Chapter 4: Financial Statements of NBFCs – Present Status and Issues

Introduction

4.1 A complete set of 'Financial Statements' normally includes a balance sheet, a statement of profit and loss, cash flow statement and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Financial reporting in the form of financial statements to users of financial information is universally accepted as an important end-product of the accounting process. External financial reporting is becoming increasingly a critical factor in business with the increase in separation between the promoters and management of a public limited company on one side and large number of scattered shareholders on the other. Similarly, present and prospective investors/creditors of a company place high reliance on the external financial reporting for their decision-making process. A mere application of proper accounting methods and procedures in the preparation of financial statements do not automatically ensure fairness of financial statements unless the financial information relevant to various users is properly disclosed therein. Users of the financial statements, particularly those who are relatively less sophisticated in technical matters of accounting, depend heavily upon the disclosures made in the financial statements when it comes to understanding and interpreting the financial information. Therefore, the critical question that has been debated all along in the evolution of the accounting process is: What should be the level that may be considered as fair disclosure keeping in mind, among other things, the nature and volume of financial information, the target user groups, objective(s) sought to be achieved, and the cost of providing, as against the benefits, of such disclosures?

4.2 It is with this philosophy the Committee considered the following key issues:

(a) present position with regard to reporting and disclosure requirements/practices, of NBFCs and adequacy or otherwise of such requirements/practices particularly in the context of phenomenal growth (both in number and magnitude of resources at command) of NBFCs;

(b) rationale for prescribing separate financial statements for NBFCs;

(c) if the present practices/requirements are inadequate, whether RBI has sufficient powers/mandate to prescribe separate formats of financial statements, either in substitution or in addition to the present formats prescribed under the Companies Act, 1956;

(d) if RBI has sufficient powers/mandate to do so, what should be the formats and contents thereof in which NBFCs have to prepare their financial statements;

(e) the present reporting requirements under the Companies Act, 1956 and the rules framed thereunder also include several additional disclosure requirements, such as particulars relating to subsidiary companies in case of holding companies (section 212), board of directors' report (section 217), circulation of financial statements and other information among members (section219) and filing of financial statements with the Registrar of Companies (section 220), etc. To what extent these provisions should also be made applicable to NBFCs?

(f) what are the types of NBFCs to which the redesigned formats should be made applicable; and

(g) in terms of the extant provisions of Chapter IIIB of the Reserve Bank of India Act, 1934, the definition of a non-banking financial company is an exclusive definition in the sense that all non-banking companies having some financial business are NBFCs excepting those whose 'principal business' is that of non-financial nature such as agriculture, industrial activity, trading, services and real estate. In the absence of a definition of the term 'principal business' in the Act itself, what should be the guidelines to be followed to determine the 'principal business' of a company.

4.3 The Committee after due deliberations makes the following observations on each of the issues.

Present disclosure requirements/practices

4.4 At present the NBFCs prepare their financial statements in accordance with the provisions of sections 210 and 211 of the Companies Act, 1956; the formats are prescribed in Schedule VI thereof. The said Schedule VI consists of the following parts;

Part I – This part prescribes two alternative forms of presenting the balance sheet, viz., horizontal form and vertical form. It also indicates the information relating to different assets and liabilities, which should be disclosed therein. Besides, certain general instructions have been prescribed in the formats, which must be followed in preparing the balance sheet.

Part II – This part deals with the requirements as to disclosures to be made in profit and loss account. Unlike balance sheet, no format for profit and loss account has been prescribed. As such, a company may adopt any format suitable to its requirements.

Part III – This part contains the interpretation of certain terms.

Part IV – This part contains Balance Sheet abstract and the company's general business profile.

4.5 While the above can be considered as basic provisions on reporting, companies are also required to disclose certain additional information such as expenditure on research and development and energy conservation measures which are mostly applicable to non-financial companies. Companies which are listed in any stock exchanges are further required, as per the listing agreement, to attach a cash flow statement and a statement containing the comparison of the projections made for the respective years in the prospectus with the actual performance.

4.6 Besides this, in terms of extant provisions of the Directions issued by RBI on deposit acceptance and prudential norms, NBFCs are also required to disclose the following information:

(i) Under the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 it has been prescribed that the report of the Board of Directors to members should contain the following particulars/ information:-
   (a) total number of accounts of public deposit which have not been claimed by the depositors or not paid by the company after the date on which the deposit became due for repayment and the total amount due in such accounts;
   (b) steps taken or proposed to be taken by the Board of Directors for the repayment

of the amounts due to the depositors remaining unclaimed or undisbursed (This statement is necessary only in such cases where the amount of deposits unclaimed or undisbursed are in excess of rupees five lakh).

(ii) Under the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 every NBFC, to which the Directions are applicable, is required to disclose in its balance sheet the provisions made under the following two heads:

(a) provisions for bad and doubtful debts
(b) provisions for diminution in value of investments.

Adequacy of disclosures under existing requirements

4.7 On a detailed study of the Schedule VI to the Companies Act, 1956, the Committee observes that the same has been designed primarily for manufacturing, trading and service companies and does not address adequately to the distinctive features of the business carried on by NBFCs. Various provisions of the Companies Act, 1956 and Rules framed thereunder have been amended from time to time to make financial statements more transparent. However, no concrete and effective attempt has so far been made to introduce any new or additional disclosure requirements in respect of business activities which are unique to the NBFCs. For example, in the Schedule VI there is no requirement for disclosing deposit/loan due and claimed but not paid (overdue loans) by the company. Similarly, in case of NBFCs or for that matter any financial intermediary, proper matching of the maturity of assets and liabilities is of utmost importance. However, the financial statements drawn up in accordance with the Schedule VI provide very little information on this crucial aspect.

4.8 The changes that are taking place in the functioning of financial system, both in Indian and global context, and the consequential developments in the reporting/disclosure requirements are phenomenal. It hardly needs to be emphasised that in the changed environment full and fair disclosure is sine-qua-non for any market to become efficient and to be resilient to market shocks. It is only natural that the changes that have been introduced in the disclosure requirements in other segments of the financial system are also extended to the NBFC segment.

4.9 The Committee notes that the prudential norms (Appendix I) have been introduced for the NBFCs which were registered earlier with RBI way back in 1994. RBI had also extended some operational freedom (under liberalisation/ rationalisation measures) in July 1996 for those NBFCs, which complied with all the provisions of prudential norms and credit rating. At that time although quite a good number of larger NBFCs have secured the freedom after satisfying RBI about the compliance with prudential norms, very few of them have actually disclosed the effect of the prudential norms such as provisioning on NPAs, accounting for diminution in the value of investments, etc. in their annual financial statements. Since the Schedule VI formats do not provide for those disclosures there is a need for prescribing separate formats of financial statements for NBFCs.

4.10 In the light of the foregoing, the Committee recommends that in view of the nature of operations of NBFCs, separate formats of financial statements providing for adequate disclosures should be prescribed as in the case of insurance companies, electricity companies and banking companies.

Powers of RBI to prescribe financial statements

4.11 In designing separate formats of financial statements for NBFCs, a basic question which was considered by the Committee was whether RBI has the power to prescribe separate formats of financial statements for NBFCs, in substitution of Schedule VI to the Companies Act, 1956 or to prescribe disclosure requirements for such companies in addition to those required in Schedule VI to the Companies Act, 1956. In this context, the Committee considered the following factors:-

a) Presently, NBFCs prepare their financial statements in accordance with the requirements of Section 211 of the Companies Act, 1956. The said section is reproduced in full in Appendix II to this report. According to the provisos to sub-sections (1) and (2) of Section 211, the requirement to prepare the balance sheet and the profit and loss account in accordance with Schedule VI does not apply to any insurance or banking company *or any company* engaged in the generation or supply of electricity *or to any other class of company for which formats of balance sheet or profit and loss account have been specified in or under the Act governing such class of company* (emphasis added). In the case of insurance, banking and electricity companies, formats of financial statements have been prescribed under the enactments governing such companies, such as Banking Regulation Act, 1949 and Insurance Act, 1938. The Committee feels that non-banking financial companies would be exempted from the requirement of preparing their financial statements in accordance with the provisions of Schedule VI, if the formats of their financial statements are "specified in or *under* the Act governing" such class of companies. A critical question, therefore, is: whether it can be said that the Reserve Bank of India Act "governs" the non-banking financial companies. To answer this question, the Committee examined the provisions of the Reserve Bank of India Act, 1934. Chapter III B of the Act contains detailed provisions relating to non-banking institutions receiving deposits and financial institutions. The Committee observed from the provisions of the said chapter that it contains a large number of requirements relating to NBFCs, such as their registration with RBI, maintenance of a certain percentage of assets in approved securities, maintenance of reserve fund, power of RBI to regulate or prohibit issue of prospectus or advertisement soliciting deposits of money, power of RBI to determine policy and issue directions to NBFCs, power of RBI to prohibit NBFCs from accepting deposits and alienating assets in certain cases, etc. Besides, the said Chapter also empowers RBI, through Section 45MA(1A), to issue directions to any NBFC or any class of NBFCs or NBFCs generally or to the auditors of such non-banking financial company or companies relating to balance sheet, profit and loss account, disclosure of liabilities in the books of account or any matter relevant thereto. Similarly, it would be observed from Section 45JA that RBI has the power to determine the policy and issue directions to all or any of the NBFCs relating to income recognition, accounting standards, making of proper provisions for bad and doubtful debts, capital adequacy, etc. Furthermore, invoking these powers vested in it RBI has issued several sets of directions to different classes of NBFCs. Thus, Chapter III-B of the Act and the directions issued thereunder contain a large number of provisions which lay down the conditions and restrictions subject to which the operations of NBFCs can be carried out. The Committee is, therefore, of the view that the NBFCs are "governed" by the RBI Act. This being the case, it appears that separate formats of financial statements can be prescribed for such companies “under” the RBI Act and the prescription of such formats will come under the provisos of sub-sections (1) and (2) of Section 211 of the Companies Act, 1956.

(b) Apart from sections 45JA and 45MA(1A) empowering RBI to issue directions to NBFCs relating to balance sheet, profit and loss account, manner of accounting, etc., Section 45Q of this legislation clearly states that "the provisions of this Chapter (i.e., Chapter III-B) shall have effect notwithstanding anything inconsistent therewith contained in any other law for the time being in force." Thus, Chapter III-B of the RBI Act overrides other laws. The Committee, therefore, concludes that even if there is any doubt as to whether the RBI Act can be said to "govern" NBFCs, a requirement by RBI pursuant to Section 45MA(1A) and/or Section 45JA of Chapter III-B of the RBI Act, making it mandatory for NBFCs to prepare their financial statements in the formats prescribed by RBI, would override the requirements of Section 211 and, therefore, NBFCs would be required to prepare their financial statements in accordance with the formats prescribed by RBI either in substitution of the formats as per Schedule VI to the Companies Act, 1956 or in addition thereto.

Formats of financial statements

4.12 The Committee is aware that some of the NBFCs are engaged in other business activities besides the business of financing. This presents special problems in designing the financial statements for NBFCs. The Committee considered the following four alternatives in this regard:-

(i) Such NBFCs may continue to prepare their financial statements in the formats prescribed under the Companies Act. Further, a separate set of supplementary financial statements, i.e., balance sheet, profit and loss account and cash flow statement, may be required to be attached by them as far as their financial business is concerned. A problem under this alternative would be that a number of accounting items, like share capital, reserves and surplus, part of current liabilities, etc., would have to be apportioned between the financial and non-financial segments.

(ii) NBFCs may prepare their financial statements in the formats prescribed by the RBI. However, a separate set of financial statements, i.e., balance sheet and profit and loss account, may be prepared as far as the non-financial business is concerned. This alternative would also require apportionment of certain common items as mentioned in (i) above.

(iii)(a) The Balance Sheet may be drawn up in accordance with the requirements of Part I of Schedule VI to the Companies Act, 1956.

(b) The Profit and Loss Account may be drawn up in accordance with the requirements of Part II of Schedule VI to the Companies Act, 1956.

(c) In addition to the Balance Sheet and Profit and Loss Account referred in (a) and (b) above, an NBFC should also annex the following:-

(1) A statement and various schedules thereto showing the assets and liabilities, separately aggregated, significantly pertaining to its financial business.

(2) A statement and various schedules thereto showing the items of income and expenditure, separately aggregated, significantly pertaining to its financial business. This statement would also disclose the amount of profit earned/ loss incurred, so determined by the company, significantly pertaining to its financial business.

(d) The statements and various schedules thereto referred to in (a) and (b) above shall be as near to the formats prescribed in the case of NBFCs engaged exclusively in financial business as the circumstances admit. The advantage of this alternative is that apportionment of various common items would be avoided.

(iv) NBFCs may prepare financial statements as per the formats prescribed by RBI. With regard to non-financial business, information as not covered by the financial statements prescribed by RBI, may be disclosed in the profit and loss account and the balance sheet as per the requirements of Schedule VI to the Companies Act, 1956. Thus, the financial statements of such NBFCs would reflect a composite picture of both the financial and non-financial business with separate schedules for financial and non-financial assets, income and expenditure.

4.13 The Committee felt that preparation of separate set of financial statements for financial as well as non-financial business, as per alternatives (i) and (ii) is beset with the problems of apportionment of certain common items which would involve some arbitrariness in deciding about the basis of apportionment. The Committee is of the view that the results so obtained may not therefore present true picture of the activities carried on by such companies besides making the accounting procedures for such companies complicated. The Committee, therefore, decided to concentrate on alternative (iii) and (iv).

4.14 With regard to alternative (iii), the Committee noted that most of the NBFCs carry on substantially the financial business. Accordingly, the Committee felt that the focus of the financial statements should be to reflect the nature of financial operations of the NBFCs. The Committee is of the view that if this alternative is followed, the focus of the financial operations carried on by the NBFCs, particularly those which carry on substantially the financial business, would be lost. The Committee, therefore, adopted alternative (iv). In view of this, the formats of financial statements recommended by the Committee in this report are in accordance with this alternative.

4.15 In view of the above, NBFCs can be classified in two categories:-

(1) Those, which are exclusively carrying on financial business, would prepare the financial statements in the formats prescribed by RBI.

(2) Those, which are also carrying on activities other than financing, would provide separate information pertaining to non-financial activities in their financial statements as recommended in item (iv) paragraph 4.12 above.

Applicability of other provisions of the Companies Act relating to disclosures

4.16 As mentioned earlier, while sections 210 and 211 of the Companies Act deal with the presentation of financial statements, there are quite a few provisions which prescribe many additional disclosures and lay down procedural requirements. Following are some of the provisions which can be cited as examples :

(i) Section 212 – Balance Sheet of holding company to include certain particulars as to its subsidiaries.

(ii) Section 215 – Authentication of balance sheet and profit and loss account by board of directors.

(iii) Section 217 – Board of Directors' Report.

4.17 The Committee is of the view that the formats prescribed by RBI would only substitute the formats prescribed in Schedule VI to the Companies Act. The other relevant provisions of the Companies Act would continue to apply, *mutatis mutandis*, to NBFCs preparing financial statements in accordance with the requirements of RBI.

Applicability of new formats

4.18 The Committee is of the view that the new formats should be made applicable to all the NBFCs which are required to be registered with RBI, irrespective of their present NOF position. Since the new formats are designed to give information relating to the effect of prudential norms in the balance sheet, the Committee feels that prudential norms directions should also be made applicable to NBFCs with NOF of less than Rs. 25 lakhs although, at present, these are not applicable to such companies.

4.19 The Committee notes that certain categories of NBFCs, viz. chit fund companies, notified nidhis, housing finance companies etc,. have been exempted from some of the core provisions of the RBI Act such as compulsory registration (section 45IA), maintenance of liquid assets (section 45IB) and creation of reserve fund (section 45IC) and also from the provisions of prudential norms directions. Having regard to these factors the Committee is of the opinion that the new formats of financial statements may not be made applicable to following types of NBFCs:-

(i) Miscellaneous Non-Banking Companies (Chit fund companies)
(ii) Mutual Benefit Financial Companies (Nidhis)
(iii) Housing Finance Companies
(iv) Broking, Stock Exchange and Insurance Companies
(v) Companies which are exclusively carrying on merchant banking activities and registered with SEBI as merchant bankers.

Definition of principal business

4.20 The formats of financial statements as recommended by the Committee in this report are applicable to companies whose principal business is financial in nature. In view of this, it is imperative to define the expression ‘principal business’.

4.21 In terms of section 45I(f) read with section 45I(c) of the RBI Act, a company is considered to be an NBFC if its business, either partly or wholly, consists of any of the six types of financial activities mentioned sub-clauses (i) to (vi) of section 45I(c). However, if the principal business of any company is of non-financial nature, such as (i) agricultural operations (ii) industrial activity (iii) trading in goods (other than securities) (iv) providing of services (v) purchase, construction or sale of immovable property, such companies will be treated as non-banking non-financial companies.

4.22 In case of a company engaged exclusively in financial business or a company doing exclusively non-financial business, the ‘principal business’ will be evident enough and it may not be necessary to dwell upon what constitutes ‘principal business’ of such a company. However, in the case of companies which are carrying on multiple activities, both financial and non-financial, in somewhat equal or near equal proportions, determining the ‘principal business’ assumes considerable significance and it would be necessary to define what constitutes the ‘principal business’ of these companies, not only from the point of view of applicability of the formats of financial statements recommended in this Report but also in the context of the obligations cast by the amended provisions of the RBI Act on the NBFCs, viz., requirement of applying for registration in case of existing companies and prior registration in case of new companies, penalties for non-compliance with registration requirements, etc. Therefore, the Committee, during the course of its deliberations, examined the need to establish objective guidelines based on the available information for classifying a composite business company as a ‘financial company’ or a ‘non-financial company’. Such identification also assumes importance in view of the RBI’s Directions to the statutory auditors casting upon them certain reporting responsibilities in respect of financial companies.

4.23 It is understood that pursuant to the provisions of section 45-IA of the RBI Act, around 37500 NBFCs have applied for registration and quite a good number of them are, prima facie, non-banking non-financial companies. Instead of deciding the status of these companies on a case to case basis it is considered desirable to lay down certain transparent and objective norms so that RBI, statutory auditors and the companies can themselves easily decide whether or not they are NBFCs.In other words, the lack of objective norms in this regard should not be cited as a reason for non-compliance with the provisions of the Act/Directions by the companies and the statutory auditors of such companies.

4.24 The Committee understands that the Legal Department of RBI has examined this issue and it has opined that there is a necessity to formulate the norms for determining the ‘principal business’ and the prescribed norms should be in consonance with the objective sought to be achieved by Chapter IIIB of the RBI Act.

4.25 The course of action to be followed for addressing this issue was deliberated by the Committee at length. Although the Legal Department of RBI has suggested that even the single largest activity could be reckoned for the purpose of classification, it has not indicated any specific parameters such as, assets and income, as reflected in the financial statements. The Committee has considered this aspect threadbare and focused the discussion on three possible parameters, viz., (a) assets (b) income and (c) combination of assets and income. Though the business profile of any company can be best captured through the nature of the assets in which funds have been deployed and level of income that is being earned from such assets, after detailed debate it was felt by the Committee that using ‘income criteria’ either independently or in conjunction with the ‘asset criteria’ may lead to certain practical difficulties in implementation. The Committee envisages following difficulties in this regard:

(i) At the outset, the Committee was unanimous in appreciating the fact that the income, such as ‘income from sale of goods’, ‘sale of capital equipment/immovable properties’ etc., which are reported on gross basis and are non-financial in nature cannot be compared with financial income such as interest, finance charges, dividend, etc. To make it comparable it is necessary to recompute the real or net operating income from the two separate streams of activities. Although such computation seems to be a simple task, it may not be so due to the fact that there always exists in case of composite companies certain income and expenditure, which are earned or incurred, as the case may be, that are relatable partly to financial and partly to non-financial activity. In such cases, the common income and expenditure are to be apportioned between financial and non-financial activities by using some rational criteria. While such criteria can be fixed by the company concerned, it may, if allowed, will only lead to heterogeneous practices in the industry. Besides, and more importantly, it is also apprehended that the company concerned may manipulate the basis for allocation of income and expenditure to its best advantage.

(ii) In India, unlike the practices in advanced countries, like the USA, Canada etc., ‘Segmented Reporting of Company Accounts’ under various items like trading, financial, services, etc., is not presently in vogue. Generally accepted accounting principles followed by Indian corporates, therefore, do not facilitate inter-activity comparison. This information asymmetry will lead to some fallacious conclusions while comparing financial income and non-financial income on the basis of financial statements alone.

(iii) Between income and asset compositions, the former is more susceptible to volatility due to market vagaries and other factors. The asset composition is considered to be more stable at least in the short term and, therefore, using income criteria either independently or in conjunction with asset criteria may not reflect the true long-term business objective.

4.26 Having regard to the foregoing, the Committee resolved to recommend that the ‘principal business’ of a company should be determined using solely the asset criteria. In other words, the extent of funds deployed in the activities mentioned in sub-clause (i) to (vi) of section 45I(c) of the RBI Act should be the sole criteria for deciding whether or not a particular company is an NBFC. The Committee, therefore, recommends that a company should be classified as an NBFC if it has financial assets (directly relatable to the activities specified under section 45I(c) of the RBI Act) to an extent of not less than 40 per cent of the total tangible assets shown in the balance sheet. A benchmark of 40 per cent is recommended having due regard to the fact that the gross assets would include certain indivisible common items relatable both to financial and non-financial segment of business.

4.27 The Committee also discussed the stray situations where the asset profile varies over a period of time. It was resolved to recommend that once a company is treated as an NBFC, it should be continued to be treated as such, notwithstanding any reduction in the percentage of the volume of financial assets to total assets, for a period of three years or till such time it brings down its public deposits (if any), accepted as an NBFC to the level prescribed under the Companies (Acceptance of Deposits) Rules, 1975 issued under section 58A of the Companies Act, 1956, whichever is later.