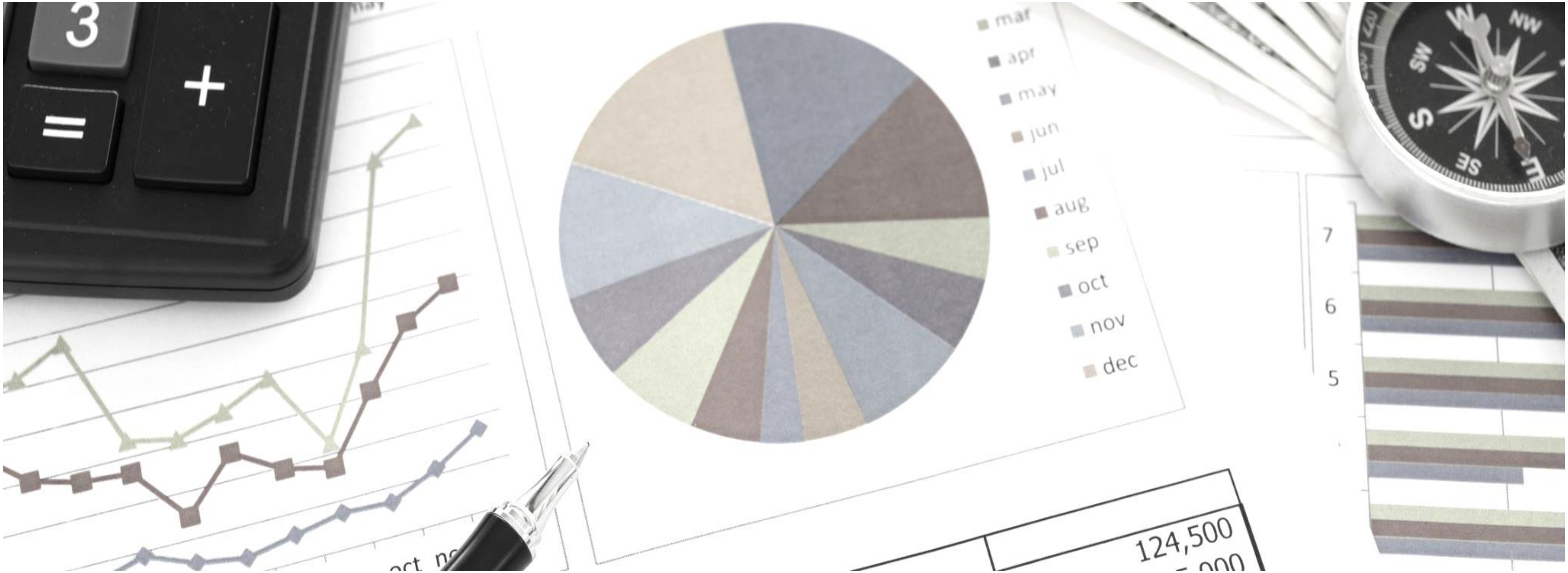

NON-BANKING FINANCIAL COMPANIES –
FINANCIAL STATEMENT AND TAX ISSUES

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CONTENT

- ❖ Additional disclosure requirements prescribed by RBI
- ❖ Impact of assessment of Ind AS on NBFC
- ❖ Penalties levied and Cancellation of CoR
- ❖ Relevant tax provision

ADDITIONAL DISCLOSURE REQUIREMENTS PRESCRIBED BY RBI

Applicability

- Applicable to all NBFCs.
- As per Scale Based Regulation.
- Disclosure requirements applicable to lower layers of NBFCs applicable to NBFCs in higher layers.
- Guidelines effective for annual financial statements for year ending March 31, 2023, and onwards.

  - Section I - Disclosures applicable for annual financial statements of NBFCs in all layers (NBFC-BL, NBFC-ML and NBFC-UL)

  - Section II- Disclosures applicable for annual financial statements of NBFCs in the middle and upper layer

  - Section III - Disclosures applicable for annual financial statements of NBFCs in the upper layer

ADDITIONAL DISCLOSURE REQUIREMENTS PRESCRIBED BY RBI

- The format for disclosures are common templates for all categories of NBFCs. Individual NBFCs may omit those line items/disclosures which are not applicable or with no exposure both in the current year and previous year.
- Mere mention of item in the disclosure template does not imply that it is permitted, NBFCs shall refer to the extant statutory and regulatory requirements while determining the permissibility or otherwise.
- Provide comparative information for all amounts reported and includes narrative and descriptive information.

SCALE BASED REGULATION

- Regulatory structure for NBFCs shall comprise of four layers based on their size, activity, and perceived riskiness.
  - Base Layer (NBFC-BL).
  - NBFC - Middle Layer (NBFC-ML)
  - NBFC - Upper Layer (NBFC-UL)
  - Top Layer is ideally expected to be empty and will be known as NBFC - Top Layer (NBFC-TL).

The **Base Layer** comprises of:

(a) non-deposit taking NBFCs below the asset size of ₹1000 crore; and

(b) NBFCs undertaking the following activities – (i) NBFC-Peer to Peer Lending Platform (NBFC-P2P), (ii) NBFC-Account Aggregator (NBFC-AA), (iii) Non-Operative Financial Holding Company (NOFHC), and (iv) NBFCs not availing public funds and not having any customer interface.

- The **Middle Layer** comprises of:

  (a) deposit taking NBFCs

  (b) non-deposit taking NBFCs with asset > ₹1000 crore and

  (c) NBFCs undertaking the following activities - (i) Standalone Primary Dealers (SPDs), (ii) Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs), (iii) Core Investment Companies (CICs), (iv) Housing Finance Companies (HFCs), and (v) Infrastructure Finance Companies (NBFC-IFCs).

- The **Upper Layer** comprises of:

  The Upper Layer of the Scale-Based Regulation framework for NBFCs in India consists of NBFCs that require enhanced regulatory requirements based on a set of parameters and scoring methodology. The selection process is based on a combination of quantitative and qualitative factors such as capital adequacy, asset quality, profitability, liquidity, market share, and governance.

- **Exposure** refers to the total amount of financial risk that the entity has in relation to its dealings with other entities, such as borrowers, counterparties, or market instruments.

  Exposure can be measured in a variety of ways, including the amount of loans and advances given out, investments made, guarantees and letters of credit provided, and other financial instruments held. Also includes potential liabilities and risks associated with that activity.

SECTION -I
1. EXPOSURE TO REAL ESTATE

Background

- Currently, Systemically Important non-deposit taking NBFCs and deposit taking NBFCs (SI-NBFCs) and HFCs are required to disclose their direct and indirect exposures to the real estate sector.

Amendment

- Now, this requirement is applicable to all layers of NBFCs.

Category	Current year	Previous year
i) Direct exposure a) Residential Mortgages - Lending fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented. Exposure would also include non-fund based (NFB) limits. b) Commercial Real Estate – Lending secured by mortgages on commercial real estate (office buildings, retail space, hotel and warehouse, etc.). Exposure would also include non-fund based (NFB) limits. c) Investments in Mortgage-Backed Securities (MBS) and other securitized exposures - i . Residential ii. Commercial Real Estate ***ii) Indirect Exposure*** Fund based and non-fund-based exposures on National Housing Bank and Housing Finance Companies		
Total Exposure to Real Estate Sector		

2. EXPOSURE TO CAPITAL MARKET

Background

- As per the prevailing guidelines, Systemically Important Non-Banking Financial Companies (SI-NBFCs) and Housing Finance Companies (HFCs) must disclose their capital market exposure in their financial statements.

Amendment

- The RBI has issued disclosure guidelines for NBFCs to provide additional information on their exposure to the capital market, including for Non-Deposit taking NBFCs.
- These guidelines require all layers of NBFCs to include specific details related to their capital market exposure in their disclosure statements.

EXPOSURE TO CAPITAL MARKET - DISCLOSURE

Particular	Current year	Previous year
i) Direct investment in equity shares, convertible bonds, convertible debentures and units of equity oriented mutual funds the corpus of which is not exclusively invested in corporate debt		
ii) Advances against shares / bonds / debentures or other securities or on clean basis to individuals for investment in shares (including IPOs / ESOPs), convertible bonds, convertible debentures, and units of equity oriented mutual funds		
iii) Advances for any other purposes where shares or convertible bonds or convertible debentures or units of equity oriented mutual funds are taken as primary security		
iv) Advances for any other purposes to the extent secured by the collateral security of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds i.e. where the primary security other than shares / convertible bonds / convertible debentures / units of equity oriented mutual funds does not fully cover the advances		

Particular	Current year	Previous year
v) Secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers		
vi) Loans sanctioned to corporates against the security of shares / bonds / debentures or other securities or on clean basis for meeting promoter's contribution to the equity of new companies in anticipation of raising resources		
vii) Bridge loans to companies against expected equity flows / issues		
viii) Underwriting commitments taken up by the NBFCs in respect of primary issue of shares or convertible bonds or convertible debentures or units of equity oriented mutual funds		
ix) Financing to stockbrokers for margin trading		
x) All exposures to Alternative Investment Funds: (i) Category I (ii) Category II (iii) Category III		
Total exposure to capital market		

3. SECTORAL EXPOSURE

Background

- For disclosure purposes, Systemically Important NBFCs (SI-NBFCs) and Housing Finance Companies (HFCs) are mandated to report sector-wise.

Amendment

As per the disclosure, NBFCs are now required to provide disclosures of total exposure (on and off-balance sheet), gross NPAs and percentage of gross NPAs to total exposure in the below mentioned sectors.

- Agriculture and Allied Activities
- Industry (additional sectors are required to be disclosed within industry)
- Services (additional sectors are required to be disclosed within services)
- Personal loans (additional details are required to be disclosed within personal loans)
- Others, if any.

*Separate disclosure - Exposure to a specific sub-sector/industry is > 10% of Tier I Capital of a NBFC

4. INTRA GROUP EXPOSURES

Background

- Currently, NBFCs or HFCs are not required to make any disclosures pertaining to intra-group exposures.

Amendment

- NBFCs shall make the following disclosures for the current year with comparatives for the previous year:
  - Total amount of intra-group exposures,
  - Total amount of top 20 intra-group exposures and
  - Percentage of intra group exposures to total exposure of the NBFC on borrower/ customers.

5. UNHEDGED FOREIGN CURRENCY EXPOSURE

Background

- Under Ind AS 107, NBFCs are required to disclose currency risk arising from financial instruments denominated in foreign currencies, including qualitative disclosures on risk exposure, management policies and processes, and changes from the previous year.

Amendment

- The RBI now requires NBFCs to disclose details of its unhedged foreign currency exposures. Further, NBFCs need to disclose their policies to manage currency induced risk.

6. DISCLOSURE OF COMPLAINTS TO CUSTOMERS

Background

Systemically Important NBFCs and Housing Finance Companies are currently obligated to report customer complaints in their financial statements in compliance with Master Directions.

Amendment

The updated disclosure mandate all layers of NBFCs to provide additional customer complaint disclosures in a prescribed format.

• The **number of complaints** pending at beginning, received & disposed of during the year, including the number of complaints rejected. Pending at the end of the year.

• Details of maintainable complaints received from the Office of Ombudsman, which includes the number of complaints resolved in favor of the NBFC, and complaints resolved through conciliation/mediation/advisories.

• Disclose the number of awards that were unimplemented within the stipulated time, except for those appealed.

• Provide information on the top five grounds of complaints received from customers.

SECTION 11-
1. CORPORATE GOVERNANCE

Background

- As per provisions of the Listing Regulations, NBFCs whose securities are listed on a recognized stock exchange are obligated to provide corporate governance disclosures in their annual reports.
- However, unlisted entities or debt listed entities are not required to provide such disclosures.

Amendment

- Corporate governance report, non-listed NBFCs should endeavor to make full disclosure in accordance with the requirement of SEBI (LODR) Regulation, 2015.

- **Composition of the Board**

- Details of change in composition of the BoD during the current and previous financial year
- Reasons for resignation given by independent director, where such resignation is before completion of his/her term
- Details of any relationship amongst the directors inter-se

- **Committees** of the Board and their composition (including the terms of reference of the committee, etc.)

- **General Body Meetings** (including special resolutions passed at the meetings)

- Provide details of **non-compliance** with requirements of Companies Act, 2013 (reasons for non-compliances should also be provided, including for accounting and secretarial standards)

- Disclose details of **penalties and strictures** imposed on the NBFC by RBI.

2. BREACH OF A COVENANT

Background

- As per Ind AS 107, NBFCs are required to disclose specified details of defaults and breaches of loan agreement terms. Similar information is currently not required under the extant norms of RBI.

Amendment

- NBFCs shall disclose all instances of breach of covenant of loan availed or debt securities issued.

3. DIVERGENCE IN ASSET CLASSIFICATION AND PROVISIONING

NBFCs shall disclose details of divergence as below, if either or both of the following conditions are satisfied:

a) the additional provisioning requirements assessed by RBI (or National Housing Bank(NHB) in the case of Housing Finance Companies) exceeds 5 percent of the reported profits before tax and impairment loss on financial instruments for the reference period, or

b) the additional Gross NPAs identified by RBI/NHB exceeds 5 per cent of the reported Gross NPAs for the reference period.

SECTION III – DISCLOSURE FOR NBFCS-UL

Amendment

- As per the SBR framework issued by RBI, NBFC-UL shall be mandatorily listed within three years of identification as NBFC-UL.
- Accordingly, upon being identified as NBFC-UL, unlisted NBFC-ULs shall draw up a Board approved roadmap for compliance with the disclosure requirements of a listed company under the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015

IMPACT ASSESSMENT OF IND AS ON NBFC

High

EXPECTED CREDIT LOSS (ECL)

IMPACT AREA 1

KEY DIFFERENCES BETWEEN GAAP AND IND AS

- Loans under the erstwhile norms are classified under the following –
  - SA and
  - NPA
    - Substandard assets
    - Doubtful assets
    - Loan assets
- Under Ind AS –
  - Stage 1 - Advances with low credit risk and where there is no significant increase in credit risk.
  - Stage 2 - Advances with significant increase in credit risk.
  - Stage 3 - Credit impaired advances

EXPECTED CREDIT LOSS (ECL)

Increase in credit risk since initial recognition

12-month expected loss	Lifetime expected loss	Lifetime expected loss

Interest revenue recognition

EIR* on gross amount (excluding loss allowance)	EIR* on gross amount (excluding loss allowance)	EIR* on amortised cost (net of loss allowance)

12-month expected credit losses

Losses resulting from default events possible within 12 months after reporting date.

Lifetime expected credit losses

Losses resulting from all possible default events over expected life of financial instrument.

EXPECTED CREDIT LOSS

$$ECL = \sum_{t=1}^{T} MPD_t * LGD_t * EAD_t * D_t$$

ECL on financial assets is an unbiased probability weighted amount based out of possible outcomes after considering risk of credit loss even if probability is low.

ECL can be defined as the difference between cash flows due under the contract and cash flows that an entity expects to receive.

The 12 months ECL or Lifetime ECL is calculated based on the following components-

- Marginal Probability of default (MPD)
- Loss given default (LGD)
- Exposure at default (EAD)
- Discount factor (D)

EXPECTED CREDIT LOSS

Other points from the notification of the RBI (13th March 2020)

- Method of computing ECL
  - Sound methodologies should be approved by the Board
  - Commensurate with the size of the NBFC
  - Complexity and the risk profile of the NBFC should be evaluated
- Parameters and assumptions of ECL model
- Changes in parameters, assumptions and ECL model and management overlays
- Default definition to be in line with the regulatory requirements
- Rebutting the presumption for significant increase in credit risk

EXPECTED CREDIT LOSS

- NBFCs should maintain asset classification and compute provision as per extant prudential norms
- Comparison between provisions required as per IRACP and Ind AS 109
- The difference between the Ind AS 109 and IRACP should be appropriated from net profit or loss after tax to a separate 'impairment reserve'. The said reserve shall not be used for regulatory capital
- No withdrawal of the same permitted

BUSINESS MODEL ASSESSMENT

IMPACT AREA II

BUSINESS MODEL DETERMINATION

KEY ISSUES FACED IN BUSINESS MODEL

Transactions such as securitisation/ direct assignment of loans may affect the business model within which underlying loans are measured.

Significant judgement involved in the assessment of 'infrequent number of sales' and 'insignificant in value' in the context of Ind AS 109 for assessing the hold to collect contractual cash flows criteria

NBFCs, based on the business model, had to modify or develop data-capture systems for classification of their loans and investments portfolio.

FAIR VALUATION

IMPACT AREA III

INTRODUCTION

- Financial instruments to be classified as per substance rather than legal form
- Post the initial recognition, financial assets should be measured at amortised cost, FVTOCI or FVTPL.
- Amortised cost classification is permissible for debt instruments – if they meet business model test and the contractual cash flow
- Equity instruments are to be measured at fair value (value changes recognised in profit and loss) except for those equity for which the entity has elected to show it as other comprehensive income
- For financial liabilities – 2 measurements exists
  - FVTPL (liabilities held in trading)
  - Amortised cost (all other liabilities)
- Reclassification of financial liabilities in and out of FVTPL are prohibited
- IND AS 109 requires balance sheet recognition for all financial instruments
- Under Indian GAAP, the use of fair value is limited to current investments which are required to be recognised at the lower of cost and fair value.

FAIR VALUATION – IND AS 113

Valuation to be done as per the hierarchy – Level 1, Level 2 and Level 3

KEY ISSUES IN FAIR VALUATION

- Fair valuation of instruments such as unlisted equity, loans and security receipts pose challenges including estimation of a discount rate.
- Challenge to understand the contractual terms of the instrument in detail and choose the right method and build the appropriate model - specially a challenge for loans and investments in unlisted equity shares.

PRESENTATION AND DISCLOSURE

IMPACT AREA IV

PRESENTATION AND DISCLOSURE

MCA vide notification dated 11th Oct 2018 Division III to Schedule III of the CA, 2013 – providing guidelines for preparation of financials of an NBFC

CLASSIFICATION AS DEBT OR EQUITY

IMPACT AREA V

CLASSIFICATION OF DEBT OR EQUITY

Ind AS 32 requires the issuer of a financial instrument to classify the instrument as liability or equity on initial recognition, in accordance with its substance based on the contractual term.

Substance of the contractual arrangement determines classification of an instrument as equity and/ or financial liability classification.

DERECOGNITION

IMPACT AREA VI

DERECOGNITION

- **Accounting guidance:**
  - Ind AS 109, *Financial Instruments* specifies the criteria for derecognition of a financial asset.
- **Key issues**
  - Securitisation/ direct assignment transaction which qualify for 'true sale' accounting under Indian GAAP may not do so under Ind AS.
  - Under Ind AS, true sale may not be adequate, additionally risks and rewards also need to be transferred.
  - All losses and gains on derecognition of a financial asset are to be recognised upfront i.e. they cannot be deferred
  - The RBI stance on Priority Sector Lending (PSL) will be an important driver on how transactions are structured in future

OTHER ASPECTS

RBI vide circular dated 13th March 2020 provided some additional guidance for NBFCs as follows –

- Exclusion of any net unrealized gains arising on fair valuation from net owned funds
- Net gains from one category should not be offset against losses in another category (netting maybe done within the category)
- Any unrealized gains or losses recognized in equity due to own credit risk and cash flow hedge reserve shall be derecognized while determining owned funds
- Unrealised gains in category (i) are required to be excluded
- NBFCs shall reduce the lower of cost or fair value un determining TIER I capital
- Fair value gain on PPE recognized under Ind AS transition, shall be reckoned as Tier II capital for NBFCs and ARCs at a discount of 55%
- 12 month ECL for financial instrument shall be included in Tier II capital within the limits specified by regulations
- Lifetime ECL shall not be reckoned for regulatory capital but should be reduced from risk weighted assets
- Securitized assets not derecognized should carry 0% risk weight.
- NBFCs to reduce 50% of credit enhancement amount given from Tier I capital and balance from Tier II capital
- Regulatory ratios, limits and disclosures to be based on Ind AS figures

PENALTIES LEVIED

Mahindra & Mahindra Financial Services Limited

Background

- The RBI conducted a statutory inspection of a company with reference to its financial position on March 31, 2019, and March 31, 2020.
- The inspection revealed that the company failed to comply with RBI directions on fair practices, including **disclosure of the annualized rate of interest charged** on loans and failure to provide notice of **changes in loan terms and conditions** to borrowers.
- The non-compliance occurred during the financial years 2018-19, 2019-20, and 2020-21.

Order

- The RBI has, by an order dated April 5, 2023 imposed a monetary penalty of ₹6.77 crore for non-compliance with the "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016."

Future Group subsidiary LivQuik Technology (India) Private Limited

Background

- It was observed that the entity was non-compliant with the directions issued by RBI on **net-worth requirement**.

Order

- The Reserve Bank of India (RBI) has imposed monetary penalty of ₹14,83,000 for non-compliance with certain provisions of the Master Direction on Issuance and Operation of Prepaid Payment Instruments.
- The penalty has been imposed in exercise of powers vested in RBI under Section 30 of the Payment and Settlement Systems Act, 2007.

Krazybee Services Private Limited

Background

- The RBI conducted a statutory inspection of a company's financial position as of March 31, 2021.
- It was found that the company failed to ensure that its recovery agents did not resort to **harassment or intimidation of customers** as part of its debt collection efforts and thereby failing to adhere to the aforesaid directions issued by RBI. There were persistent customer complaints of harassment.

Order

- The RBI has, by an order dated February 1, 2023, imposed a monetary penalty of ₹42.48 lakh for non-compliance on "Managing Risks and Code of Conduct in Outsourcing of Financial Services by NBFCs" and "Fair Practices Code for applicable NBFCs", contained in the "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016".

Ola Financial Services Private Limited

Background

- It was observed that the entity was non-compliant with the directions issued by RBI on **KYC requirements.**

Order

- The RBI has imposed monetary penalty of ₹1,67,80,000 for non-compliance with certain provisions of the Master Directions on PPIs and the Master Direction – Know Your Customer (KYC) Direction, 2016. The penalty has been imposed in exercise of powers vested in RBI under Section 30 of the Payment and Settlement Systems Act, 2007.

CANCELLATION OF CERTIFICATE OF REGISTRATION

- Reserve Bank cancels Certificate of Registration (CoR) of five NBFCs due to **irregular lending practices.**
- The Reserve Bank of India, in exercise of powers conferred on it under Section 45-IA (6) of the Reserve Bank of India Act, 1934, has **cancelled** the Certificate of Registration of the following companies.

Sr. No.	Name of the Company	CoR Issued On	Reason
1.	UMB Securities Limited	May 13, 1998	The CoR of the abovementioned NBFCs have been cancelled on account of **violation** of RBI guidelines on outsourcing and **Fair Practices Code in their digital lending operations** undertaken through third party apps which was considered detrimental to public interest.
2.	Anashri Finvest Limited	April 03, 2018	
3.	Chadha Finance Private Limited	December 15, 2005	
4.	Alexcy Tracon Pvt Ltd	March 04, 2003	
5.	Jhuria Financial Services Private Limited	August 27, 1998	

RELEVANT TAX PROVISION ICDS-VIII SECURITIES

- ICDS deals with securities held as stock-in-trade.
- Recognition and **Initial Measurement** of Securities:

  a. Securities should be recognized at actual cost on acquisition.

  b. Actual cost includes purchase price and acquisition charges.

  c. If securities are acquired in exchange for other securities or assets, their fair value will be their actual cost.
- **Subsequent Measurement** of Securities:

  a. Securities held as stock-in-trade should be valued at actual cost or net realisable value at the end of the previous year, whichever is lower.

  b. Comparison of actual cost and net realisable value should be done category-wise, not for each individual security.

  c. Securities should be classified into categories such as shares, debt securities, convertible securities, and others.

INCOME TAX ACT, 1961

- **Section 36(1)(viia):** Deduction in case of provision for bad debts in case of banks and certain financial institution

  "a non-banking financial company, an amount **not exceeding five per cent** (5%) of the total income (computed before making any deduction under this clause and Chapter VI-A)."

- **Section 43B (da):** Deductions allowed only on actual payment

  "any sum **payable by the assessee**_as interest on any loan or borrowing from a deposit taking non-banking financial company or systemically important non-deposit taking non-banking financial company, in accordance with the terms and conditions of the agreement governing such loan or borrowing."

QUESTIONS

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