Impact of Fair Value Measurement on the Financial Position and Performance of NBFC's Adopting Ind AS- An Insightful Discussion

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Abstract: Non- Baking Financial Companies (NBFCs) have taken a very significant role in the financial sector of India. These companies have adopted Ind AS mandatorily in a phased manner commencing from 1st April 2018. Ind AS is a set of accounting standards that align with International Financial Reporting Standards (IFRS) with a view to enhance the quality of financial information, transparency, comparability, and acceptability from a global perspective. One of the critical aspects of Ind AS is the measurement of the Fair Value of the assets and liabilities. It intends to reflect the current market expectations of the cash flows.

The paper aims to analyse the impact of fair value measurement on NBFCs adopting Ind AS. Further, it also explains the problems and opportunities of Fair Value Measurement. Finally, the paper intends to provide certain policy recommendations mitigating the challenges involved with fair value measurement.

Key Word: Fair Value Measurement, Ind As.

Introduction

Non- Banking Financial Companies (NBFCs) are the financial business entity providing diverse financial services to individual businesses and governments in the country. According to the RBI report in March 2020, the number of registered NBFCs was 9601 in India. They contribute a total balance sheet size of Rs. 51.47 lakh crores. This sector contributes 25.6% of the total credit to the country's financial system.

As per the mandate of the Ministry of Corporate Affairs (MCA), NBFCs in India are required to adopt Ind AS in a phased manner; in the first phase, the NBFCs having net assets over Rs. 500 crores were required to adopt Ind As from 1st April 2018. The second phase commenced on 1st April 2019, where the NBFCs having net assets less than Rs. 500 crores but above Rs. 250 crores were mandatorily adopted Ind AS.

In order to enhance the quality, transparency, and comparability of the financial information and reporting, the MCA has notified the implementation of Ind AS in different classes of Indian NBFCs. Ind AS (Indian Accounting Standards) are the accounting standards aligned with International Financial Accounting Standards (IFRS), having global acceptability. Ind AS attempts to provide more comprehensive, reliable, transparent, and consistent accounting information and more extensive disclosures to the users of financial statements, such as investors, shareholders, government, creditors, and other stakeholders.

The adoption of Ind AS impacted the financial position and performance of the NBFCs significantly because the Ind AS has prescribed some new concepts, policies, and practices regarding measurement, treatment valuation, recognition, and disclosures of financial transactions. One of the very significant aspects is the 'fair value measurement,' which indeed has significant implications on the financial position and performance of the NBFCs. According to Ind AS, fair value refers to 'the price that would be receivable on the sale of an asset or payable to transfer a liability in an orderly transaction between market participants at the measurement date.' Precisely, fair value measurement shows current market situations and the expectations of future cash flows but not the historical cost or amortized cost of assets or liability. Fair Value Measurement not only resits more volatility of the income/ loss or assets and liability of the NBFCs but also involves more significant disclosure requirements.

The application of Ind AS on NBFCs and the consequent adoption of Fair Value Measurement have given rise to many questions and queries and necessitated the need for an in-depth analysis.

The paper attempts to provide an insightful analysis of the impact of fair value measurement on the financial position and performance of the NBFCs adopting Ind AS. Further, it will also aim to study the challenges faced by the NBFCs during fair value measurement and its effect on certain significant financial indicators such as profit, loss, capital adequacy ratio, and its consequent effect on decision-making and stakeholders' perception. Moreover, the paper will highlight the relative opportunities and drawbacks in the context of its complexity, volatility, and comparability.

Objectives of the Study:

The study is based on the following objectives:

a. To analyze the impact of fair value measurement on the financial position and performance of the NBFCs adopting Ind AS.
b. To study the challenges encountered by the NBFCs during the fair value measurement process and its effect on profit, loss, capital adequacy valuation, decision-making process, and stakeholders perception.
c. To analyze and highlight the potential opportunities and drawbacks in the context of volatility, complexity, and comparability.
d. To provide some policy recommendations for better and effective adoption of fair value measurement.

Methodology:

The study will be an explanatory and analytical one based on secondary data explored from a comprehensive review of relevant literature, statutory and regulatory frameworks, and financial reports of the NBFCs.

The discussion of the study will be based on the insightful analysis and observation of the relevant literature taken from journals, reports, websites, etc.

Literature Review:

Review of some of the significant studies on the impact of fair value measurement on the financial performance and position of the NBFCs adopting Ind AS.

CAG (2020) conducted an extensive study on the implementation of Ind AS on some selected NBFCs from 2018 to 2020. The selected NBFCs include 10 public sector NBFCs controlled by the central government. The study reveals that the Ind AS impacted profit after tax, revenue recognition, and net assets of the NBFCs. It also noted that the value of assets and liabilities increased or decreased as a result of adopting different accounting treatments and due to availing exemptions on the adoption of Ind AS. Further, the study also indicates that the fair value measurement results from higher volatility on the income statement, balance sheet, and extensive disclosure norms of the NBFCs. It recommends enhancing data quality and internal control systems in order to ensure compliance and sound governance.

RBI (2018) published a notification regarding the New Capital Adequacy Framework (NCAF) for NBFCs adopting Ind AS. The notification specified the requirements for regulatory capital for these NBFCs. It prescribes maintaining a minimum capital to Risk-Weighted Assets Ratio (CRAR) of 15% for Tier I capital, 10%, and 12 % for NBFC lending, mainly against gold. This notification states that the NBFCs made a valuation of their financial assets through fair value measurement under Ind AS 109 must reduce net unrealised gains from owned funds to achieve Tier I capital.

Deloitte (2015) provides guidance notes to Ind AS 32 and Ind AS 109 on Financial Instruments. It states an overview of the concepts of these standards and their impact on NBFCs. It classifies the financial instruments into three classes: amortized cost, fair value through profit or loss, and fair value through other comprehensive income depending on the financial instruments' contractual cashflow features and business model. Liabilities are also classified under amortized cost or fair value through profit or loss. These classifications are also based on whether or not these liabilities are designated as such. This circular also provides an exclusive discussion regarding recognition measurement impairment under Ind AS 109, including hedge accounting for financial instruments. The notes also believed that the fair value measurement had noted implications on the income statement, balance sheet, own funds, and capital adequacy ratio.

ICAI (2019) The study was conducted on 10 NBFCs in India on March 31, 2019, to evaluate the impact of Ind AS on NBFCs. The study observed that due to the implementation of Ind AS on NBFC, the recognition, presentation, and measurement of different items have significantly changed, specifically financial instruments, leases, impairment, differed tax, etc. It also noted that fair value measurement enhances the volatility and complexity of the financial statements and the disclosure requirements. The NBFCs should enhance data quality and control systems to ensure compliance and sound governance.

PWC (2017) studied the impact of Ind AS on NBFCs in India. The study observed the financial statements of 10 leading NBFCs in India and compared them with the previous Indian GAAP. The study shows that the Ind AS has significantly impacted the financial performance and position of the NBFCs, including certain key ratios and performance indicators. It observed that the fair value measurement was instrumental and greatly affected various financial aspects such as loans and advances, derivatives, investments, etc. The study also emphasized the major challenges of implementing fair value measurement on the NBFCs in India. According to this analysis, selecting appropriate valuation techniques, inadequate market data risk, and volatility are some major problems associated with implementing Fair Value Measurement.

KPMG (2018) studied the significant challenges and key impact of implementing Ind AS on NBFCs in India. It is viewed that fair value measurement is the most important and influential factor in Ind AS. According to the fair value measurement, the NBFCs need to value most of their financial assets either by fair value through profit or loss or fair value through the comprehensive income method. It also observed that due to the implementation of Ind AS, the NBFCs are required to have adequate valuation models, reliable databases, and extensive disclosures. Further, regulatory norms of the NBFCs need to be aligned with Ind AS. The study recommends adopting an aggressive approach, precise and clear guidance, and stakeholder engagement to successfully implement Ind AS or NBFCs.

Agarwal Suraj R. (2020). Fair Value Concept, Ind AS 113 Fair Value Measurement: The article discussed the underlying basic concept and principles of Ind AS 113, Fair Value Measurement. The study highlights the definition., scope applicability, valuation techniques, and required disclosures of these standards. Further, the study also comprehensively compares IFRS 13 and US GAAP with Ind AS 113. The study provides a comprehensive theoretical understanding of fair value measurement under Ind AS 113 and clearly shows its practical implications in the accounting system.

EY (2020)studied how the transition to Ind AS has impacted the financial reporting landscape for NBFCs. The study compared the financial statements of 12 NBFCs that have implemented Ind AS for the first time. The study reveals that expected credit loss model, effective interest model, and fair value measurement of financial instruments, business combinations, and revenue recognition were the major impacted areas for the adoption of Ind AS. The study also explains the associated challenges of implementing Ind AS on NBFCs and provides some insightful recommendations to address the problems.

Sarda M. and Babu Ramesh Chandra (2018) studied the financial performance of five NBFCs in India. The parameters used in this study were capital adequacy, asset quality, liquidity, performance of the management, and earning capacity. The study ranks the NBFCs on the basis of their performance, and LIC got the highest rank. It also recommends specific measures to enhance the performance of the NBFCs in both qualitative and quantitative aspects.

An Overview of Fair Value Measurement under Ind AS

Fair Value Measurement under Ind AS discussed by Ind AS 113. The standard specifies how to determine fair value and provides a framework and guidance for measuring fair value.

Definition: Fair value is 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.'

Scope: This standard will apply to all Ind AS where fair value measurement is necessary other than share-based and leasing transactions.

Fair Value Hierarchy: Fair value hierarchy classifies the inputs used in the valuation method into three levels.

Level 1: For identical assets and liabilities quoted price in an active market.

Level 2: For similar assets and liabilities and observable market data, quoted price except those in level 1.

Level 3: This level includes unobservable data for which few or no market data are available and which needs significant judgment.

Valuation Techniques: For choosing the appropriate valuation method, the Ind AS 113 provides adequate user guidance. This valuation method includes the income, cost, and market approaches. However, the selection of methods depends on the nature of assets and liabilities.

Nonfinancial Assets and Liabilities: Ind AS 113 standard also includes nonfinancial assets for fair value measurement. Such Nonfinancial Assets and Liabilities include plant, equipment, intangibles, and biological assets. However, the guidance for measuring fair value for biological assets and investments is specific and not included in general guidance.

Fair Value Disclosure: Ind AS 113 requires that business entities measure their assets and liabilities under fair value to provide detailed disclosures in their financial statements. The disclosures must show the quantitative information regarding significant unobservable inputs (Level 2), sensitivity analysis for Level 3, valuation, and hierarchy of inputs used in their valuation.

Transition Period: The standard requires that the entity used Ind AS113 must implement prospectively. As per its transition guidance notes, the entity must recognize previously reported fair value with the opening retained earnings or another suitable equity category.

However, adequate professional judgment is indispensable to ensure accurate and reliable fair value measurement.

Challenges of fair value measurement by Non-Banking Financial Companies:

The NBFCs in India are required to adopt Ind AS as per the mandate of MCA from the financial year 2018-19 in two phases. Ind AS required the NBFCs to adopt fair value measurement under the governance of Ind AS 113. Fair value measurement refers to the system of determining the value of the financial assets and liabilities based on their current market price. The following are some of the problems the NBFCs encountered in adopting fair value measurement.

A.   Non-availability of the active market: Fair value measurements are based on the available active market where similar nature financial assets are traded. The active markets are not available in the case of some financial instruments, which are unique in nature. In such cases, the determination of fair value accurately is challenging.

B.   Complex Instruments: On certain occasions, the NBFC deals with some complex financial instruments such as derivatives, structured products, or scrutinized assets. These instruments involve certain complex characteristics, including special cash flow patterns. As such, determining the fair value of such instruments is more problematic because a deep understanding of the features of financial instruments and their market dynamics is needed for accurate and fair value.

C.   Subjectivity and Judgement: On a particular occasion, fair value measurement in level 3 hierarchy, where there are no observable inputs, the fair value measurement needs subjective judgments and estimates. Due to personal judgment, fair value measurement may involve consistency and personal bias. As such, the NBFCs need a sound and accurate valuation model in order to ensure that the person responsible for the fair value measurement has the required skill and expertise.

D.   Non Availability of observable inputs: Fair value measurement based on observable inputs, that is, market price or quoted price of similar nature financial instruments. Certain financial assets dealt by NBFCs have no such directly available or readily available market inputs. In such cases, the NBFCs will have to follow alternative methods, such as discounted cash flow models or option pricing models, creating new complexity for the NBFCs.

E.   Regulatory Compliance: NBFCs will have to comply with certain regulatory compliance for adopting fair value measurements, such as guidance or standards of IFRS or GAAP. This compliance creates complexities and requires expert staff and resources.

F.   Volatility and uncertainty: Fair value measurement may be highly volatile, particularly for those financial instruments with limited markets or trading activity. As such, the financial market may experience sudden fluctuation or liquidity shocks due to significant fair-value fluctuations. So, the NBFC should monitor regularly and consistently and access the fair value so that the fair value reflects the market's current condition.

G.   Disclosure and transparency: Fair value measurement under Ind AS involves an extensive disclosure to reflect transparency. This disclosure includes methods, inputs, and assumptions for fair value measurement. Complying with extensive disclosure and ensuring transparency may be problematic, particularly for complex financial instruments.

In order to mitigate the challenges, the NBFCs need robust and appropriate models and systems and sound internal control systems for periodic and consistent monitoring of the fair value measurement process.

Opportunities for adoption of fair value measurement:
As a result of adopting fair value measurement, the NBFC's can avail several opportunities in their financial reporting. Some of the benefits are discussed below:

a.   Increase transparency and comparability: Fair value measurement enables the valuation of assets, liabilities, and transactions in the current market price, which facilitates better transparency and comparability of the financial statements within the organization and across the industries. Transparency allows the stakeholders and regulators to make accurate decisions on the financial performance and overall position of the NBFCs.
b.   Better asset valuation: Marketable securities, derivatives, and other financial instruments are difficult to accurately value. Fair value measurement can be used to value these assets more accurately to determine the true worth of these assets. Fair value measurement provides a consistent, unbiased and depicts the current market value in order to ensure more reliable financial statements.
c.   Develop risk management: Fair value measurement considers the fluctuations of the market and changes in the value of assets and liabilities. It provides an understanding of the relative risk exposure. This ultimately lead NBFC's to initiate proper risk management, prompt and timely decision-making, and effective hedging techniques to mitigate potential losses.
d.   Compliance of standards: Fair value measurement is governed by Ind AS 113 and IFRS 13. As such, it is necessary for the NBFCs to follow these standards mandatorily. As such, the adoption of fair value measurement ensures compliance with standards and, thereby, avoids potential penalties arising from non-compliance.
e.   Access to capital market: As a result of adopting fair value measurement, the NBFCs can enhance the transparency and comparability of their financial statements. As such, it ensures credibility, which in turn shows compliance with internationally acceptable standards and their commitment to better financial reporting. Ultimately, it enables the NBFCs to easily access the capital market, lowering their borrowing cost and enhancing opportunities for growth and development.
f.   Merger and Acquisition: Fair value measurement plays a significant role in merger and acquisition transactions. A proper valuation is essential for determining the purchase consideration and the financial effects of the transactions. The NBFCs adopting the fair value measurement are in a position to conduct more reliable and smoother financial transactions relating to mergers and acquisitions. It enables the NBFCs to maximize the value of these transactions.
g.   Valuation of intangible assets: Fair value measurement is more effective for the valuation of intellectual properties, brand value, and consumer relationships. The conventional cost-based methods are inadequate for determining the actual economic value of such assets. The NBFC, by adopting fair value measurement, is able to determine the true economic value of these assets and thereby ensure a better financial reporting and accurate decision-making.

Impact of fair value measurement:

Impact on income

Fair value measurement can significantly impact the income of the NBFCs in the following ways:

1.   Change in fair value: Assets and liabilities will have to undergo revaluation on the basis of current market conditions. The changes in the assets and liabilities value due to fair valuation are to be adjusted positively or negatively in the income statement. These are called fair value gains if the effect is positive or fair value loss if the effect is negative. As such, fluctuations in the value of assets and liabilities due to fair value measurements have resulted in significant volatility in the income statement of the NBFC and its reported income.

Fair Value through Profit or Loss (FVTPL) classification: Ind AS provides that specific financial instruments, e.g., derivatives, are measured at fair value and the deviations of the fair value are to be adjusted in the profit and loss account. As a consequence, the income of such instruments is affected due to the changes in the fair value. For example, the income of Aditya Birla Finance Ltd. (ABFL) was affected due to the adoption of fair value measurement when the assets and liabilities of this company were valued at FVTPL, designated as hedging instruments under hedge accounting. The company recognized a fair value gain of Rs. 1163.6 million due to a change in the fair value of financial assets and a fair value loss of Rs. 1036.5 million as a result of changes in the fair value of financial liabilities at FVTPL as on 31st March 2019. Further, ABFL also recognized a net gain of Rs. 1044.8 million due to the effective portion of the cash flow hedge as on that date.

2.   Valuation of assets and liabilities: Fair value measurement significantly affects the valuation of assets and liabilities of NBFCs.

a.   **Financial instruments**: As per Ind AS, investment in marketable securities, derivatives, and specific other financial instruments needs to be valued at fair value. The fair value measurement of these assets will have to be made as per fair value hierarchy level 3, that is, on the basis of observable market price, using appropriate valuation models. Any deviations due to fair value measurement will have to be reflected in the balance sheet, and unrealized profit or loss will have to be adjusted with the other comprehensive income or as retained earnings. For example, the consolidated financial statements of ABFL for the year ended 31st March 2019 show that the company has fair value of Rs. 14357.3 million of its financial assets against fair value of Rs. 13197.3 million of its financial liabilities of FVTPL. Further, the financial statement also reflected that the fair value of its derivatives and financial instruments was Rs. 2449.8 million against a fair value of Rs. 2449.8 million of its derivative financial instruments representing liabilities.

In the case of Bajaj Finance Limited, the fair value hierarchy of the financial assets and liabilities as on 31st March 2019 appeared as follows:

Level	Description	Rs. (Crores)
I	Quoted price in an active market for identical assets or liabilities	3525.87
II	Inputs other than quoted price included under level 1, that are observable for the assets or liabilities either directly or indirectly.	1,07,144.76
III	Inputs for the assets or liabilities which are not based on observable market data.	2003.25

Nonfinancial Assets: Ind AS also advocates the application of fair value measurement on some nonfinancial assets, including properties and intangible assets, provided that such assets are used for trading purposes or that fair value measurement can determine their adequate values. The fair value of these nonfinancial assets is computed with the best available information, either market price or valuation techniques. Any changes in these assets due to fair value are shown in the balance sheet with the reported value of these assets.

In addition to these financial and nonfinancial assets, certain liabilities designated at fair value through profit or loss need to be valued at fair value. Any changes in these liabilities are recognized in the balance sheet, and the reported value of these liabilities is shown in the balance sheet.

3. Net Worth:

The fair value measurement significantly impacts the net worth of the NBFC.

The profit or loss of the NBFCs is greatly influenced by adjustments of fair value gain or loss. Ultimately, it affects the retained earnings of the NBFCs.

For example, Bajaj Finance Company Ltd. has shown a net worth increase of 29.8% from 13,344.77 crores as on 31st March. 2018 to Rs. 17,321 crores as on 31st March 2019. This increase was mainly due to increased retained earnings by Rs. 3976.51 crores, which includes the net gain of fair value deviation of financial instruments. Again, the ABFL has recognized a net gain of Rs. 2043.7 million as a result of the changes in the fair value of debt instruments as on 31st March 2019 at FVTPL and a net gain of Rs. 1044.8 million from the effective portion of cash flow hedges in other comprehensive income. Moreover, the ABFL has recognized an amount of Rs. 1044.8 million for the reclassification of cash flow hedges in the profit and loss account.

4. Business Combination:
Fair value measurement can influence the net worth at the time of business combination. When assets and liabilities are taken over, they would be valued at fair value on the acquisition date. The deviation may result in either goodwill or purchase gain, which ultimately affects the net worth of the NBFCs.

Further, adopting fair value measurement may significantly influence the risk management of the NBFCs, including hedging strategies and portfolio management. On the other hand, fair value measurement may also create volatility in the financial statements of the NBFC, which may potentially impact access to capital and borrowing costs.

Finally, it is significant to note that the impact of the adoption of fair value measurement will vary based on the nature of assets and liabilities, market conditions, and effective valuation model. As such, in order to ensure adequate financial reporting and proper risk management, it is essential to install an adequate fair value measurement system and effective monitoring mechanism.

Suggestions

The following suggestions were put forward for the effective implementation of the fair value measurement system on NBFCs in India:

1. Extensive disclosures: In order to make disclosure of fair value measurement more effective, the following additional disclosures are to be noted:
a. Broad explanations of assumptions
b. Extended and improved disclosures about inputs in level 1, level 2, and level 3 of the fair value hierarchy.
c. Additional information about valuation models and valuation standards.
d. Increase the scope of disclosure in order to include non recurring measurement.
e. The policy of the business entity for determining the active market and primary valuation methods
2. Measurement of the valuation of biological assets, which appears to be inconsistent, requires appropriate and consistent valuation models for the valuation of biological assets.
3. Establish a robust valuation system: The NBFCs should develop a comprehensive valuation system in conformity with Ind AS 113. The valuation framework must indicate the underlying assumptions, methodologies, and potential data sources for fair value measurement. At the same time, the NBFC should ensure that the framework must be based on best practices and must align with the regulatory guidelines.
4. Ensure effective internal control system: Introduce a strong internal control system in order to ensure reliability and integrity of the fair value measurement system, which advocates appropriate, timely review of valuation results and consistent monitoring of the fair value measurement system. They may introduce an internal audit system for evaluating the performance of the valuation system.

5.   Educate staff: Training and educating the staffs engaged in the process of fair value measurement with a view to ensure consistent and accurate adoption of fair value measurement. It is essential that the person engaged in the process must have an adequate understanding of valuation techniques and have knowledge of the requirements of Ind AS113.

6.   Ensure a sound data management system: A sound data collection and management system is a prerequisite for the effective implementation of fair value measurement, which includes collecting reliable market data, selecting appropriate valuation techniques, and maintaining appropriate documentation. Moreover, the data collection process must be accurate, timely, and verifiable.

It is essential to note that effective implementation of fair value measurement requires essential technical knowledge, an adequate process, and timely upgradation with concerned standards and regulatory guidelines.

Conclusion:

It is observed that the fair value measurement has a significant impact on the profitability, liquidity, and solvency of the NBFCs adopting Ind AS. In spite of having some operational challenges and subjectivity of fair value measurement, it enhances the quality of financial reporting and thereby enhances the transparency, comparability, and acceptability of the financial statements. The study adds some suggestions for the successful and effective implementation of fair value measurement such as additional disclosure on certain key areas and consistent valuation models for biological assets; it introduced robust internal control systems and data collection management. Further, it also stressed on the need for qualified staff to have adequate understanding and knowledge in the process of fair value measurement. It also suggests to review and monitor the fair value measurement process and adopt the updated standards and guidelines of regulatory bodies. It is anticipated that the study will contribute to the existing literature on fair value measurement.

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