NFRS reporting in Nepalese Banks: Challenges ahead

1. Background

Nepal has started International Financial Reporting Standard (IFRS) 'Adoption' by applying IFRS which is implementing IFRS in the same manner as issued by the International Accounting Standards Board (IASB) and would be compliant with the guidelines issued by IASB. Nepal Financial Reporting Standard(NFRS) is Nepali Version of International Financial Reporting Standards (IFRS). The Accounting Standards Board of Nepal has developed NFRS in compliance with the IFRS.

Although in common parlance, many users are using 'Adoption' and 'Convergence' interchangeably, but there exists a significant difference between the two which all users of IFRS must understand and implement.

Convergence with IFRS means that the Accounting Standard Board of the Country applying IFRS would work together with IASB to develop high quality compatible Accounting Standards over time. Thus, Countries converging with IFRS may deviate to a certain extent from the IFRS's as issued by the IASB.

Our local standards are rule based, procedure oriented and emphasizes on best practice whereas IFRSs are principle based object oriented and emphasizes on professional judgement.

The Institute of Chartered Accountants of Nepal (ICAN) had rolled out implementation plan for commercial bank to prepare NFRS Complied Financial Statements by FY 2015-16. Accordingly, Banks were supposed to prepare NFRS compliant Financial Statement by mid July 2016, comparative periods financial statement by mid July 2015 and restatement of opening balance sheet by mid July 2014.

2. NRB in NFRS implementation for Banking Sector

NFRS implementation has got place in monetary policy since 2014-15 and had mandated full compliance with NFRS in financial sector by 2017.

Further, Nepal Rastra Bank (NRB) issued 'NFRS Migration Guidelines – 2014' which had provided the milestones to be achieved and had stated that the key impacts of NFRS convergence on respective directives / regulations will be issued separately along with the related amendments. It had required BFIs to conduct a preliminary impact assessment of NFRS on financial reporting, supporting business processes, systems and controls and submission to NRB of key impacts areas identified by BFI.

NRB also issued notice on 2073/10/17 requesting all commercial banks to submit NFRS compliant financial statement or the progress of Banks who were availing NFRS consulting service from E&Y Srilanka along with local Chartered Accountant firm.

Further, NRB has also shared the draft final report dated 2074/02/16 on Uniform Chart of Accounts (COA) for BFIs in Nepal under program 'Financial Sector Stability Component (FSSP) under Accelerating Investment and Infrastructure in Nepal'. The project report had recommended banks to have its own COA in place, which should be upgraded/ changed in order to align to the new NFRS requirements.

NRB Circular dated 2074/08/14 has mandated commercial banks to prepare financial statement in compliance with NFRS from FY 2074/75.

3. Challenges presently being faced by BFIs undergoing NFRS implementation

3.1 Technical challenges

3.1.i Impairment of financial assets

Currently, banks recognise the provisioning and writes offs based on the directives issued by NRB. The existing NRB Directives require a limited use of judgement and are more mechanistic nature with prescribed loss/provision rates.

In IFRS, the impairment of financial assets are measured on an 'incurred loss' basis under IAS

Most of the IFRS adopted countries are moving from incurred loss model to expected loss model as per IFRS 9 from 2018. Impairment loss computation under Expected Loss Model will further increase the complexity due to involvement of subjectivity judgment in determining expected loss. Countries adopting IFRS experienced that implementation of IAS 39 will create foundation for implementation of IFRS 9.

39. This means that no impairment allowance can be established at initial recognition of a financial asset. Impairment is recognised if objective evidence indicates that an asset is impaired due to events occurring after initial recognition. Establishing the criteria for objective evidence itself is a big challenge.

Loans which are significant for the banks are classified and considered for as individual impairment and other than those are assessed collective impairment. The impairment loss of individual customers are measured as the difference between an asset's carrying amount and the present value of the estimated future cash flows based on discount rate.

In case of collective impairment, loss rate is calculated as:

LR=PD multiplied by LGD

Where PD is probability to default which is computed based on historical trend of homogenous class of financial assets and LGD is loss given default which is calculated based on the actual historical losses arising from defaults (Historical Write-offs)

In case of group of loans carrying homogeneous characteristics like loan products, types of collateral, location etc. impairment can be assessed on a collective basis. In case of investments also similar analysis is conducted. Only the difference is that the fair value of the investment is also considered as an input in addition to the financial/credit standing of the issuer.

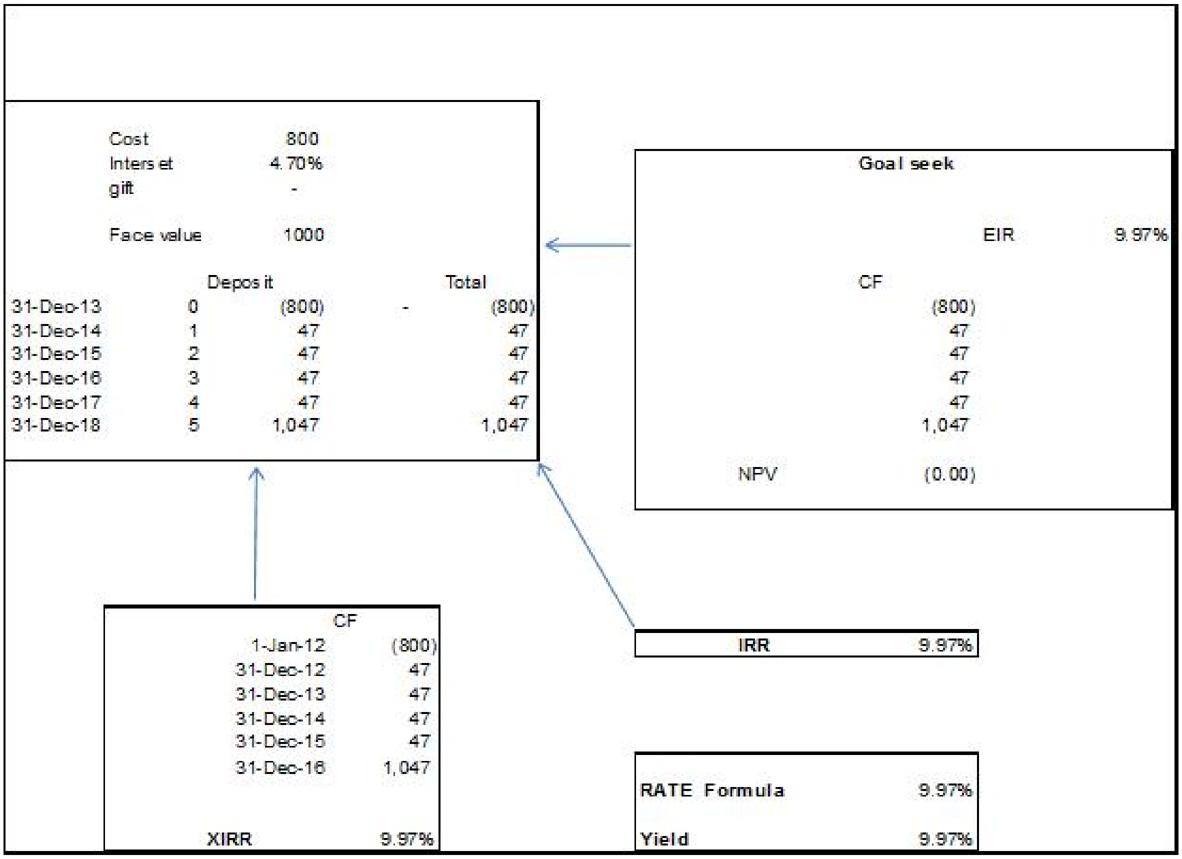
Gaining consensus and assigning responsibilities amongst finance department, IT department, recovery department, internal and external auditors, Executive Management etc is vital for the success in case of first time adoption. To conclude, localized and tested model will help to best calculate the impairment.

3.1.ii Fair Value

Under local GAAP, balance sheets are not fair valued but carried out at historical cost. In IFRS, fair value measurement needs to be used. Subject to the materiality level, few areas where fair values needs to be worked out are

A Effective Interest Rate (EIR): Effective Interest Rate computation can be illustrated as below:

- ► At the end of 2013 a company purchases a debt instrument with five years remaining to maturity for its fair value of Rs 800 (including transaction costs).
- ► The instrument has a principal amount of Rs1,000 and carries fixed interest of 4.7% payable annually (Rs1,000 × 4.7% = Rs 47 per year. Accounting implications is depicted below:



	O Balance	Interest at EIR	Cash flow	Closing Balance
0				
1	800	80	(47)	833
2	833	83	(47)	869
3	869	87	(47)	908
4	908	91	(47)	952
5	952	95	(1,047)	0

B Deposit linked with benefits/incentive

C Valuation of unquoted investments

D Fixed Assets

E Staff Loans at below Market Interest Rate

Staff loans should be classified as Loans & Receivables (L&R). Initial and subsequent measurement of staff loans should be at fair value and amortized cost respectively. Staff loans below market rate should be initially measured at fair value, the difference between the fair value and the initial loan amount should be treated as pre-paid staff expenses. The Bank will have to determine the “market rate” at the grant date for the loans granted below market rate to assess the fair value of the loan. The Bank should establish a process in order to determine the “ Market rate” for the loans granted below the market rate. This should be determined for each loan on the date that Bank grant the loan and quantify the employment benefit.

F Non Banking assets

3.1.iii Consolidation of Financial Statements

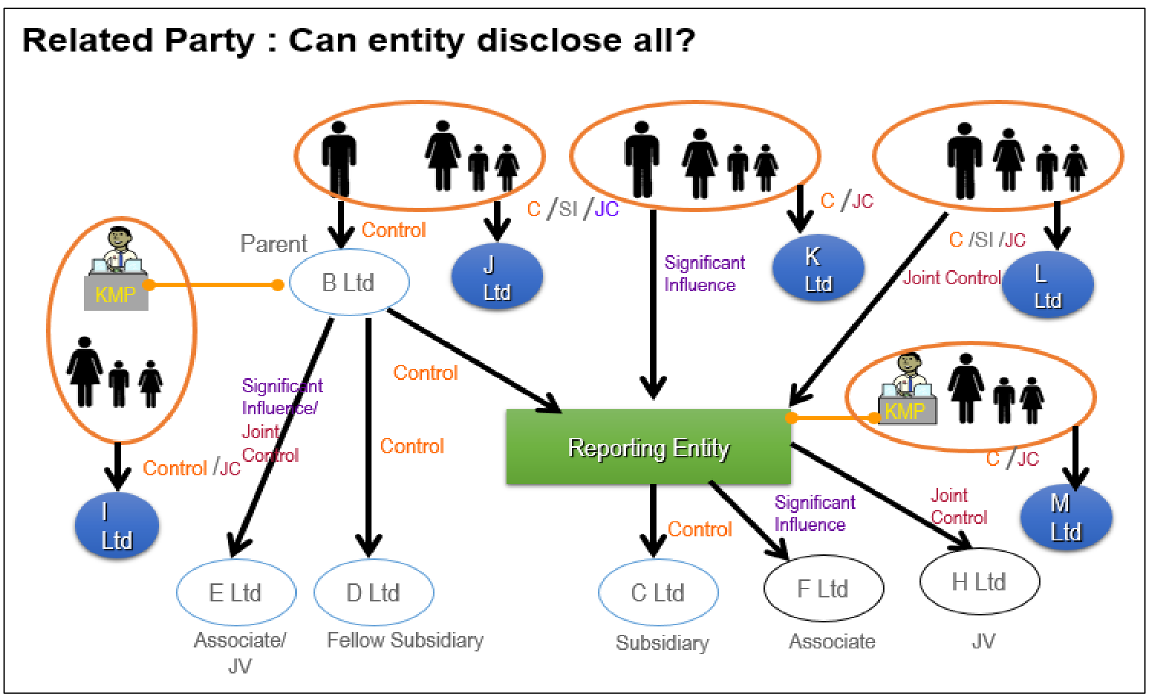
The consolidation of financial statements are purely based upon the ownership and control over another organisation. Under the existing accounting standards, consolidation is not mandatory for all organisation. However, as per IFRS the consolidation is mandatory for all the organisation. The measurement and test of control shall also be changed in the IFRS. It has covered the potential voting rights other than the actual stakeholders.

3.1.iv NFRS-1 Fist Time Adoption of NFRS

An early understanding on the numerous mandatory and optional exemptions from the retrospective application of IFRS that are available to first time adopters of IFRS is paramount for a successful and cost effective implementation of NFRS.

3.1.v Disclosures

There will be lots of disclosure under NFRS. Disclosure of transactions, and outstanding balances with related parties that have the possibility of affecting the financial position and financial performance



3.2 Other challenges

3.2.1. Amendment to the existing legal framework and own policies

The accounting framework in Nepal is affected by laws and regulations. It is mainly the Company Act, 2006 and local GAAP which governs the accounting practices in Nepal. Other existing laws, such as SEBON regulation, NRB Regulation also provides guidelines on preparation of financial statements. NFRS do not recognise these laws. For adoption of NFRS these existing laws have to be amended as per the requirements of IFRS. ICAN has to receive full co-operation from other regulators like, SEBON, NRB, Tax authorities to make the adoption successful.

3.2.2. Shortage of Trained and experienced Resources

It has been felt that at present Nepal does not have enough number of resources with training or experience in IFRS. The adoption of IFRS by the Nepalese entities would result in huge demand for IFRS trained or experienced resources. Along with professional accountants, other resources like Accountants, Govt. Officials, CEOs, would be responsible for smooth adoption of NFRS.

3.2.3. Creation of Awareness about NFRS

Adoption of NFRS means a complete set of different reporting standards which will have significant difference with local GAAP. Currently there is still absence of awareness of NFRS among the stakeholders. Considerable time and efforts would be required on making complete awareness and communicating to investors, Banks, stock exchanges, the analyst community etc which would be big task for the entities.

3.2.4. Measurement of Business Performance

Adoption of NFRS would have significant difference with local GAAP. This would have significant impact on financial position and financial performance of the BFIs. The impairment of loans and fair value measurement can bring a lot of volatility and subjectivity in the financial statements. As till now the companies have been following Historical Cost basis for preparation of financial statements.

3.2.5. Complexity in financial Reporting

There will be a need to consider several factors which were not required and relevant as per the local GAAP for preparation of financial statements with adoption of IFRS. As Fair value measures would require the companies, auditors, users and regulators to get familiar with fair value. This would initially increase the complexity in financial reporting process and may make financial statements more difficult to understand for certain class of users.

3.2.6. Increased Initial Cost

Adoption of NFRS would lead to increase initial onetime cost. These costs includes additional cost of modifying IT systems, costs of training internal corporate staff, increased audit cost, costs of educating various constituents like investors, analysts, board members etc.

Change Management in implementation: a big challenge

4. Conclusion

The transition to the NFRS, more than a technical exercise, is a business transformation process that goes beyond debit and credit of transactions. Besides its effect on financials and disclosures, it will have a substantial impact on every aspect of the Bank including its Systems and Processes, Business Practices, Internal Controls, IT and Human Resource Management. Thoroughly planned implementation plan, tested and localized implementation approach is key for hassle-free transition to NFRS.

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