CONCEPT NOTE - ACCOUNTING TREATMENT OF GAIN ON ASSIGNMENT UNDER IND AS

BACKGROUND OF THE COMPANY

MAS Financial Services Limited (the ‘Company’ or ‘MAS’) is 25 years old Non-Banking Financial Company (‘NBFC’), predominantly into MSME lending. From an AUM of Rs. 2 crores to Rs. 6,000 crores in 2020, the Company has focused and created a niche expertise in the MSME space. Having a strong distribution network of more than 3,500 centres and partnering with more than 100 NBFCs, it plays an important role in an efficient last mile delivery of credit.

The loan assets created by the Company have witnessed a consistent and a strong demand by the banks. Enabled by an immaculate track record of decades, the Company is in a position to assign more than 35% of its loan assets to bigger banks creating a very robust value chain.

The Company went public in 2017 and got a stupendous response from the investors on the basis of a very strong compounding performance of more than two decades. The Company believes and have demonstrated its capabilities to maintain a healthy growth rate of more than 25% mainly through internal accruals. The Company works on very strong fundamentals. Maintaining capital adequacy of more than 25% (tier-1 capital), net NPA of around 1-1.5% and ROCE of 18%+ reflecting its strong value add to all its stakeholders.

BACKGROUND OF THE TRANSACTION

The Company has been transacting with various banks and NBFCs in order to assign its portfolio of loans. Direct assignment is not only a strategic tool for achieving liquidity needs but creates a very robust value chain by virtually expanding the reach of the large banks to the hinterlands and the underserved with high degree of credit and cost control thus creating a win-win situation for all the stake holders.

The key features of assignment agreements entered by the Company are as following:

- Agreements are generally entered with the bank.
- Assignment is for the balance period of loan over which cash flow were originally agreed with the borrower.
- Assignor (MAS) performs servicing of a loan wherein Assignor assumes a contractual obligation to pay the cash flows to the Assignee.

- There are no credit enhancements to the assignment transaction.
- As per RBI norms, based on the balance life of the pool the Assignor is required to retain 5% / 10% of the Assignment pool as minimum retention requirement (MRR) in lines with RBI guidelines. Retention of right to receive MRR portion ranked **pari-passu** with the sold asset. The pool of loan is assigned by the Assignor *does not undertake to make good any losses suffered by the Assignee* due to the non-receipt of the contractual cash flows (i.e. loan principal and interest thereon).

IND AS 109 'Financial Instruments' specifies the accounting for assignment transactions as under:

- Financial assets are derecognized on the date of assignment.
- Any right on interest on sold portion of asset retained is required to be recognized as a new financial asset at fair value.
- On de-recognition of a financial asset in its entirety, the difference between the carrying amount (measured at the date of de-recognition) and the consideration received (including any new asset obtained less any new liability assumed) shall be recognized in profit or loss.
- As and when cash collections are made for interest retained, receivables are reduced to that extent.

The above accounting is based on the following guidance within IND AS 109. As per para 3.2.4, 3.2.5, 3.2.6 and 3.2.12 of IND AS 109 ***the asset assigned qualifies for de-recognition*** *and the interest portion retained is required to be recognized* ***at fair value as new financial asset*** *and the difference* between:

a. the carrying amount (measured at the date of de-recognition) and,
b. the consideration received (including any new asset obtained less any new liability assumed) is recognised in the **statement of profit and loss.**

ACCOUNTING POLICY CHANGE/DEVIATION

Gain on direct assignment transactions

As per the new policy, on de-recognition of financial assets on account of direct assignment of loans, gain is recognized as “Unearned income on assigned loans” under the head other non-financial liabilities and amortized in the statement of profit and loss over the underlying residual terms of the assigned portfolio instead of recognition of the gain in the statement of profit and loss immediately upon assignment of the loans (that qualify the de-recognition guidance stated above).

It will adhere to the basic intent of the accounting standard to project the asset and liabilities at fair value while depicting a fair and transparent picture of the P&L.

COMPANY RATIONALE FOR ADOPTING THE ABOVE ACCOUNTING POLICY CHANGE

As per the current IND AS accounting system, when the loans are assigned and meets the requirement of de-recognition, fair value of interest spread earned is recognized on the date of sale as “gain on assignment of financial assets” in the statement of profit and loss post the adoption of IND-AS.

However, booking upfront gain in the profit and loss statement on day one of de-recognition is considered to have serious limitations as enumerated in following paras:

The current accounting treatment as per IND AS results into abnormal outcome varying with the tenure of the underlying pool.

The income to be booked on the date of sale of asset as per IND AS and if amortized over the period of loan on can be demonstrated from the table mentioned below:

Sr. No.	Loan for Sale	Lender ROI	Purchaser (Assignee) ROI	Assignor margin %	Residual Tenure (Months)	As per IND AS	As per Amortization	% Change
1.	100	17%	9%	8%	24	8.70	6.37	36.51%
2.	100	17%	9%	8%	36	12.94	7.01	84.63%
3.	100	15%	9%	6%	48	12.71	5.47	132.20%
4.	100	15%	9%	6%	60	15.73	5.61	180.32%
5.	100	13%	9%	4%	120	19.38	3.91	396.04%
6.	100	13%	9%	4%	180	26.90	3.96	579.49%
7	100	14%	9%	5%	180	34.03	4.95	587.02%

A. Thus it inflates the income at the time of transaction which is to be received over a period of time over the tenure of loan. The same has the potentiality to decrease suddenly & substantially if the liability model of the company changes affecting all the vital parameters severely thus adversely affecting the stake holders interest as a true conclusion on the profitability of the company can’t be drawn.(As clearly observed in the annexure attached)

B. Additional revenue can be used for reporting higher Earning per Share, potentially higher dividend Payout and improved CRAR. Thus the companies will have the option to manipulate income for projecting better financials of the company by entering in to such transaction with adverse terms also for temporary increasing the income which may not be in the best interest of the company thus jeopardizing the interest of the stakeholders.

C. The proposition removes the subjectivity and therefore the level of judgment involved with the estimation of prepayment risk which impacts the recognition of gains.

Further the COVID-19 health crisis is unfolding into an unprecedented global economic situation, which has put severe stress on overall economic activity and brought volatility and uncertainties and in such situations any faulty analysis of financials may add further trouble for the sector.

Further, *the file in the below link covers overall impact on the income in various situation on following the accounting as per the requirement of IND AS 109.*

Link:

HTTPS:\\WWW.MAS.CO.IN\PDF\CALCULATOR - IMPACT ON THE INCOME FROM ASSIGNMENT IN VARIOUS SITUATION.XLSX

Regulatory Approach

Before IND AS implementation, the accounting treatment for the benefits (if any) retained by the assignee in any form post sale of the assets was recognized over the period in the statement of profit and loss, as per RBI circular no. DNBS. PD. No. 301/3.10.01/2012-13 dated 21 August 2012. As per para 1.4.1 of RBI Circular "The amount of profit in cash on direct sale of loans may be held under an accounting head styled as "Cash Profit on Loan Transfer Transactions Pending Recognition" maintained on individual transaction basis and amortised over the life of the transaction."

RBI considers upfront booking of income as abnormal profit and hence in the draft comprehensive framework for "Sale of Loan Exposure" dated 8 June 2020 suggests excluding such income from the computation of Tier 1 capital and net worth. However, the above if implemented as a guideline also will just address the concerns of the regulator (i.e. RBI) concerned, but the impact of upfront booking on computing return on asset, return on capital employed, net interest margin and other financial ratios remains unaddressed.

Further, on 13 March 2020, RBI, vide its circular, issued guidance to Non-Banking Financial Companies ('NBFCs') on implementation of IND AS stated that " The responsibility of preparing and ensuring fair presentation of the financial statements of a NBFC / ARC vests primarily with its Board of Directors.

Reserve Bank expects a high-quality implementation of IND AS which will require detailed analysis, application of judgment and detailed documentation to support judgments".

The Conceptual Framework for Financial Reporting under Indian Accounting Standards (Conceptual Framework) describes the objective of, and the concepts for, general purpose financial reporting. Under the Framework for preparation of financial statements for Ind AS, it has been provided that the **objective** of **general purpose financial reporting** is to provide financial information about the reporting entity that is **faithful representation of the performance of the company.**

CONCLUSION

The responsibility of preparing and ensuring fair presentation of the financial statements of the Company vests primarily with its Board of Directors as mentioned above. As per paragraph 19 of IND AS 1 'Presentation of Financial Statements', board has concluded that the upfront booking of income which is to be received over underlying residual terms of the assigned portfolio would be misleading that it would conflict with the objective of financial statements set out in the Framework to the IND AS. To address the above serious limitations and to ensure the true, fair and the transparent financial position of the Company, the gain is amortized over the tenure of the loan assets assigned in the statement of profit and loss account and the same is recognized as "Unearned income on assigned loans" in the balance sheet.

As per paragraph 14(b) of Ind AS 8 *'Accounting Policies, Changes in Accounting Estimates and Errors'*, an entity may change its accounting policy if it results in the financial statements providing reliable and more will be achieved.

This change/deviation will maintain the essence of the accounting standard of projecting the assets and the liabilities at the fair value and at the same time present the fair and transparent picture of the P&L thus ensuring true, fair and transparent financial position of the company every time which is the essence and preamble of the accounting standard.