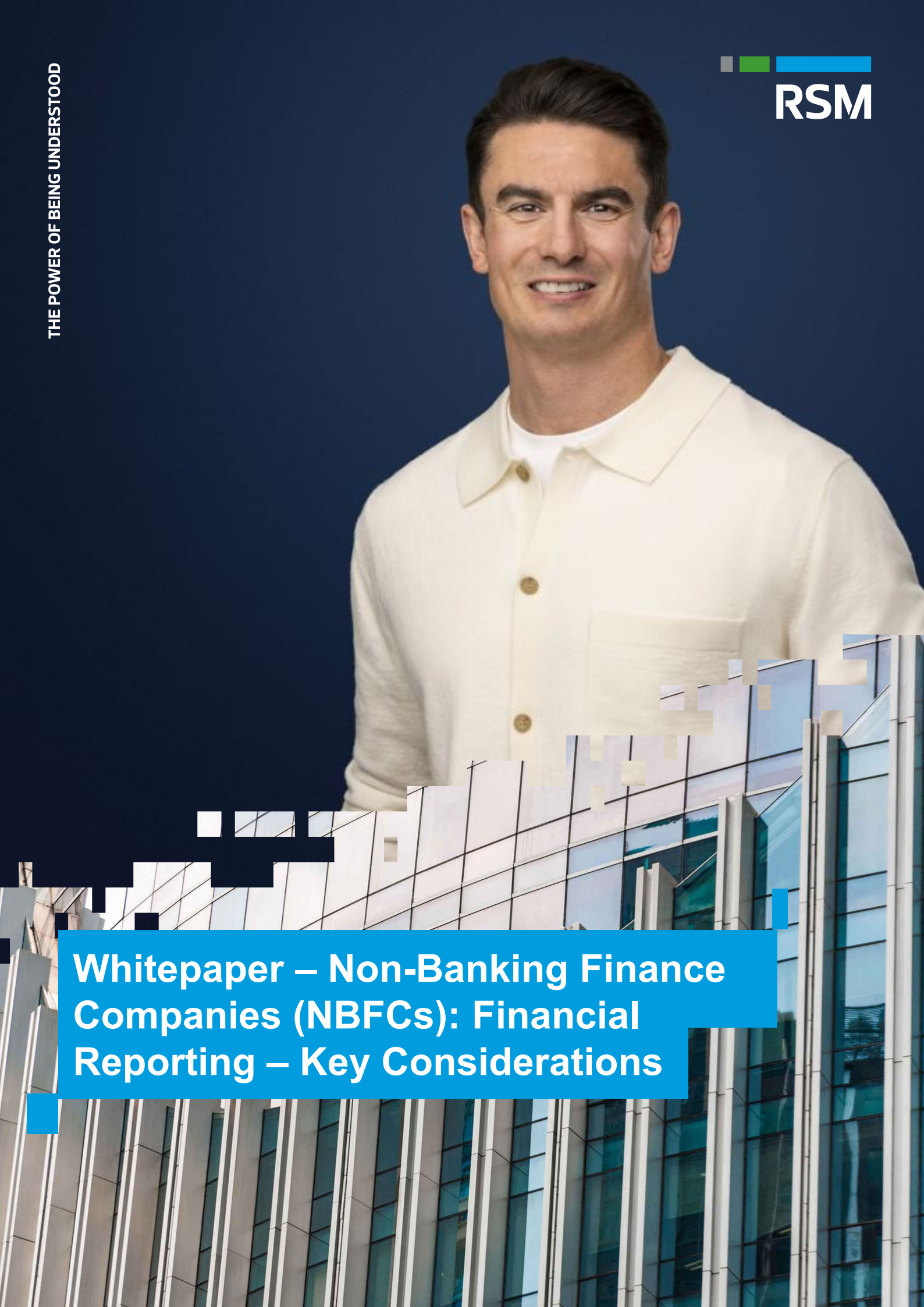


A man with dark hair, wearing a light-colored button-down shirt, stands in front of a modern glass skyscraper. The image is partially obscured by a blue banner at the bottom.

Whitepaper – Non-Banking Finance Companies (NBFCs): Financial Reporting – Key Considerations

Whitepaper

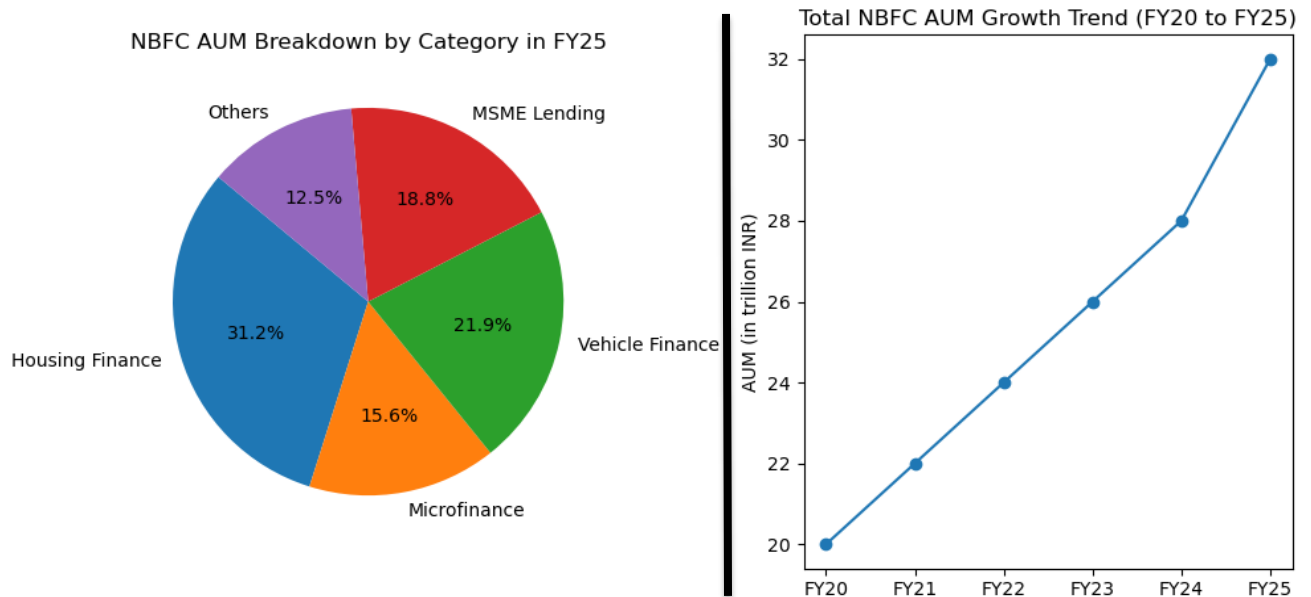
Non-Banking Finance Companies (NBFCs): Financial Reporting – Key Considerations

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1.0 Introduction

Non-Banking Finance Companies (NBFCs) in India have undertaken a key role of providing crucial finance for a large portion of the country's population, including small and medium sized enterprises and the economically unserved and underserved people. NBFCs have contributed towards the financial inclusion process by supporting the underserved and unserved population. NBFCs play a key role in contributing towards the country's economic growth, especially in the underbanked expanses. Over the past decade, NBFCs have risen significantly in number, magnitude and intricacies within the country's financial sector.

As per the Reserve Bank of India (RBI), the total Assets Under Management (AUM) of Non-Banking Financial Companies (NBFCs) stood at approximately Rs. 32 trillion as of March 2025.



Sound market intelligence and swift loan processing capabilities aided by technology-backed tools in the background of stable macro-economic environment in India since past couple of years have allowed NBFCs to carve out a niche in the financial services sector. Their focused business model, backed by robust understanding of relevant geographies, demographics, local business, business cycles and profiles of borrowers and their families, affords customisation of products, enabling better assessment of credit risk and risk-adjusted interest rates.

Some of the challenges that NBFCs face include, dynamic regulatory environment, the RBI has been closely monitoring developments in upper-layer and middle-layer NBFCs, constantly evolving asset quality, geo-economic developments and risk exposure to affected customers and interest rate risk.

The Indian Accounting Standards¹ (Ind AS) were introduced in India in a phased manner. As per the RBI's roadmap, listed NBFCs and NBFCs with a net worth of Rs. 500 crores or more migrated to Ind AS since 1 April 2018 (financial year ended 31 March 2019). Subsequently, with effect from accounting periods beginning 1 April 2019 (financial year ending 31 March 2020), NBFCs with net worth exceeding Rs. 250 crores were required to transition to Ind AS. The holding, subsidiary, associate and joint venture companies of the covered NBFCs also have to transition to Ind AS in the same year.

The RBI has deferred Ind AS transition for banks, due to the necessary legislative amendments, to make the format of financial statements, prescribed in the Third Schedule to the Banking Regulation Act, 1949, compatible with accounts under Ind AS. This is still under consideration.

2.0 Key Financial Reporting Considerations for NBFCs

Over the past few years, several large NBFCs have issued their financial statements under Ind AS. Several key financial reporting areas have emerged due to the differences between the Indian GAAP² read with the guidelines issued by the RBI, and Ind AS. Indian GAAP is driven by “form” in a number of areas rather than “substance,” which is the focus under Ind AS. **Certain key areas that have had a transformational impact on NBFCs are summarized hereunder:**



2.1 Measurement of Investment in debt instruments

Ind AS 109 contains three classification categories for investment in debt instrument financial assets:

- Amortized cost;
- Fair value through other comprehensive income (FVOCI) and
- Fair value through P&L (FVPL).

A debt investment is subsequently measured at amortized cost if the asset is held within a business model whose objective is to collect contractual cash flows and the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest (SPPI). Financial assets are subsequently measured at FVOCI if it meets the SPPI criterion and is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. All other financial assets are classified as being subsequently measured at FVTPL.

There could be complexities around the classification of debt investment as to whether there can be two different business models: one with the objective to hold the loan to collect the contractual cash flows and another with the objective to originate and distribute, i.e., the intention to sell. In the first case, the part that is held to collect contractual cash flow may be classified as amortized cost and the one with the intention to sell may be categorized as FVTPL. A detailed analysis of the fact pattern

¹ Indian Accounting Standards issued under Companies (Indian Accounting Standards) Rules, 2015

² Accounting Standards issued under Companies (Accounting Standards) Rules, 2021

may be required to arrive at a conclusion as each case may pose unique challenges in terms of the business model of the NBFC.

2.2 Measurement of Investment in equity instruments

At initial recognition of an equity investment that is not held for trading, Ind AS 109 permits an entity to make an irrevocable election to present the changes in the fair value of an investment in an equity instrument either in Other Comprehensive Income (OCI) or in Profit or Loss Account (P&L). This election is made on an instrument-by-instrument (i.e, share-by-share) basis. Amounts presented in OCI shall not be subsequently transferred to P&L. However, the entity may transfer cumulative gain or loss within equity i.e. from FVOCI Equity Investment Reserve to Retained Earnings in Statement of Changes in Equity without routing through P&L.

Dividends on such investments are recognised in P&L unless the dividend clearly represents a recovery of part of the cost of the investment. Determining when a dividend does or does not clearly represent a recovery of cost would be judgmental in practice, especially since there is no detailed guidance in the standard.

2.3 Debt Vs. Equity classification of instruments issued

An issuer of a financial instrument is required to classify the instrument as liability or equity on initial recognition, based on the economic substance and the definitions of the terms. This may require certain instruments that have the form of equity to be classified as liability. For example, mandatorily redeemable preference shares on which a fixed dividend is payable are treated as a liability. Previously, under Indian GAAP, classification was normally based on form rather than substance.

2.4 Effective interest rate and revenue recognition under Ind AS 115

NBFCs are required to assess which fees earned are an integral component of the effective interest rate ('EIR') of financial assets and liabilities measured at amortised cost. Those that are an integral component of the EIR calculation will be within the scope of Ind AS 109, and therefore outside the scope of Ind AS 115. NBFCs often enter into contracts that cover a number of different services. Such contracts might contain components within, and components outside, the scope of Ind AS 115. Ind AS 115 looks first to guidance included in other standards on how to separate and measure one or more parts of a contract. Therefore, an entity only applies the guidance in Ind AS 115 where it has contracts that are all or partly outside the scope of Ind AS 109.

2.5 Impairment of financial assets

Ind AS 109 contains a new "expected credit loss" (ECL) model for the impairment of financial assets, other than those measured at FVTPL, including certain bank deposits, loans, lease and trade receivables, debt securities, and specified financial guarantees and loan commitments issued. The model uses a dual measurement approach, under which the loss allowance is measured as either 12-month expected credit losses or lifetime expected credit losses.

These requirements represent a significant shift from the current practice in the Indian financial service industry, which follows the income recognition, asset classification and provisioning norms as prescribed by the RBI. Under these norms, the provisioning is based on objective criteria fixed by the RBI, i.e. when the asset is 180-day past due. The provisioning requirements are based on the period for which the asset has remained nonperforming and the security available.

However, the Expected Credit Loss (ECL) model needs to be applied to all the financial instruments that are subject to impairment accounting. These instruments include financial assets classified as amortized cost and fair value through other comprehensive income, lease receivables, trade receivables, and commitments to lend money and financial guarantee contracts.

Interest income is recognized on gross carrying amount less impairment for Stage 3 assets of ECL as against interest income recognition on receipt basis currently followed by NBFCs.

2.6 Interest and dividend income

Interest income for all financial instruments except for those classified as held for trading or those measured or designated as at fair value through profit or loss (FVTPL) are recognised in 'Interest income' in the profit or loss account using the effective interest method (EIR). The calculation of the EIR includes fee income paid or received between parties to the contract that are incremental and directly attributable to the specific lending arrangement, transaction costs, and all other premiums or discounts. The interest income is calculated by applying the EIR to the gross carrying amount of non-credit impaired financial assets (i.e. at the amortised cost of the financial asset before adjusting for any expected credit loss allowance). For credit-impaired financial assets, the interest income is calculated by applying the EIR to the amortised cost of the credit-impaired financial assets (i.e., the gross carrying amount less the allowance for expected credit losses (ECLs)). For financial assets originated or purchased credit impaired (POCI) the EIR reflects the ECLs in determining the future cash flows expected to be received from the financial asset.



Dividend income is recognised when the right to receive dividend is established by the reporting date and no significant uncertainty as to collectability exists.

2.7 Securitisation or assignment transactions

NBFCs often undertake transactions involving securitization or assignment of their loan portfolio in order to improve their liquidity.

Under Indian GAAP, financial assets were generally derecognised upon their legal transfer (for example, when the legal title passes on a sale). Ind AS 109 requires a financial asset to be derecognised when

- (i) the rights to receive cash flows expire,
- (ii) the company has substantially transferred all risks and rewards pertaining to the asset, and
- (iii) the company has not retained control over the asset. A company will retain substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer.

In a typical securitisation of loans or receivables by NBFC, where credit enhancements are provided for a substantial portion of expected losses, the loans will not qualify for derecognition under Ind AS since substantially all risks and rewards are retained.

2.8 Derivatives and Hedge Accounting

Under Ind AS 109, derivative instruments are measured at fair value at initial recognition and subsequent measurement. Subsequently, derivatives are measured at fair value through profit or loss (FVTPL), unless hedge accounting is applied. In order to qualify for hedge accounting under Ind AS 109:

- Hedging relationship must be formally documented at inception.
- The hedge relationship must meet hedge effectiveness criteria
- Economic relationship between hedged item and hedging instrument shall be established.
- Credit risk shall not dominate value changes, and
- Hedge ratio shall be identified and consistent with risk management strategy.

Hedge Accounting shall be discontinued if either the hedge no longer meets the qualifying criteria or the hedging instrument expires or is sold or terminated or the forecast transaction is no longer expected to occur.

3.0 Key Audit Matters reported by auditors of NBFCs

Key audit matters are those matters that, in the professional judgment of the auditors, are of most significance in the audit of the financial statements. These matters are addressed in the context of the audit of the financial statements. The auditors are required to determine the key audit matters and are required to be communicated in their auditor's report.



3.1 Impairment of carrying value of loans and advances

NBFCs exercise significant judgment using subjective assumptions over both when and how much to record as loan impairment, and estimation of the amount of the impairment provision for loans and advances. Due to the significance of the judgments used in classifying loans and advances into various stages stipulated in Ind-AS 109 and determining related provision requirements, this is often identified as a key audit matter.

The auditors generally perform a range of audit procedures to address this key audit matter, including:

- Gaining understanding of the key credit processes comprising granting, booking, monitoring and provisioning and tested the operating effectiveness of key controls over these processes;
- For exposures determined to be individually impaired, testing loans and advances and examining the management's estimate of future cash flows, assessed their reasonableness and checked the resultant provision calculations; and
- For provision against exposures classified as Stage 1 and Stage 2, obtaining an understanding of the provisioning methodology, assessed the reasonableness of the underlying assumptions and the sufficiency of the data used by the management.

With respect to impairment methodology, auditors' audit procedures generally comprise of the following:

- Reviewing Ind AS 109-based impairment provisioning policy and comparing it with the requirements of Ind-AS 109;
- Checking the appropriateness of the staging;
- Checking and understanding the key data sources and assumptions for data used in the Expected Credit Loss (ECL) models (the Models) used by the NBFC to determine impairment provisions and the appropriateness of determining Exposure at Default, including the consideration of prepayments and repayments in the cash flows and the resultant arithmetical calculations;
- Checking the completeness of loans and advances included in the ECL calculations as at the period end;
- Understanding the theoretical soundness and tested the mathematical integrity of the models
- Where relevant, using Information System specialists to gain comfort on data integrity; and
- Checking consistency of various inputs and assumptions used by the management to determine impairment provisions

3.2 Valuation of Investments

Evaluation of business model is a subjective matter and impacts the classification of investments upon initial recognition and consequently the measurement of the same. Investments carried at fair value generally comprising of Fair value through profit and loss (FVTPL) investments and Fair value through other comprehensive income (FVOCI) investments.

The effect of fair value adjustments may impact either the profit or loss or other comprehensive income. The valuation of investments measured at fair value entails significant management estimates and is based on a combination of observable market data and or valuation techniques which are often based on unobservable inputs.

Determination of fair value of investments is often a key audit matter because of the degree of subjectivity and judgment exercised by the NBFCs' management in determining the inputs used in the valuation techniques and methodologies.

The auditors generally perform a range of audit procedures to address this key audit matter, including:

- Testing the design, implementation and operating effectiveness of management's key internal controls over the valuation process and inputs.
- Reviewing the investment agreements on a sample basis, to understand the relevant investment terms and identify any conditions that were relevant to the classification and valuation of investments;

- Assessing the appropriateness of the valuation methodology and tested key inputs used such as pricing inputs and discount factors;
- Checking that valuation methodology was consistently followed and critically evaluated any change in valuation technique;
- Assessing whether the disclosures appropriately reflected the Corporation's exposure to investment valuation risk with reference to the requirements of the prevailing accounting standards;
- Evaluating the reliability of inputs i.e. market observable/unobservable data to determine fair value of investments and checked the appropriateness of disclosures in accordance with Ind AS 107 on 'Financial Instruments: Disclosures'.

3.3 Revenue recognition on loans and advances

Revenue of NBFCs mainly comprises interest income & fee-based income. Recognition of interest income, which forms significant item of revenue, and fee-based income is often considered to be a key audit matter as there is a possibility that there could be misstatement or omission of amounts recorded in the system. There is a risk around the accuracy of the revenue recorded given the reliance on the Information Technology (IT) system and impact of the terms of loan / debenture agreements on the revenue recognition.



Interest income is recognised as per Effective Interest Rate (EIR) model in accordance with the requirements of Ind AS 109, which involves significant judgments for inclusion / exclusion of certain components from EIR methodology and also recognising Interest on performing & underperforming assets (till the period of 90 days past due; Stage 1 & 2) on gross carrying value of a loan asset and on nonperforming assets (more than 90 days past due; Stage 3) on net carrying value of the asset. Fee based income: Such revenues are recognised when certain criteria are met – these include persuasive evidence of existence of an arrangement, evidences of rendering of services, the fee or commission is fixed or determinable, and collectability is reasonably assured.

As regards to the Fee based income, significant management judgment is involved in recognising certain component of fee received as upfront income and which is not included in the definition of EIR & therefore accounted in accordance with Ind AS 115.

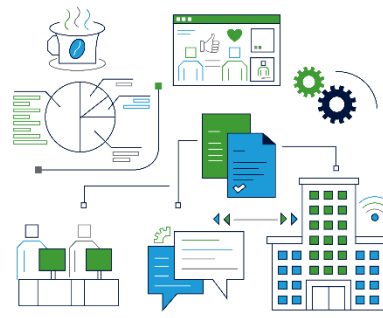
The auditors generally perform audit procedures to address this key audit matter, including:

- Performing test of controls, (including the logic and controls of the IT systems wherever required), over revenue recognition with specific focus on whether interest income is recorded as per the terms of the contract based on EIR model.
- Performing tests of details, to review the case contracts entered into with the customers to assess whether interest income recorded is as per the contract terms.
- Reviewing the completeness of interest income recorded during the year by comparing the income as appearing in entity's loan management system with that of accounts.

- Performing detailed substantive analytical procedures for select periods and validated variations / corroboration with the results drawn as per the process.
- Performing tests of details, to review the underlying agreement/ executed memo along with evidence of contractual services performed as stated per the agreed terms.
- Reviewing the management assessment of compliance with the conditions put under Ind AS 109 for income recognition based on the principles of Ind AS 115 in respect of certain items which may not form a part of EIR.

3.4 Information technology and general controls:

NBFCs are dependent on their information technology ('IT') systems due to the significant number of transactions that are processed daily across such multiple and discrete IT systems. Also, IT application controls are critical for NBFCs to ensure that changes to applications and underlying data are made in an appropriate manner and under controlled environment. Appropriate controls contribute to mitigating the risk of potential fraud or errors as a result of changes to applications and data. On account of the pervasive use of its IT systems, the testing of the general computer controls of the IT systems used in financial reporting is often considered to be a key audit matter by auditors of NBFCs.



The auditors generally perform audit procedures to address this key audit matter, including:

- For these elements of the IT infrastructure, the areas of auditors' focus generally include access security (including controls over privileged access), program change controls, database management and network operations.
- Testing the design, implementation, and operating effectiveness of the Company's general IT controls over the IT systems relevant to financial reporting.
- Evaluating of controls over segregation of duties and access rights being provisioned/modified based on duly approved requests, access for exit cases being revoked in a timely manner and access of all users being recertified during the period of audit.
- Testing key automated business cycle controls and logic for the reports generated through the IT infrastructure that were relevant for financial reporting or were used in the exercise of internal financial controls with reference to standalone financial statements.
- Testing of the compensating controls or alternate procedures to assess whether there were any unaddressed IT risks that would materially impact the standalone financial statements.

4.0 Key Recent Regulations that have bearing on Financial Reporting

4.1 Scale-Based Regulations

To align the regulatory framework for NBFCs, the RBI had issued the 'Scale Based Regulation, a revised regulatory framework for NBFCs' (the Framework') which has been effective since 1 October 2022. The Framework has categorised NBFCs into four types based on the asset size, business activity and perceived risk.

- NBFCs with asset size of less than INR1,000 crore – NBFC-Base Layer
- NBFCs with asset size of more than INR1,000 crore – NBFC-Middle Layer
- NBFCs posing a sizable amount of systemic risk especially identified by the RBI with a heightened regulatory requirement - NBFC-Upper Layer
- The top-most category shall be identified only if the RBI is of the opinion that there is a requirement to move up from upper layer to top layer considering the potential specific systemic risk - 'NBFC-Top Layer'

Depending on the above categorisation, the regulations shall differ with NBFC-Base Layer being least regulated and NBFC-Upper Layer and NBFC-Top Layer being subjected to bank-like regulations. Scale Based Framework is expected to benefit the sector from the risk management and stakeholders' perspective.

4.2 Digital Lending Regulations

The Reserve Bank of India (Digital Lending) Directions, 2025, issued on 8 May, 2025 aims to enhance transparency, accountability, and consumer protection in India's digital lending ecosystem. These regulations are applicable to all regulated entities (RE's), including NBFCs (including Housing Finance Companies) and their Lending Service Providers (LSPs) covering digital loans offered over web or mobile platforms, including through digital lending applications (DLAs).

These directions define Default Loss Guarantee (DLG) as contractual arrangements, called by whatever name, between the RE and another entity, under which the latter guarantees to compensate the RE, for the loss due to default up to a certain percentage of the loan portfolio of the RE, specified upfront. Any other implicit guarantee of similar nature, linked to the performance of the loan portfolio of the RE and specified upfront, shall also be covered under the definition of DLG.

These directions permit DLG arrangements only with a LSP/ other RE engaged as a LSP, provided the LSP providing DLG is an incorporated company under the Companies Act, 2013. RE are prohibited from entering into DLG arrangements for revolving credit facilities offered through digital lending channel and credit cards. Further, DLG arrangements shall be backed by an explicit and legally enforceable contract between the RE and the DLG provider. RE shall ensure that the total amount of DLG cover on any outstanding portfolio which is specified upfront shall not exceed 5% of



the total amount disbursed out of that loan portfolio at any given time. In case of implicit guarantee arrangements, the DLG Provider shall not bear performance risk of more than the equivalent amount of five per cent of the underlying loan portfolio. Further, the directions state that recognition of individual loan assets in the portfolio as Non-Performing Asset (NPA) and consequent provisioning shall be the responsibility of the RE as per the extant asset classification and provisioning norms irrespective of any DLG cover available at the portfolio level. The amount of DLG invoked shall not be set off against the underlying individual loans, i.e. the liability of the borrowers in respect of the underlying loan shall remain unaffected. Recovery by the RE, if any, from the loans on which DLG has been invoked and realised, can be shared with the DLG provider in terms of the contractual arrangement. DLG amount once invoked by the RE shall not be reinstated, including through loan recovery.

4.3 Information Technology Governance, Risk, Controls and Assurance Practices

Reserve Bank of India (Information Technology Governance, Risk, Controls and Assurance Practices) Directions, 2023 were issued on 7 November, 2023, and became effective from 1 April, 2024. These directions were issued with an objective to strengthen the IT governance and cybersecurity posture of regulated entities (REs) including, NBFCs.

These directions contain various aspects such as,

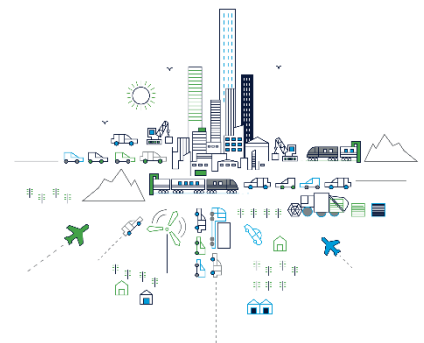
- Establishment of an IT Governance Framework.
- IT Infrastructure & Services Management
- **Defined roles for:**
 - Board of Directors
 - IT Strategy Committee
 - Senior Management
 - Head of IT Function
- **Guidelines on:**
 - Third-party IT services
 - Change and patch management
 - Audit trails
 - Cryptographic controls
 - Access controls
 - Teleworking controls
- **IT and Information Security Risk Management**

- Information Security and Cybersecurity Policies
- Risk assessments
- Vulnerability Assessments (VA) and Penetration Testing (PT)
- Cyber incident response and recovery plans
- Business Continuity and Disaster Recovery
- Information Systems (IS) Audit
- Periodic IS audits to ensure compliance and identify gaps.
- **Reporting and Oversight**
 - Regular reporting to the Board and RBI.
 - Maintenance of metrics and documentation for audits and inspections.

4.4 Investments in Alternative Investment Funds (AIFs)

With an objective to address the concerns about evergreening of loans by NBFCs and other RBI-regulated entities through indirect exposures, the RBI had issued a circular in December 2023. **The highlights of the circular are as follows:**

- RBI-regulated entities (REs), including NBFCs, shall not make investments in any scheme of AIFs which has downstream investments either directly or indirectly in a debtor company of the RE. For this purpose, the debtor company of the RE is any company to which the RE currently has or previously had a loan or investment exposure anytime during the preceding 12 months.
- If an AIF scheme, in which RE is already an investor, makes a downstream investment in any such debtor company, then the RE shall liquidate its investment in the scheme within 30 days from the date of such downstream investment by the AIF.
- If REs have already invested into such schemes having downstream investment in their debtor companies as on date, the 30-day period for liquidation shall be counted from date of issuance of this circular.
- In case REs are not able to liquidate their investments within the above-prescribed time limit, they shall make 100 percent provision on such investments.
- In addition, investment by REs in the subordinated units of any AIF scheme with a 'priority distribution model' shall be subject to full deduction from RE's capital funds. 'Priority distribution model' shall have the same meaning as specified in the SEBI circular SEBI/HO/AFD-1/PoD/P/CIR/2022/157 dated 23 November, 2022.



In May 2025, the RBI has proposed revised guidelines for investments in AIFs. **These draft guidelines proposed investment limits as follows:**

- **Individual Cap:** REs can invest up to 10% of an AIF scheme's corpus.
- **Collective Cap:** All REs together can invest up to 15% of the total corpus of an AIF
- **Unrestricted Investment:** Investments can be made up to 5% of an AIF's corpus by an RE. These do not trigger provisioning requirements.
- **Provisioning Requirement:** If a RE invests more than 5% in an AIF and the AIF has downstream debt exposure to a company that also owes money to the RE, then, the RE must make a 100% provision for its share of the exposure. This excludes investments in equity shares, compulsorily convertible preference shares (CCPS), and compulsorily convertible debentures (CCDs) from the definition of downstream debt.

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