

Chapter 2: Introduction – Genesis of the Committee

2.1 The developments that have taken place in the non-banking financial sector in the recent past, particularly after the submission of the 'Report of the Working Group on Financial Companies' (Chairman: Shri A.C.Shah) in 1992, are considered to be a watershed in more ways than one. During this period, the Reserve Bank of India (RBI) has initiated several regulatory and supervisory measures to ensure the healthy and disciplined growth of this sector. It was in this period (April 1995) that an expert group (Chairman: Shri P.R.Khanna) was appointed for designing a supervisory framework for non-banking financial companies (NBFCs). Similarly, with a view to providing adequate regulatory support for streamlining the NBFC sector and to ensure that the sector grows on strong foundation, Reserve Bank of India (Amendment) Ordinance, 1997 (subsequently replaced by an Act) was promulgated in January 1997. The Act, apart from imposing certain entry point restrictions, has, inter alia, strengthened RBI's powers in the regulation and supervision of the NBFC sector. The process of consolidation of the sector has thus begun.

2.2 Khanna Committee had recognised the need for exploring the possibility of prescribing separate set of formats of financial statements to bring in more transparency in the financial position and the operating results of NBFCs. The Committee had observed in its report (para12.6) that "a comprehensive system of ensuring financial discipline and soundness through prudential norms has been brought into force in respect of registered NBFCs. However, the NBFCs may still continue to follow the conventional method of accounting which does not envisage a system of classification of assets, provisioning against various categories of assets, income recognition based on record of recovery, etc. , for preparation of balance sheets/profit and loss accounts. As a result, the financial position as revealed through the half-yearly return based on prudential norms could be different from that presented to the public, including the depositors and the shareholders. In order to reflect a correct and consistent financial position, the Bank may, therefore, explore whether the balance sheet compilations could be done in tandem with the prudential norms/guidelines in the larger public interest."

2.3 In pursuance of the recommendations of the Khanna Committee as above there has been regular interaction between the Reserve Bank and the Institute of Chartered Accountants of India (ICAI), particularly in respect of those recommendations which impinge on the role of statutory auditors in regulation of NBFCs. ICAI, while welcoming the recommendations had suggested that a study group may be constituted with members from both RBI and the ICAI to deliberate in detail about the various recommendations of the Committee. Accordingly, after due examination of the suggestion, the Chief General Manager In-Charge of the Department of Non-Banking Supervision in the RBI had held a meeting of representatives of ICAI, led by the then President Shri. M.M.Chitale, to elicit their views on June 2, 1997. The meeting was also attended by the then Vice President Shri Rahul Roy and other senior officials of the ICAI and RBI. It was unanimously decided in that meeting to constitute a Committee to go into the various aspects relating to the issue of bringing in more transparency in the financial statements of NBFCs.

2.4 The composition of the Committee was as under:

1. Shri V.S.N. Murty, Chairman
Chief General Manager In-Charge
Department of Non-Banking Supervision
Reserve Bank of India
Central Office
Mumbai
2. Shri S. Bandyopadhyay Member
Consultant
Department of Non-Banking Supervision
Reserve Bank of India
Central Office
Mumbai
3. Shri S.P. Chhajed, FCA Member
President
The Institute of Chartered Accountants of India
New Delhi
4. Shri A.C. Shah, FCA Member
Chairman
Research Committee
The Institute of Chartered Accountants of India
New Delhi.
5. Shri H.N. Motiwalla, FCA Member
Chairman
Auditing Practices Committee
The Institute of Chartered Accountants of India
New Delhi
6. Shri V.C.Darak, FCA Member
Mumbai
7. Dr. Kamal Gupta, FCA Member
Former Technical Director
The Institute of Chartered Accountants of India
New Delhi
8. Shri Asish K. Bhattacharyya, FCA Member
Technical Director
The Institute of Chartered Accountants of India
New Delhi
(in place of Dr. Kamal Gupta)

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| 9. | Shri A.K. Arora
Joint Director (Technical)
The Institute of Chartered Accountants of India
New Delhi | Member |
| 10. | Dr. Avinash Chander
Additional Director & Secretary,
Auditing Practices Committee
The Institute of Chartered Accounts of India
New Delhi | Member
(in place of Shri A.K. Arora) |
| 11. | Shri A.K.Ghosh
Deputy General Manager
Department of Non-Banking Supervision
Reserve Bank of India
Central office
Mumbai | Member-Secretary |

2.5 The Terms of Reference of the Committee were as follows;

2.5.1 To deliberate on the need for designing separate formats of balance sheet and profit and loss account in respect of NBFCs with a view to ensuring that these financial statements reflect the true and correct picture of the financial position as per the prudential norms and other guidelines issued by RBI and other authorities and preparation of the draft financial statements and schedules thereto.

2.5.2 To design a Long Form Audit Report format as in the case of commercial banks to be submitted by the statutory auditors to RBI after completion of statutory audit of an NBFC.

2.5.3 To suggest guidelines for setting up of Audit Committees to ensure better corporate governance by larger NBFCs.

2.5.4 To discuss any other related aspects which are incidental or relevant to the above.

Scheme of the Report

2.6 After recording the genesis and Terms of Reference of this Committee in this Chapter, the Report gives an overview of the NBFC sector in India in Chapter 3. In Chapter 4, certain issues connected with designing of new formats of financial statements such as present disclosure practices, adequacy of disclosure, powers of RBI to prescribe formats of financial statements, recommended formats of financial statements and applicability thereof etc., have been discussed. Detailed issues, including the rationale behind inclusion of some of the items in the recommended format of balance sheet and profit and loss account, have been dealt with in Chapter 5. The Committee's views on setting up of Audit Committees by NBFCs are contained in Chapter 6. In Chapter 7, the

Committee has come to the conclusion that prescribing Long Form Audit Report would tantamount to duplicating the work in the light of the Directions to Statutory Auditors of NBFCs by Reserve Bank. Executive Summary of the Report is presented in Chapter 1.

(V.S.N. Murty)
Chairman

(S. Bandyopadhyay)
Member

(S.P. Chhajed)
Member

(A.C. Shah)
Member

(H.N. Motiwalla)
Member

(V.C. Darak)
Member

(Asish K. Bhattacharyya)
Member

(Dr.Avinash Chander)
Member

(A.K. Ghosh)
Member-Secretary

Mumbai,
September 30, 1999