

Indian accounting standards may lead to increase in charge to P&L account for NBFCs having track record of past NPAs

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While Ind AS implementation has been deferred for banks by a year, the journey of convergence initiated by NBFCs has begun. (Representational photo)

The adoption of Indian Accounting Standards (Ind AS) has catapulted India to the stage of high quality and transparent financial reporting. It will also ensure comparability between financial statements in accordance with global accounting standards and, more importantly, synchronise financial statements to economic reality. While the Ind AS implementation has been deferred for banks by a year, the journey of convergence initiated by NBFCs has already begun. There are some key accounting implications for NBFCs.

Expected credit loss (ECL): As against the existing methodology of rule-based provisions for credit losses, Ind AS expects NBFCs to follow the ECL model, wherein the loan loss provision is calculated on the basis of the loan book's historical loss experience and future expected credit loss depending on credit quality assessment. The introduction of Ind AS may lead to a significant increase in the charge to P&L account for NBFCs having higher track record of past NPAs. Newly-formed companies will find the process of adoption of Ind AS quite challenging, as they don't possess historical credit risk data and may have to rely on industry data. The model should not only build historical data but also consider forward-looking information based on customers' expected recovery patterns, time of recovery, probability of default and recovery expected from collaterals. A variety of ingredients used by NBFCs while following the ECL model poses a challenge to users in terms of its analysis and benchmarking performance amongst peers.

Amortisation of fee income under effective interest rate: Commercial understanding at the time of lending is based on the concept of XIRR, which gets split between upfront fees and yield. Under Indian GAAP, fees were getting accrued to P&L upfront, whereas yield accrued over the tenure of the loan. Under Ind AS, accounts will start reflecting the commercial understanding and hence fees generated on loans will have to be amortised over the life of the loan. This will result in temporary deferral of revenue recognition. For NBFCs, it means a negative impact on profits and hence in net worth. P&L account will get normalise over the period.

Fair value implications on financial assets: On the date of transition, all financial assets have to be recorded in the balance sheet at fair value. The impact of fair valuation of financial assets, post initial recording in the balance sheet, may have to be

accounted through the statement of P&L (FVTPL), which could have a positive or negative impact on the profitability of a company. The mark-to-market gain or loss as on every reporting period will result in volatility in the P&L account.

Consolidation of subsidiaries: Some NBFCs have formed JVs with partners. Most have a shareholders agreement covering a variety of rights, including veto over certain matters. These may be in the nature of protective rights. Under Ind AS, one will have to evaluate the definition of 'control' based on agreement between the partners. It may lead to either consolidation of entire balance sheet and P&L of a JV, or de-consolidation of the same, as the case may be. This changes the entire top line or the balance sheet size of an entity on a consolidated basis. In extreme situations, even some SPVs will have to be treated as subsidiaries and need to be consolidated; for example, Securitisation Trusts floated by asset reconstruction companies, over which it has 'control'.

Segment reporting: As opposed to the existing requirement of segmenting operations of the group based on similarities of 'risks and rewards', Ind AS expects financials to disclose segments based on the management's evaluation of financial information for allocating resources and assessing performance. This is a welcome change, as it ensures that the user of financial information views the exact information, which the chief operating decision maker (CODM or management) uses for the purpose of strategy formulation and resource allocation.

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