Chapter 5 : Proposed Financial Statements

Introduction

5.1 The users of financial statements need, relevant, reliable and comparable information which assist them in evaluating the financial position and the results of operations of an enterprise even though the enterprise may provide various types of information to its regulatory authorities, such as RBI, and is subject to regulation by such authorities. Therefore, disclosure requirements in financial statements should be sufficiently comprehensive to meet the needs of the users.

5.2 As indicated in the previous Chapter, the present disclosure requirements pertaining to balance sheet and profit and loss account are not adequate from the point of view of the users of financial information of NBFCs, whose principal business is financial in nature.

5.3 While recognising the above, the Committee recommends formats that are not very different from the existing formats specified in Schedule VI to the Companies Act. It should be mentioned here that the Committee considered Schedule VI as the benchmark and worked on the same to provide certain additional information under various schedules (to the balance sheet and profit and loss account) so that more focused and relevant information is available. Certain additional disclosures are in the form of 'Statements' such as, cash flow statement, NOF statement, capital adequacy ratio statement, factual position about SLR compliance, etc. Suggested formats of financial statements are given in an Annexure to this report.

5.4 As explained earlier, keeping in view the functionally diversified nature of operations of NBFCs, the accounting and reporting requirements of NBFCs should be different from those of other enterprises. The users of the financial statements of an NBFC are primarily interested in its liquidity, solvency and the risks related to the assets and liabilities recognised on its balance-sheet. Liquidity refers to the availability of sufficient funds to meet the short-term requirements of repaying the deposit-holders and for meeting other financial commitments as they fall due. Solvency refers to the excess of realisable value of assets over outside liabilities and hence, to the adequacy of the capital of the NBFC. An NBFC is exposed to various types of risks, such as default risk, liquidity risk, market risk, interest rate risk, concentration of exposure risk, asset-liability maturity mismatch risk, etc. The NBFCs, of late, are also becoming more vulnerable to financial difficulties through intra-group exposures. NBFCs are, therefore, required to diligently manage their assets and liabilities portfolios.

5.5 Keeping in view the above requirements in the functioning of the NBFCs and the needs of various users of financial statements, the Committee has designed the financial statements which recommend the disclosures which would be useful to the users in appreciating the liquidity, solvency and other risks associated with NBFCs. Some of the major disclosures and the rationale therefor are dealt with in the following paragraphs.

Disclosure of Accounting Policies

5.6 Every enterprise prepares its financial statements on the basis of the accounting policies decided in advance by the management. Of course, in deciding the accounting policies to be followed, the management has to take cognisance of relevant legal and regulatory requirements. In order to appreciate the operating results and financial position of the enterprise, a user of the financial statements is interested in knowing the basis on which the financial statements have been prepared. It is, therefore, of paramount importance that the significant accounting policies are disclosed at one place in the financial statements. The formats designed by the Committee provide for such a disclosure. The accounting policies must be in conformity with the applicable prudential norms issued by RBI relating to income recognition, asset classification and provisioning for non-performing assets as also diminution in value of investments. Where any accounting policy is not in conformity with the Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India, the particulars of the departures shall be disclosed together with the reasons therefor. The financial effect thereof on the financial position and results of operations shall also be disclosed; where such effect is not ascertainable, the fact shall be so stated.

Balance Sheet Disclosures

5.7 Keeping in view the broad features of the assets and liabilities profile of NBFCs, the Committee has designed formats of financial statements which provide for disclosures which would be useful to the users in ascertaining the liquidity, solvency and other risks of NBFCs. Certain schedules for most of the balance sheet items have also been conceived to make the financial statements more transparent and objective. For instance, an NBFC has to show the secured/unsecured loans borrowed by it based on three different classification criteria, viz., (i) classification by nature (ii) classification by source (iii) classification by maturity. It may be generally said that the Committee has endeavoured to bring in change more in substance than in form of the financial statements.

Maturities of Assets and Liabilities

5.8 The maturities of assets and liabilities and the ability to replace interest-bearing liabilities as they mature at an acceptable cost are important factors in assessing the liquidity of a non-banking financial company. The maturity grouping applicable to individual assets and liabilities differs from company to company and in their composition of particular assets and liabilities. In order to provide the relevant information for the assessment of its liquidity, the Committee has recommended, as a minimum, the following maturity classifications in respect of long term loans (both secured and unsecured) raised by an NBFC and in respect of the loans and advances provided to various customers of the

NBFCs in the following groupings:

i. Short term loans maturing less than one year
ii. Long term loans

(a) maturing between 1 and 3 years

(b) maturing between 3 and 5 years
(c) maturing after 5 years.

5.9 Maturity may be expressed in terms of :

a) the remaining period to the repayment date
b) the original period to the repayment date.

The Committee is of the view that the analysis of assets and liabilities by their remaining periods to the repayment date provides the best basis to evaluate the liquidity of an NBFC. However, an NBFC may also disclose, additionally, repayment maturities based on the original period to the repayment date in order to provide information about its funding and business strategy.

Concentration of Assets and Liabilities

5.10 The Committee is of the view that an NBFC should disclose concentration in the holding of its assets and in the sources of its liabilities because it is a useful indication of the potential risk inherent in the realisation of the assets and also vulnerability to availability of liquid funds to the NBFC. The Committee has recommended in the formats such disclosures to be made in terms of customer groups and related party groups (e.g., subsidiaries and holding companies, companies in the same group, firms or proprietary concerns in which the company and/or one or more directors of the company have substantial interest) in respect of secured and unsecured loans raised by an NBFC and the assets given on lease, investments and loans and advances. Such disclosures are recommended in addition to the disclosure of classification of these assets and liabilities by nature, by source, and by performance as per the prudential norms directions for NBFCs. Apart from the aforesaid disclosures in schedules, the Committee also recommends a separate statement showing fund-based assets (i.e. assets given on lease, investments, and loans and advances) of an NBFC segregating such assets into two categories, viz., (i) those fund-based assets in respect of which funds have been locked in an account of an individual or an individual enterprise in excess of 10 percent of the total funds locked in the fund-based assets, and (ii) other assets. This information would highlight the concentration of fund-based assets of an NBFC in the hands of a few individuals/individual enterprises and about the dispersion of risk in an NBFC.

Other Major Disclosures

5.11 As distinguished from Schedule VI, the assets have been classified primarily keeping in view the nature of operations of the NBFCs. Thus, the assets given on lease (finance and operating), investments, loans and advances, security deposits and other current and liquid assets have been given precedence with regard to the order of disclosure over the fixed assets meant for their own use.

5.12 In the determination of the financial health of an NBFC, information related to overdue liabilities in the form of debentures, public deposits, inter-corporate loans and other credits, is of significant importance to users. The Committee, therefore, recommends that on the face of the balance sheet itself the total amount of overdue loans, public deposits and other credits should be disclosed and the detailed information related to the nature of the loans bifurcated into principal and interest should be shown in the relevant Schedule.

5.13 Another disclosure highlighting a factor of risk profile of an NBFC is with regard to the disclosure of the market values of various categories of quoted investments. Similarly, in respect of unquoted investments, break-up values thereof has also been recommended to be disclosed. Such an information will enable the users of the financial statements of the NBFCs to analyse the exposures of the NBFCs locked in the various types of investments.

5.14 With a view to provide information related to solvency, the assets given on lease and loans and advances, etc., disclosure is also recommended to be made on the basis of performance of assets as per the prudential norms prescribed in this regard.

Profit And Loss Account Disclosures

5.15 With regard to the disclosures in the profit and loss account, keeping in view the financial focus, the Committee has recommended the disclosure of the income into three categories, namely, (i) fund-based income, i.e., lease income, hire purchase income, bills discounting income, interest income, investment income and, profit on sale of investments; (ii) fee-based income, i.e., guarantee fee, underwriting commission, other merchant banking income, and income from brokering and syndication in bills/ICDs/lease, and (iii) miscellaneous income. Similarly, the focus of attention on the expenses side is also to the fund related expenses, such as, depreciation on leased assets; interest on public deposits, inter-corporate deposits, borrowings from banks and financial institutions; brokerage; discount charges on bills rediscounted; bad debts; provisions against non-performing assets (NPAs); reversal of income; diminution in the value of investments and loss on sale of investments. In respect of interest expense, to appreciate the risk profile, it is recommended that the expenses relating to loans taken from subsidiaries, group companies (other than subsidiaries), companies, firms or proprietary concerns in which the company and/or one or more directors of the company have substantial interest, directors, relatives of directors, and shareholders having substantial shareholding in the company shall be shown separately.

5.16 For the NBFCs which are also engaged in non-financial business, the format of profit and loss account recommended by the Committee provides for showing the income and expenditure directly attributable to such non-financial business with details in schedules. The information to be disclosed in these schedules shall be in accordance with the requirements of Schedule VI to the Companies Act.

5.17 The Committee also recommends that the amount of provision to be made in respect of accounting for taxes on income shall be made in accordance with the tax effect accounting method as recommended in the guidance note/accounting standard, issued by the ICAI. The Committee feels that the existing method of accounting for taxes on income, viz., the taxes payable method, is not appropriate in view of the significant differences in the taxable income and the income as per the books of account in the case of NBFCs. The Committee notes that this method of accounting is not generally followed elsewhere in the country and, therefore, is a landmark recommendation.

Additional Disclosures

5.18 As has been recommended earlier, an NBFC which carries on non-financial business along with financial business, should prepare its financial statements as per the formats recommended in this report along with other disclosures as per the requirements of Schedule VI to the Companies Act, 1956. The Committee is of the view that as far as the balance sheet is concerned, such disclosures would be required to be made in respect of current assets, loans and advances, current liabilities and fixed assets. Similarly, such additional information would be required in the profit and loss account with regard to turnover, stocks, etc. and Part IV of Schedule VI to the Companies Act, 1956. The Committee accordingly recommends that in such cases the additional information as per Schedule VI to the Companies Act, 1956 shall be separately provided so that the users of the financial statements may have sufficient relevant information for evaluating the performance of the financial business and non-financial business carried on by the NBFC.

5.19 While the above prescriptions will ultimately get reflected in either balance sheet or profit and loss account, the Committee would further recommend that the NBFCs should make following additional disclosures and/or attach the statements:

(i) A cash-flow statement shall be annexed to the balance-sheet showing cash flows, classified as operating, investing and financing activities. It should be prepared in accordance with Accounting Standard 3 of Cash Flow Statements issued by ICAI. A copy of AS-3 is enclosed as Appendix -III.

(ii) In case an application for winding-up of the company due to the inability of the company to pay its debts within the meaning of Section 434 of the Companies Act, 1956 has been made to a Court, the facts shall be disclosed.

(iii) A statement showing the computation of net owned fund, as defined in Explanation (I) to section 45 IA of the Reserve Bank of India Act, 1934 (after necessary provisions in accordance with Prudential Norms issued by RBI and Accounting Standards and Guidance Notes issued by the Institute of Chartered Accountants of India) as at the end of the financial year.

(iv) A statement showing the computation of capital adequacy ratio as at the end of the financial year in accordance with the prudential norms issued by RBI.

(v) A statement showing –

a) the amount required to be maintained by the company, as of the last day of the financial year, in unencumbered approved securities in pursuance of the provisions of section 45-IB of the Reserve Bank of India Act, 1934;

b) value, as of the last day of the financial year, of securities maintained by the company in pursuance of the aforesaid section;

c) name and address of the bank/ custodian to whom the above-mentioned securities have been entrusted in pursuance of the Non-Banking Financial

Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998/ Residuary Non-Banking Companies (Reserve Bank) Directions, 1987.

5.20 Apart from the above disclosures of the specialised types, the Committee also recommends various other disclosures which are necessary for meaningful presentation of the financial statements. The Committee recognises that there could be many other areas in respect of which further disclosures could have been recommended. One such recommendation could have been the preparation of consolidated financial statements for all companies in a group. The Committee feels that preparation and presentation of consolidated financial statements would be of great relevance and use in case of companies having inter-corporate transactions within the same group. However, the Committee has not made this recommendation keeping in view the fact that the practice of presenting consolidated financial statements by a Group is yet to find a root in our country. This requirement would automatically come into existence once the corporate law of the country/ Accounting Standard issued by ICAI provides for the companies to prepare consolidated financial statements. The Committee could have also recommended recognition of only the finance income and capitalisation of assets by the lessees in respect of finance leases. It is felt that once the accounting standard on the aforesaid lines is issued, the NBFCs would have to automatically follow it.

5.21 In making certain recommendations regarding disclosures in financial statements, the Committee has departed from not only the requirements of the Companies Act, 1956, but also from the prudential norms prescribed by RBI in this regard, e.g., disclosure of fund-based assets locked in an account of an individual or an individual enterprise in excess of 10 percent of the total fund locked in the fund-based assets, in order to present more meaningful financial information.

5.22 It is understood that RBI is considering to make it obligatory on the part of the non-banking financial companies to carry on only the financial business. In view of this, the Committee recognises that the disclosures in the formats pertaining to non-financial business would be transitory in nature.

5.23 Presently, different NBFCs are closing their books on different dates which lead to difficulties for the regulator to arrive at a uniform data base and assess the comparative performance of this sector of the financial system. For the sake of uniformity in the entire financial system, the Committee recommends that all NBFCs should prepare their audited financial statements as of March 31, every year.