WIRC Knowledge Series on Banking, Pension & Insurance

Financial reporting: Perspectives on overview and key issues relating to:

- Banks
- NBFCs
- IND-AS

...CA Viren H. Mehta

11 August 2018

Source: Internet

Banks

Perspectives on

- NPA
- RBI Divergence
- Revised Framework
- LFAR
- LOU
- RBI Enforcement action against statutory auditors

Source: Internet

Non-performing Assets

Definition: An asset including leased assets, becomes non performing when it ceases to generate income for the bank

A non performing asset (NPA) is where:

- Term Loan/Bills discounted and purchased/Derivative receivables is ‘overdue’ for a period of more than 90 days
- Working capital loans remains ‘out of order’
- Stock statement not received for six months
- Not reviewed/renewed within 180 days
- Agri Loans: overdue for two crop seasons for short duration crops; one crop season for long duration crops
- Credit Card account will be treated as NPA if the MAD is not paid fully within 90 days from the payment due date

Types of divergence observed – RBI inspections

- Transactions from group companies on critical dates
- Restructuring
- Ever-greening
- Achievement of DCCO for project loans
- Security Valuation of NPAs
- Standard assets provision – classification of MSME and Agriculture advance

Revised framework on resolution of stressed assets

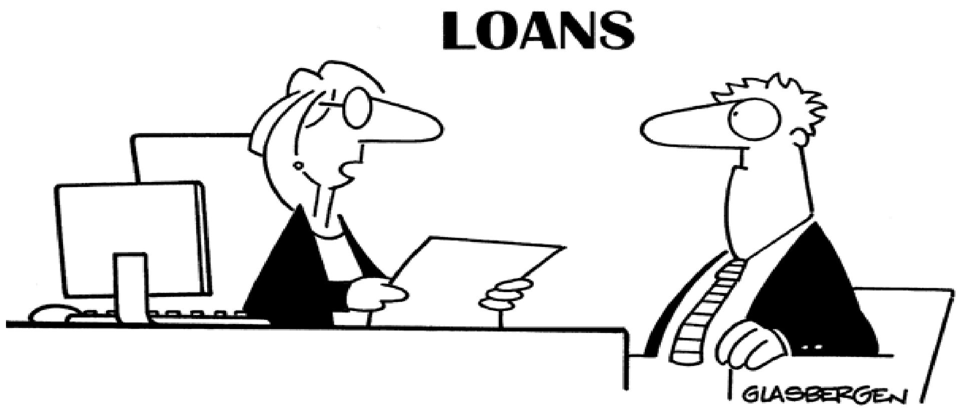
- Timely recognition of stress and enforce resolution discipline – one day default reported as SMA-0
- Timelines for implementing resolution plan
- Independent ratings for resolution plans – RP4 or better
- Definition of financial difficulty
- Change in definition of restructuring
- Upgrade of restructured assets – change in definition of specified period
- Effect on existing restructuring schemes

Long Form Audit Report

- Policies and procedures on key areas:
  - Loans and advances
  - Treasury
  - Deposits
  - Cash and Balance with RBI
  - Other assets
- Key issues identified in loans, treasury and other key areas
- Control environment
- Systems and automations
- Capital Adequacy

LOU Fraud

- Letter of undertaking (‘LOU’) fraud – Decentralised process
- Integration of SWIFT system with CBS
- Strengthening the control mechanism around SWIFT system
- Reconciliation of SWIFT messages with entries in CBS
- RBI discontinued the practise of issuance of LOC/LOUs



“Do you have any other collateral...
besides this e-mail from a Nigerian prince?”

RBI enforcement action framework against Statutory Auditors

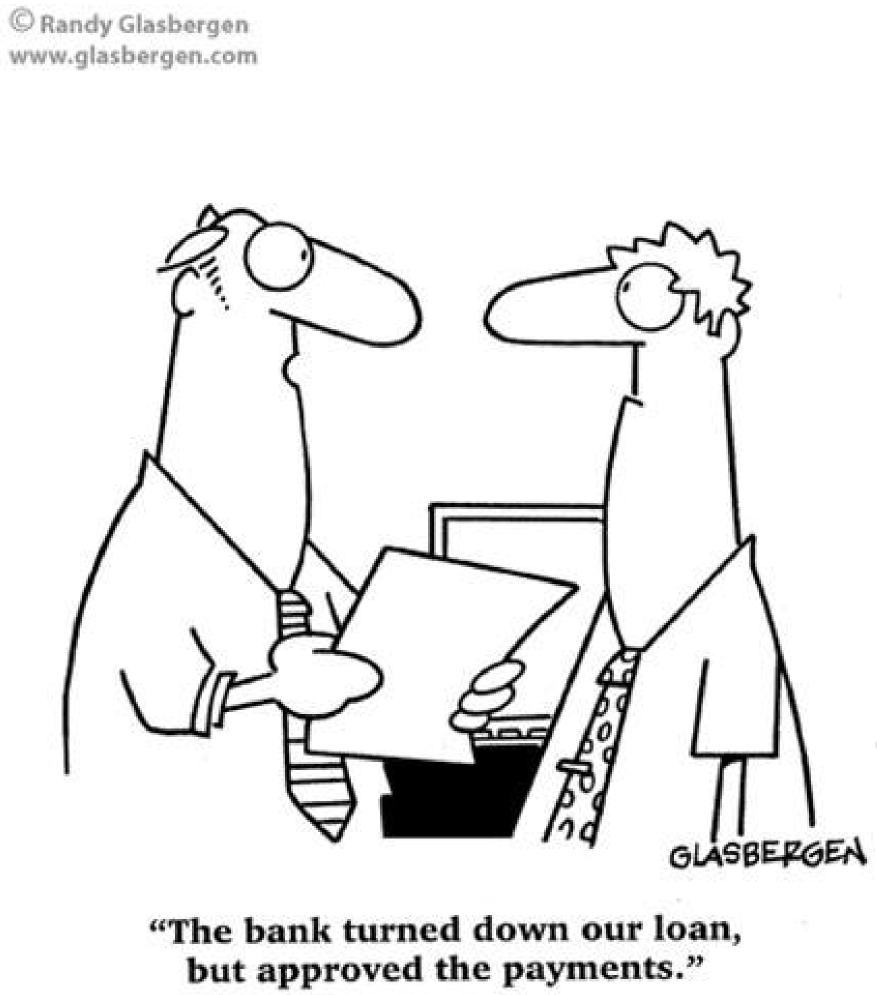
Enforcement action framework in respect of Statutory Auditors

- With a view to improving audit quality and instituting a transparent mechanism to examine accountability an enforcement action framework has been instituted
- It would cover, inter alia divergences in asset classification and provisioning from RBI inspections
- RBI to not approve appointment in cases where (a) their audit quality or conduct is not found satisfactory or (b) debarred by other regulators/law-enforcement agencies/government agencies
- Lapses would be judged on the criteria of (a) fact of the lapse and (b) materiality of the lapse
- Any enforcement action, including issuance of cautionary advice, on an audit firm shall be communicated to ICAI and placed in the public domain by RBI

NBFCs

Perspectives on

- Definition of NBFC
- Types of NBFCs
- NBFC - MFIs
- NBFC – Housing Finance Companies
- Financial reporting differences between Banks and NBFCs



Source: Internet

Definition of a NBFC

In common parlance, NBFCs are institutions offering a wide spectrum of financial services to its customers who would normally not have access to the banking system

The key aspect to determine whether a company is an NBFC or not depends upon its asset and income pattern i.e. more than 50% of assets should be financial assets and more than 50% of income should be from financial assets

NBFCs are categorized mainly as per the following dimensions:

- Whether the accept deposits from public or not
- Whether they are systemically important or not (total assets whether more than Rs.500 crore or less)
- Nature of business (such as – asset finance, investment company, microfinance, infrastructure finance, etc.)

Categories of NBFCs

- Asset Finance Company
- Investment Company
- Loan Company
- Infrastructure Finance Company
- Infrastructure Debt Fund
- Micro Finance Institution
- Factors
- Mortgage Guarantee Company
- Non-Operative Financial Holding Company
- Core Investment Company

Reporting in addition to statutory auditor's report on financial statements:

- Annual statutory auditor's certificate on asset-income pattern
- Reporting to Board of directors on specified matters
- Direct reporting to RBI for any adverse remarks/qualifications/non-compliance
- Certification on changes to composition of board of directors in the last quarter

Corporate governance norms

- Rotation of audit partner mandatory after a period of 3 years
- Audit partner eligible for conducting audit after completion of 3 years

NBFC-MFI defined as a non-deposit accepting NBFC fulfilling following conditions:

- Minimum NOF of INR 5 crore (for MFIs in north-east region – INR 2 crore)
- Atleast 85% of net assets must be "qualifying assets" (assets originating on or after January 1, 2012)

Qualifying asset criteria:

- Income: < INR 1 lakh (rural) / < INR 1.6 lakh (urban/semi urban)
- Loan amount: < INR 60K (first cycle) / < INR 1 lakh (subsequent cycles)
- Total indebtedness of borrower: < INR 1 lakh (excluding loans towards education and medical purpose)
- Loan tenure: at-least 24 months if loan amount exceeds INR 30K
- Loans without collateral
- Loans given for income generation not to be less than 50% of total loans
- Repayment frequency: weekly, fortnightly or monthly as per borrower's choice

NBFC – Microfinance institutions (contd.)

Key operational compliance – Pricing of qualifying assets:

- Aggregate margin cap not to exceed 10% (12% for MFI with loans more than Rs.100 crores)
- Ceiling on interest rates for loans sanctioned by MFI to be lower of following:
- Average of base rates of five largest commercial banks x 2.75
- Cost of funds + margin cap mentioned above
- Variance between maximum and minimum interest rates not to exceed 4%
- Processing fees restricted to 1% of the loan amount – not to be considered in margin cap
- Recovery of insurance premium capped at actual cost of insurance
- Collection of penal/delayed payment charges is prohibited

Housing Finance Company (HFC) is a company registered under the Companies Act:

- which primarily transacts or has as one of its principal objects to conduct the business of providing finance for housing, whether directly or indirectly
- is regulated by the National Housing Bank (NHB)

HFCs are generally engaged in providing:

- Home loans – Loans given for purchase/construction of houses
- Loans against property – Loans given against pre-owned real-estate property as a primary security

Key Financial reporting differences between Banks and NBFCs

Parameter	Banks	NBFCs
Reporting framework	Banking Regulation Act, 1934	Schedule III to the Companies Act, 2013
Standard asset provisioning	Sector-wise requirement: SME's – 0.25% Commercial Real estate – 1% Commercial residential housing – 0.75% Other advances – 0.4%	0.4% for all types of advances
Special reserve	25% of annual net profit	20% of annual net profit
Capital adequacy	Universal banks – 9% Small finance banks – 15% (Basel norms)	15% (Asset based approach)
Sectoral exposure	Priority sector lending norms	No specific requirement for NBFC's
Tax benefits	- Special reserve deductible - Allowance for doubtful debts – 8.5% of taxable income	- Special reserve non deductible - Allowance for doubtful debts – 5% of taxable income

Forming an opinion and reporting on financial statements (revision to SA700)

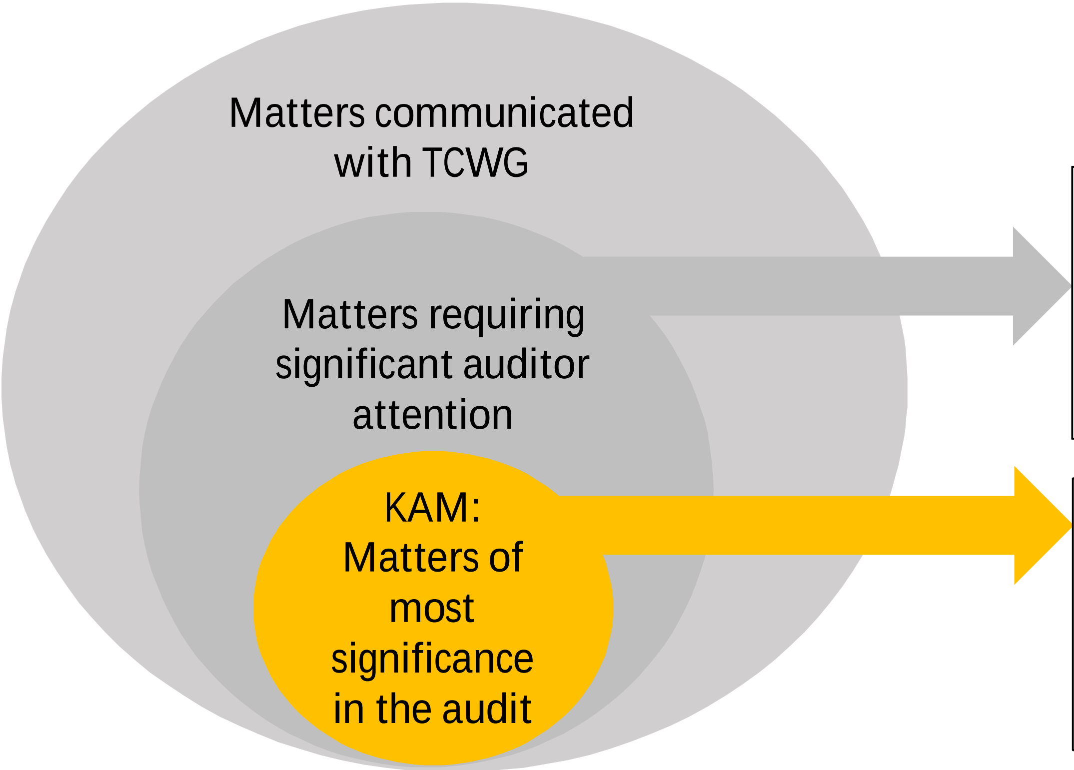
Why change?
• Auditors reporting initiatives by standard setters and regulators worldwide, prompted by the global financial crisis • The "pass/fail" opinion is valued but the auditors report should convey more, according to investors and other stakeholders

What's new?
• Opinion presented first • Key audit matters (KAM) – centrepiece of the new report • Affirmative statement of independence and fulfillment of ethical responsibilities • Expanded descriptions of management and auditor responsibilities • Disclosure on going concern

- Inclusion of KAM in auditor's report for all general purpose financial statements of listed entities
- Not to be substituted for matters that give rise to a modified opinion

Communicating KAM in the independent auditor’s report (new SA701)

- Those matters that, in the *auditor’s professional judgment*, were of *most significance* in the audit of the financial statements of the *current* period
- KAM are selected from matters communicated to those charged with governance (TCWG)



Always consider:
- Higher assessed risks and significant risk
- Areas of significant management judgement and estimation uncertainty
- Significant transactions or events

Description of each KAM required to include:
- Why the matter was considered to be one of most significant in the audit
- How the matter was addressed
- Reference to the related disclosure(s)

Ind-AS

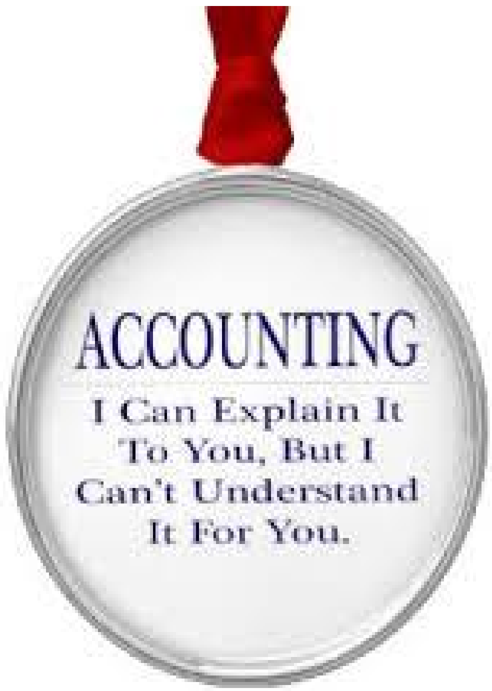
Perspectives on

- ECL
- Business Model
- EIR

Source: Internet

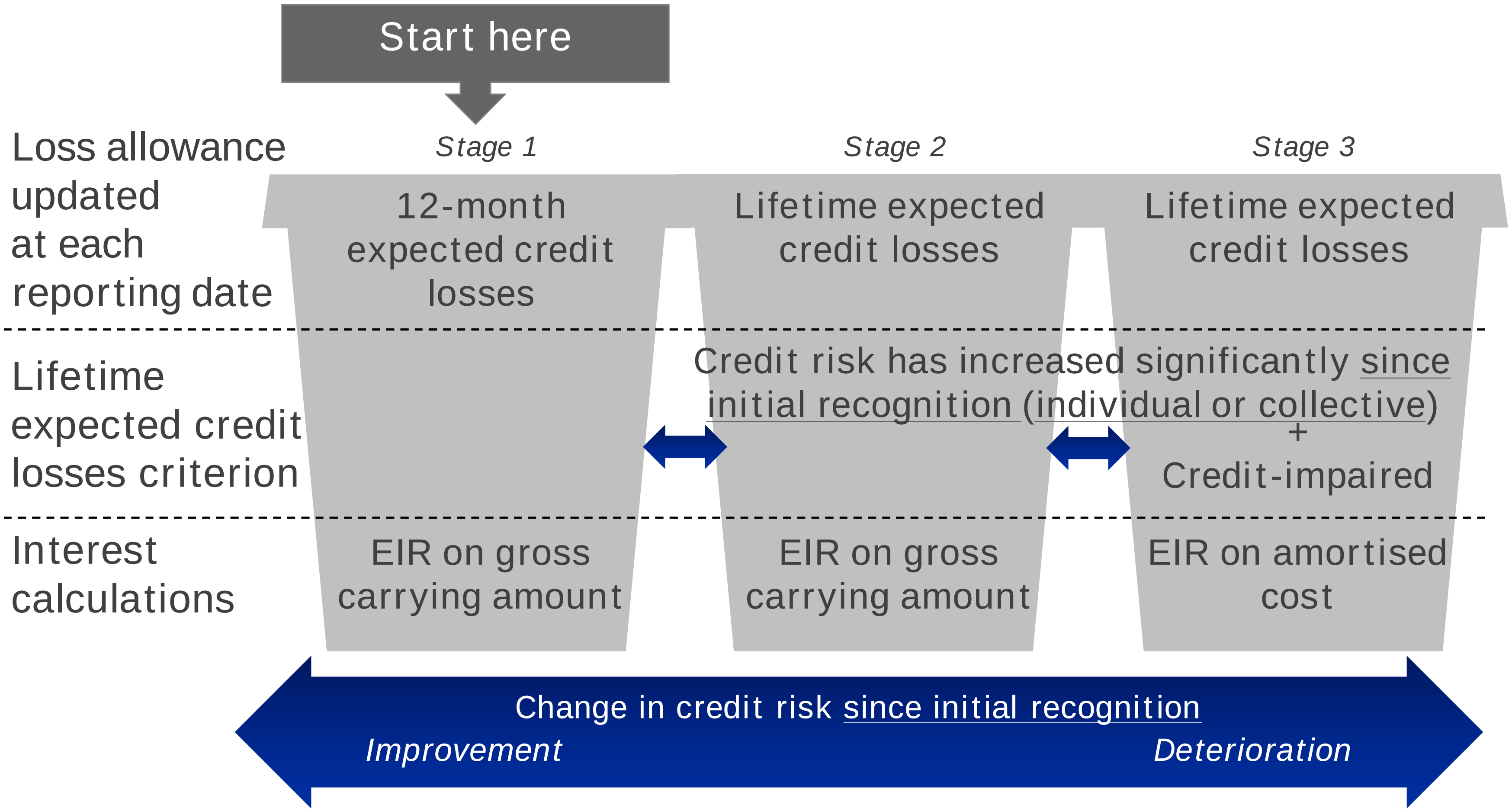
Ind-AS

- Journey so far
  - SCB to submit pro-forma Ind-AS financial statements to RBI
  - Ind-AS applicable to SCB effective 1 April 2019
  - NBFCs have started reporting under Ind-AS
- Challenging topics
  - ECL
  - Business model



PD x LGD x EAD = Expected Credit Loss

PD	▸ % likelihood the borrower will default
LGD	▸ Likely loss on default as a % of Exposure At Default
EAD	▸ Exposure that a bank would have at default ▸ Funded plus non-funded exposure (weighted by CCF)


Start here
Stage 1
Stage 2
Stage 3
Loss allowance updated at each reporting date
12-month expected credit losses
Lifetime expected credit losses
Lifetime expected credit losses
Lifetime expected credit losses criterion
Credit risk has increased significantly since initial recognition (individual or collective)
+
Credit-impaired
Interest calculations
EIR on gross carrying amount
EIR on gross carrying amount
EIR on amortised cost
Change in credit risk since initial recognition
Improvement
Deterioration

Ind-AS – ECL implementation challenges

- Portfolio segmentation
- Staging criteria
- Maturity
- Forward Looking data – economic overlay
- Modelling challenges
- EIR
- IT systems support

Ind-AS – business model

Business model		Contractual cash flow characteristics test	
	Financial asset objective	Pass	Fail
	Held in order to collect contractual cash flows	Amortised cost	FVTPL
	Held to collect contractual cash flows or sell	FVOCI	FVTPL
	Neither held at amortised cost nor at FVOCI	FVTPL	FVTPL

- Currently banks allowed sale of up to 5% of HTM portfolio; sale under OMO
  - FVOCI classification will require all unrealised gains and losses to be recognised in OCI, impact on CRAR
- HLQA sold to support LCR (to test saleability) – such securities' business model cannot be amortised cost

Under Ind AS, loan processing fees and transaction cost will be amortised over the life of the loan using the “effective interest rate” method

- The computation is required to be carried out at an account level, hence considering the volume of data in Banks a robust IT system would be required to develop for the same

- Operational complexities and challenges to apply EIR retrospectively would depend upon various factors such as nature of product, IT environment, data retention policy of bank, loan features like pre-payment, extension options, call / put option, conversion option etc.

Questions, comments?

"Look at the bright side. Bad credit is your best protection against identity theft."

Source: Internet

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. The information collated and used for this material is from sources considered reliable. The presenter has not independently verified this information and accordingly, accepts no responsibility for incompleteness or inaccuracies. Please refer to your advisors for specific advice.

Views are personal.