangements, however, are expected to be more detailed and consistent as the covered companies progress in this journey of applying Ind AS requirements on an ongoing basis.

Ind AS 109 ECL staging – Per cent of ECL allowance



Source: KPMG in India's analysis, 2020 basis annual reports of NBFCs for the year ended 31 March 2019.

For the covered NBFCs, on an average, the Stage 3 loss allowance represented 71 per cent of total loss allowance under Ind AS 109.

Segmentation of loans

The level of segmentation depends on the size of the financial institution and nature of its lending activities. Segmentation process addresses the risk associated with the loan portfolio and should be customised to financial institution's requirements.

Out of 48 companies, 38 companies have disclosed the information about portfolio segmentation. The most common bifurcation used by companies is corporate and retail loans.

Staging criteria

Ind AS 109 requires staging assessment for retail loans based on rebuttal of Days Past Due (DPD) criteria. 41 companies out of 48 companies have done staging of their loan's basis the number of DPD. Out of balance companies, six have used rating basis[1] and balance one company has not provided any information about this disclosure requirement.

Particulars	No of companies
Days past due	41
Rating basis	6
Not disclosed	1

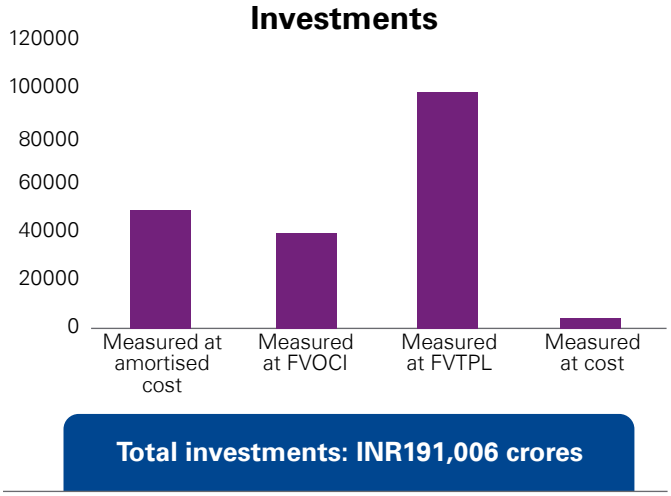
Source: KPMG in India's analysis, 2020 basis annual reports of NBFCs for the year ended 31 March 2019.

Classification and measurement of investments

Ind AS 109 requires investments in debt instruments to be classified into categories and measured at Fair Value through Profit or Loss (FVTPL), FVOCI or amortised cost on the basis of the business model assessment of the entity and the contractual cash flow characteristics of the asset. Investments in equity instruments are to be classified and measured at FVTPL, unless a company exercises the irrevocable option to classify and measure non-trading equity investments at FVOCI.

As per our analysis of the annual reports published by covered listed NBFCs, investments are primarily held in instruments such as mutual funds (quoted and unquoted), equity shares (quoted and unquoted), government securities and corporate bonds (generally unquoted).

Below figure summarises the composition of each category of financial assets based on the nature of investments held.



Source: KPMG in India's analysis, 2020 basis annual reports of NBFCs for the year ended 31 March 2019.

The above analysis indicates the following broad trends:

- Investments in quoted and unquoted mutual funds, including debt mutual funds and fixed maturity plans, are generally classified at FVTPL even though they may not be held for trading within the short-term.
- Investment in government securities and debt instruments comprise significant portion of the investments which are classified as FVOCI primarily based on the business model of partially holding the investments to collect contractual cash flows and partially holding them for sale. Investment in equity shares classified as FVOCI typically represents the strategic investments which are not classified as subsidiary, associate or joint venture nor are held for trading. While reporting entities under Ind AS have a free one time irrevocable choice to classify such investment in equity shares as either FVTPL or FVOCI, considerations relating to taxation (especially Minimum Alternate Tax (MAT) under Section 115JB of the Income-tax Act, 1961), volatility in statement of profit and loss, etc. has resulted in most companies choosing to classify such investment in equity shares as FVOCI.
- Investments classified as at amortised cost are primarily debt instruments where the business model of the companies typically involves holding such investments till contractual maturities.

1. Rating basis is the tool used by companies to measure credit risk of a loan asset. The companies have used external and internal credit rating model for staging assessment of loans.

Disclosure of fair value hierarchy

Ind AS 107 also requires companies to disclose the fair value of each class of financial assets and liabilities. Further, Ind AS 113, *Fair Value Measurement* requires companies to categorise the fair values (for items that are measured at fair value as well as those for which fair value is disclosed) into a hierarchy based on the inputs used in determining their fair value.

The following are the levels prescribed by Ind AS 113 for categorising fair value measurements and the results of the analysis of disclosures in the financial statements:

- **Level 1:** Fair value is measured based on unadjusted quoted prices in an active market for identical assets or liabilities.
- **Level 2:** Fair value is based on inputs that are observable in nature (other than quoted prices used in level 1), for example, quoted prices for similar assets/ liabilities in an active market, interest rates or yield curves, or other market-corroborated inputs.
- **Level 3:** One or more inputs used for determining fair value is unobservable in nature, for example, historical volatility used as an input in an option pricing model or a swap rate calculated based on different yield curves in a long term currency swap.

71 per cent of the mutual funds that are fair valued are considered by companies to be Level 1 in the hierarchy. Mutual fund investments are generally valued based on their Net Asset Value (NAV) per unit. We believe careful assessment is required as to the volume of redemptions and subscriptions, extent to which subscriptions were received from new investors, ability to redeem the investment at NAV and the consistency with the principles of fair value as defined under Ind AS 113 in the determination of NAV.

In comparison to the hierarchical classification of mutual funds above, the classification of equity shares suggests that 73 per cent of quoted equity shares are not classified as Level 1 in the hierarchy but are instead included in Level 3.

Out of the aggregate absolute fair value of derivative contracts, 66 per cent of the derivatives are classified as Level 2 and 34 per cent at Level 3 suggesting that most of the entities have not transacted in exchange traded derivatives. Further, five per cent of the fair values represented those arising in respect of a cash flow hedges as the fair values are recognised in OCI.

Derivative and hedging

19 of the covered NBFCs have entered into derivatives to mitigate their exposure to financial risks and in certain cases for trading. The derivatives are generally in the nature of foreign currency forward contracts, option contracts, currency futures and interest rate swaps (INR as well as cross currency). 12 of these 19 companies have applied hedge accounting to their derivative exposures.

It is important to note that while most of the companies have entered into derivative transactions as part of their risk management policy to manage the interest rate and exchange rate risk, not all companies are choosing to apply the requirements of hedge accounting, partly on account of the stringent requirements in relation to hedge documentation and periodic assessment of hedge effectiveness.

Ind AS 107 requires detailed disclosures of derivatives used for hedging exposures and additional information where such derivatives are designated as hedges under Ind AS 109. We have observed that several companies have not provided sufficient disclosures related to their hedging transactions to the extent required by Ind AS 107 and to enable analysis of derivative transactions on an aggregated basis.

Separating the cost of hedging

Ind AS 109 permits companies to separate the costs of hedging, in the form of time value of options, forward element of forward exchange contracts or currency basis spreads in cross currency swaps, from a hedge relationship. One of the 12 companies that have applied hedge accounting principles, have elected to separate the cost of hedging from their designated hedging relationships.

Capital to Risk Weighted Asset Ratio (CRAR)

Capital to Risk (Weighted) Assets Ratio (CRAR) or Capital Adequacy Ratio is the ratio of a company's capital to its risks. The Capital Adequacy Ratio is calculated by dividing a NBFC's capital by its risk-weighted assets. The capital of the NBFCs used to calculate the capital adequacy ratio is divided into two tiers i.e. Tier 1 and Tier 2.

CRAR is a crucial indicator, as it ensures NBFCs have enough capital to absorb losses. Also, CRAR is important for regulators to determine capital adequacy for the entity.

Out of the total of 48 companies covered by us in the analysis, reporting on capital adequacy was applicable to 40 companies. 52.5 per cent of these 40 companies did not report a change in the capital adequacy ratios for the year ended 31 March 2018 presented in the Ind AS financial statements as compared to the financial statements for the year ended 31 March 2018 under the erstwhile Indian GAAP. This suggests that there is a mixed practice adopted by companies with respect to the re-computation and presentation of the ratios for the comparative period. This trend is similar even if the equity listed companies and debt listed companies are analysed separately. 56 per cent of equity listed companies have not reported a change in the ratios in the 31 March 2019 Ind AS financial statements for the ratio pertaining to the year ended 31 March 2018 while that number was at 46.7per cent for debt listed companies.

Also, it is interesting to note, that at an aggregate level, the net worth under Ind AS as at 31 March 2018 has shown an increase when compared to the net worth under the erstwhile Indian GAAP as at 31 March 2018, only 15 per cent of the companies have reported an increase in the CRAR ratios.

Key audit matters reported by auditors

An analysis of the Key Audit Matters (KAMs) reported by the auditors in their audit opinions of NBFCs is summarised below.

KAM	Number of NBFCs
Measurement of ECL	39
Adoption of Ind AS/transition	32
Information technology systems/controls	25
Valuation of financial assets	12
Tax positions	4

Ind AS provides comprehensive disclosure requirements for NBFCs and HFCs to be provided in annual and interim financial statements. The analysis discussed in this chapter provides some of the trends for the financial services sector in relation to adoption of Ind AS. However, it can be expressed that quality of disclosures provided by NBFCs and HFCs are not as robust as expected. We expect that as the industry gains experience in applying the requirements of Ind AS, they would be able to appreciate the requirements and provide detailed disclosures.

The RBI lays down regulatory provisions relating to various aspects of operation of NBFCs/Asset Reconstruction Companies (ARCs) such as provisioning of loan exposures, maintenance of regulatory capital, etc. Ind AS prescribes accounting treatment in the financial statements of NBFCs/ARCs, of which certain provisions vary with the regulatory stipulations. Accordingly, NBFCs/ARCs required clarifications on certain aspects. Therefore, in this regard, RBI issued a circular on 13 March 2020 which provides regulatory guidance on Ind AS for NBFCs and ARCs. These guidelines focus on the need to ensure consistency in the application of the Ind AS in specific areas including asset classification and provisioning and provide clarifications on regulatory capital while applying Ind AS. These RBI guidelines are applicable to NBFCs and ARCs for preparing their financial statements for financial years 2019-20 and onwards.

Also refer to KPMG in India's First Notes: **RBI issues regulatory guidance on Ind AS for NBFC and ARC** dated 20 March 2020 for more insights on the topic.

Conclusion