The Reserve Bank of India issues regulatory guidance on Ind AS for NBFCs and ARCs

20 March 2020

First Notes on

Financial reporting

Corporate law updates

Regulatory and other information

Disclosures

Sector

All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

Relevant to

All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

Background

Large Non-Banking Financial Companies (NBFCs) and Asset Reconstruction Companies (ARCs) reported their first Ind AS financial statements for the financial year ended 31 March 2019. The Ind AS implementation has affected various regulatory provisions applicable to NBFCs and ARCs. Therefore, the Reserve Bank of India (RBI) expects a high quality implementation of Ind AS which requires detailed analysis and application of judgement and detailed documentation to support judgements.

New development

Considering the impact of Ind AS on the regulatory provisions, on 13 March 2020, RBI issued a notification providing regulatory guidance on Ind AS (RBI guidelines). These guidelines aim to promote high quality and consistent implementation of Ind AS (pertaining to specific prudential aspects), and to facilitate comparison and better supervision. The RBI guidelines are applicable to NBFCs and ARCs for preparing their financial statements for financial years 2019-20 and onwards.

This issue of First Notes provides an overview of these guidelines.

RBI guidelines

The RBI guidelines focus on the need to ensure consistency in the application of the accounting standards in specific areas, including asset classification and provisioning, and provide clarifications on regulatory capital in the light of Ind AS implementation.

They provide clarifications on the following aspects of Ind AS:

Governance framework

Provisions of Ind AS 109, *Financial Instruments*	Clarifications by RBI guidelines
A. ***Business Model assessment***	
An entity should subsequently classify and measure financial assets at amortised cost, Fair Value through Other Comprehensive Income (FVOCI) or at Fair Value Through Profit or Loss (FVTPL) on the basis of both: - The business model for managing the financial assets; and - The contractual cash flow characteristics of the financial asset.	Considering the criticality of the nature of business model in determining classification of financial assets and restrictions in subsequent reclassifications, NBFCs/ARCs are advised to: - Put in place Board of Directors (Board) approved policies that clearly articulate and document their business models and portfolios - Articulate the objectives for managing each portfolio, and - Frame policies for sales out of amortised cost business model portfolios, and disclose the same in notes to financial statements.
B. ***Expected credit losses***	
I. ECL Model	
A loss allowance is required to be recognised on financial assets subsequently classified and measured at amortised cost and at FVOCI using specific ECL models.	**Methodologies for computing ECL:** Since the ECL models or methodology is not defined by the standard, the Board should approve sound methodologies for computation of ECL. The methodology so approved should define the policies, procedures and controls[1] for assessing and measuring credit risk on all lending exposures. **Parameters and assumptions of ECL model:** The parameters and assumptions considered for computing ECL, as well as their sensitivity to the ECL output should be documented. **Changes in parameters, assumptions and ECL model:** Changes should not be made in the parameters, assumptions and other aspects of the ECL model for the purpose of profit smoothening. In case of a change in the ECL model, the rationale and justification for the same should be documented and approved by the Board. **Management overlays:** Where the management makes adjustments to the ECL model output, it should seek the approval of the Audit Committee of the Board (ACB), and clearly document the rationale and basis for such adjustments.
II. Significant increase in credit risk	
Entities should initially recognise a 12-month ECL on all financial assets, and subsequently, on every reporting date test whether there has been a significant increase in credit risk of that asset, in which case, a lifetime ECL is recognised on such asset.	**Rebutting the presumption:** NBFCs/ARCs may, in limited circumstances rebut the presumption, if they have reasonable and supportable information that demonstrates that credit risk has not increased significantly since initial recognition even though contractual payments are 30 days past due.

[1] The policies, procedures and controls should be commensurate with the size, complexity and risk profile specific to the NBFC/ARC

Generally, for assessing whether there has been a significant increase in credit risk, entities compare the probability of default on the financial asset at the reporting date with the probability of default on the financial asset as at the date of initial recognition. **Rebuttable presumption**: Ind AS 109 also provides a rebuttable presumption, wherein the credit risk of a financial asset is presumed to have increased significantly since initial recognition when contractual payments are more than 30 days past due.	There should be clear documentation of the justification for rebutting the presumption, and all such cases should be placed before the ACB. However, the recognition of a significant increase in credit risk of any exposure should not be deferred if it is overdue beyond 60 days.
III. Default	
Ind AS 109 does not explicitly define default, however, it requires entities to define the term in a manner that is consistent with that used for internal credit risk management. However, it provides a rebuttable presumption that an account has defaulted if it is 90 days past due.	The ACB should approve the classification of accounts that are 90 days past due but not treated as impaired, and document the rationale for the same. NBFCs/ARCs are required to disclose the following in their financial statements: - Total number of accounts that are past due beyond 90 days, but not treated as impaired - Total amount outstanding with regard to such accounts, and - The overdue amounts.

Prudential floor for ECL

Provisions of Ind AS 109, *Financial Instruments*	Clarifications by RBI guidelines
NBFCs/ARCs are required to compute and record impairment allowances in accordance with Ind AS 109.	**A. Comparison between Ind AS and prudential norms** NBFCs/ARCs should simultaneously maintain asset classification and compute provisions as per extant prudential norms on Income Recognition, Asset Classification and Provisioning (IRACP)[2]. A comparison between the provisions required under the IRACP and the impairment allowance computed as per Ind AS 109 should be disclosed in the notes to the financial statements in the prescribed format (as given in Annexure I below). This is done to provide a benchmark to the Board, RBI supervisors and other stakeholders regarding the adequacy of provisioning for credit losses. **B. Impairment reserve** 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 impairment reserve should not be reckoned for regulatory capital. Further, no withdrawals are permitted from this reserve without the prior permission from the Department of Supervision, RBI.

[2] This includes borrower/beneficiary wise classification, provisioning for standard and restructured assets, NPA ageing, etc.

Computation of regulatory capital and regulatory ratios

Various Ind AS adjustments affect equity and reserves which in turn impacts 'owned funds'[3], 'net owned funds'[4], 'regulatory capital'[5] and regulatory ratios of NBFCs and ARCs.

Provisions of Ind AS 109, *Financial Instruments*	Clarifications by RBI guidelines
A. Determining owned funds, net owned funds and regulatory capital	
i. Gains or losses on fair valuation of financial instruments measured at: - FVOCI are recorded in other comprehensive income, and - FVTPL are recorded in statement of profit and loss. Further, the difference between the carrying amount and fair value of the instruments on the date of transition to Ind AS are recorded in retained earnings.	i. Net unrealised gains on fair valuation of financial instruments (including gains on transition to Ind AS) should be reduced from owned funds, however, net losses should be considered. For this purpose, NBFCs should categorise financial assets measured at fair value into two categories: - Investments in shares of other NBFCs and in shares, debentures, bonds, etc. in group companies that are required to be reduced while determining Tier I capital, and - Others (While netting may be done within the aforementioned categories, net gains from one category should not be offset against losses in the other category)* NBFCs should reduce the lower of acquisition cost or fair value of investments/advances in subsidiaries/other group companies and other NBFCs while determining Tier I capital. Net unrealised gains on 'Others', to the extent reduced from regulatory capital, should also be reduced from risk-weighted assets.*
ii. Ind AS 109 requires NBFCs/ARCs to present fair value changes: - Due to own credit risk on liabilities designated at FVTPL in other comprehensive income, and - On the effective portion of a cash flow hedge in cash flow hedge reserve in other comprehensive income.	ii. Unrealised gains or losses recognised in equity due to own credit risk and on cash flow hedge reserve should be derecognised while determining owned funds.*
iii. Ind AS 101, *First-time adoption of Indian Accounting Standards* permits NBFCs/ARCs to elect measuring Property, Plant and Equipment at its fair value, and consider it as deemed cost on the date of transition to Ind AS. The difference between the fair value and the carrying cost is adjusted directly in retained earnings.	iii. These fair value gains should be reckoned as Tier II capital for NBFCs/net owned funds for ARCs at 55 per cent discount.
iv. NBFCs/ARCs are initially required to recognise a 12-month ECL on all financial assets (except trade receivables), and subsequently assess whether there has been a significant increase in credit risk, in which case a lifetime ECL is recorded for the asset.	iv. 12-month ECL allowances for financial instruments should be included in general provisions and loss reserves in Tier II capital within the limits specified by the extant regulations. However, lifetime ECL should not be reckoned for regulatory capital, while it is reduced from risk weighted assets.
v. Securitised assets against which a credit enhancement has been extended by the originating NBFC do not qualify for derecognition under Ind AS 109.	v. For regulatory purposes, these assets should be risk weighted at zero per cent, and 50 per cent of the credit enhancement should be reduced from Tier I capital, and the balance from Tier II capital.
* ARCs should apply these guidelines *mutatis mutandis* while determining net owned funds.	
B. Regulatory ratios, limits and disclosures should be based on Ind AS figures. Impaired and restructured assets should be considered as Non-Performing Assets (NPA) for calculation of NPA ratios.	

[3] 'Owned Fund' means aggregate of the paid-up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, after deducting therefrom accumulated balance of loss, deferred revenue expenditure and other intangible assets.

[4] 'Net Owned Fund' is the amount as arrived at above, minus the amount of investments of such company in shares of its subsidiaries, companies in the same group and all other NBFCs and the book value of debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group, to the extent it exceeds 10% of the owned fund.

[5] Tier I and Tier II capital as defined by Non Banking Financial Company-Systemically Important Non-Deposit taking Company and Deposit taking company (Reserve Bank) Directions, 2016

Our comments

The RBI lays down regulatory provisions relating to various aspects of operation of NBFCs/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. The RBI guidelines brings clarity to, and provides directions on many such matters.

The RBI clearly spells out the importance of the involvement of the Board and the ACB in setting and approving policies in assessment of business model and various facts of computing ECL.

Some of the key clarifications provided by RBI guidelines are as follows:

- **Board defined policies on business model assessment**: NBFCs/ARCs should have clear documented policies, approved by the Board, that defines the business model within which each loan/advance (or group of loans/advances) is held. This would enable the management to easily classify and measure all advances at the time they are initiated.

- **ECL methodologies:** It is essential that all NBFCs/ARCs recognise a significant increase in credit risk and impaired loans on a timely basis, since a delay would aggravate underlying weaknesses in credit quality and adversely affect capital adequacy. Thus RBI lays the responsibility of approving ECL methodologies/ECL models, and change in such models on the Board. Further, the audit committee is accountable for approving:
  - o Accounts that are 90 days past due, but which are not considered as impaired, and
  - o The classification of accounts that are overdue beyond 30 days, whose risk is not considered to have increased significantly since initial recognition.

- **Creation of impairment reserve and disclosure of impairment provision**: IRACP prescribes certain percentages to be applied while computing provision on advances. However, Ind AS 109 requires entities to compute ECLs on a probability weighted basis. This led to a divergence in the impairment computed under the two norms, which was a matter of great contention.

  The introduction of the requirement to maintain an impairment reserve, now provides clarity that NBFCs/ARCs are required to compare the impairment as per IRACP and Ind AS 109 and recognise the higher of the two. However, since this mandates the IRACP provision to be recorded (where higher), it would lead to a mandatory carve out from IFRS 9, *Financial Instruments*, which requires entities to record impairment allowance on financial assets based on the loss expected to occur on the asset over 12 months/life of the asset (where there is a significant increase in credit risk on initial recognition).

  NBFCs/ARCs now need clarity on how to present the impairment reserve- i.e. on the face of the statement of profit and loss or in the statement of changes in equity.

  The RBI guidelines require the impairment allowance under IRACP and Ind AS 109 to be disclosed in the financial statements. This would provide a benchmark to the Boards of NBFCs/ARCs, RBI supervisors and other stakeholders on the adequacy of provisioning for credit losses.

- **Computation of regulatory capital:** Ind AS prescribes various accounting adjustments that are recorded in equity on a one-time (on implementation of Ind AS) or a regular basis. This affects the computation of regulatory capital, including computation of net owned funds. The RBI guidelines now clarify, how the Ind AS adjustments should be dealt with while computing regulatory capital and net owned funds.

- **Reference to Ind AS guidelines:** The RBI guidelines do not provide any commentary or technical interpretation pertaining to the accounting standards. Thus for matters not dealt with by the RBI guidelines, NBFCs/ARCs should refer to notified accounting standards, application guidance, education material and other clarifications of the Institute of Chartered Accountants of India.

  While the RBI guidelines provide clarifications on various aspects, there are still certain areas that need further explanation such as treatment of guarantees and compound financial instruments while computing regulatory capital and regulatory ratios, guidance on which sales are considered 'infrequent in number' or 'insignificant in value' when determining the business model of financial assets, etc.

Annexure I- Template for disclosure in the Notes to Financial Statements

Asset classification as per RBI norms	Asset classification as per Ind AS 109	Gross carrying amount as per Ind AS	Loss allowance (provisions) as per Ind AS 109	Net carrying amount	Provisions required as per IRACP	Difference between provisions as per Ind AS 109 and IRACP
(1)	(2)	(3)	(4)	(5)=(3)-(4)	(6)	(7)=(4)-(6)
Performing Assets						
Standard	Stage 1					
	Stage 2					
Subtotal						
Non-Performing Assets (NPA)						
Substandard	Stage 3					
Doubtful- up to 1 year	Stage 3					
1 to 3 years	Stage 3					
More than 3 years	Stage 3					
Subtotal for doubtful						
Loss						
Subtotal for NPA						
Other items such as guarantees, loan commitments, etc. which are in the scope of Ind AS 109, but not covered under IRACP	Stage 1					
	Stage 2					
	Stage 3					
Subtotal						
Total	**Stage 1**					
	Stage 2					
	Stage 3					
	Total					

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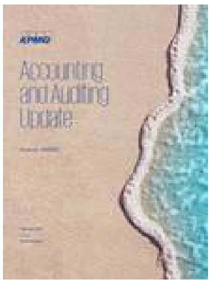


Issue no. 43 – February 2020

The topics covered in this issue are:

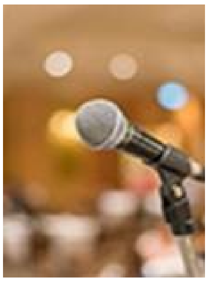
- Auto sector- Impact of slowdown on financial reporting
- SEBI reviews norms relating to related party transactions
- US GAAP- Recent emerging issues
- Regulatory updates.

MCA provides clarification on the liability of independent directors, non-promoters and non-KMP non-executive directors

17 March 2020

The Ministry of Corporate Affairs (MCA) through its circular dated 2 March 2020 (the circular) provides a clarification on both the prosecution filed as well as internal adjudication proceedings initiated by the Registrar of Companies (Registrar) against IDs, non-promoter and non-Key Managerial Personnel (KMP) NEDs.

This issue of first notes provides clarification on the above provisions.



Voices on Reporting

KPMG in India is pleased to present Voices on Reporting (VOR) – a series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

A special session of VOR webinar was held on 26 February 2020 to discuss some of the significant accounting issues arising due to a business combination with the help of practical examples or case studies relevant for the technology sector.

For registration details, please click here.

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