8

Financial Reporting for Financial Institutions

BASIC CONCEPTS

MUTUAL FUNDS

In India, mutual funds are regulated by SEBI (Mutual Funds) Regulations, 1996. According to the SEBI (Mutual Funds) Regulations, 1996, a 'mutual fund' means a fund established in the form of a trust to raise monies through the sale of units to the public under one or more schemes for investing in securities including money market instruments. A mutual fund should be registered with SEBI.

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal.

The money thus collected is invested by the fund manager in different types of securities depending upon the objective of the scheme. These could range from shares to debentures to money market instruments

Types of Mutual Funds

On the basis of Structure- The mutual fund schemes can be classified as open ended and close ended. The open-ended schemes permit entry by subscription or exit by sale of units on a continuous basis. The mutual fund announces daily sale and repurchase prices of units for the purpose. . The sale and repurchase prices announced by a mutual fund are based on Net Asset Value (NAV) and hence are called the NAV related prices. The close-ended funds have fixed maturity periods e.g. 5-7 years. These schemes are kept open for subscription only during a specified period at the time of launch of the scheme. To provide liquidity, the units are however listed on stock exchanges.

On the basis of Investors Objectives - In terms of investment objectives, mutual fund schemes can be classified as the growth funds and income funds. The growth funds invest major parts of their corpus in equity instruments and hence are exposed to comparatively higher risks. These schemes are expected to provide higher return in form of dividends and capital appreciation. Income funds invest in fixed income debt instruments, e.g. corporate debentures, Government securities and money market instruments and hence are also called the debt funds. They provide steady flow of comparatively lower return for lower risks.

Mutual funds sell their shares to public and redeem them at current Net Asset Value (NAV) which is calculated as under –

$$\frac{\text{Total market value of all MF holdings - All MF liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. If the NAV is more than the face value (₹ 10), it means your money has appreciated and *vice versa*.

Every mutual fund or the asset management company is required to prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.

NON-BANKING FINANCE COMPANY

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act* 1956, engaged in the business of providing loans and advances, acquisition of shares, debentures and other securities, leasing, hire-purchase, insurance business and chit business. The term NBFC does not include any institution whose principal business is that of agriculture activity, industrial activity or sale/purchase/construction of immovable property. For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a – Loan company, Investment company, Hire purchase finance company, Equipment leasing company and Mutual benefit financial company". No non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration issued by the Reserve Bank of India.

Functions of Non-Banking Financial Companies are similar to banks. However there are a few differences:

(a) A NBFC cannot accept demand deposits;

(b) Non-Banking Financial Companies do not take part in the payment and settlement system and hence cannot issue cheques to its customers; and

(c) Deposit Insurance and Credit Guarantee Corporation (DICGC) does not insure the NBFC deposits.

"Owned fund" means paid up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any;

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC. – Book value of debentures, bonds, outstanding loans and

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* *Now Companies Act, 2013.*

advances made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund).

Revised Regulatory Framework for NBFCs

RBI vide notification no. DNBR (PD)CC.No. 002/03.10.001/2014-15 dated November 10, 2014 has revised the regulatory provisions relating to the functioning of NBFCs (except primary dealers) in India.

The revisions brought through this circular shall be applicable to NBFCs-MFI and registered Core Investment Companies also except wherever in conflict with the provision of Non-Banking Financial Company- Micro Finance Institutions (Reserve Bank) Directions, 2011 and Core Investment Companies (Reserve Bank) Directions, 2011 respectively, in which case the Directions ibid will be followed.

The changes introduced to the regulatory framework are delineated below.

a. Requirement of Minimum NOF of ₹200 lakh

Although the requirement of minimum NOF stands at ₹ 200 lakh, the minimum NOF for companies that were already in existence before April 21, 1999 was retained at ₹ 25 lakh. but the revised regulatory framework has mandated all NBFCs to attain a minimum NOF of ₹ 200 lakh by the end of March 2017, as per the milestones given below:

- ₹ 100 lakh by the end of March 2016
- ₹ 200 lakh by the end of March 2017

b. Deposit Acceptance

As per extant NBFCs Acceptance of Public Deposit (Reserve Bank) Directions, 1998, an unrated Asset Finance Company (AFC) having NOF of ₹ 25 lakh or more, complying with all the prudential norms and maintaining capital adequacy ratio of not less than fifteen per cent, is allowed to accept or renew public deposits not exceeding one and half times of its NOF or up to ₹ 10 crore, whichever is lower. AFCs which are rated and complying with all the prudential regulations are allowed to accept deposits up to 4 times of their NOF.

In order to harmonise the deposit acceptance regulations across all deposit taking NBFCs (NBFCs-D), existing unrated AFCs shall have to get themselves rated by March 31, 2016. Those AFCs that do not get an investment grade rating by March 31, 2016, will not be allowed to renew existing or accept fresh deposits thereafter. Further, it has also been decided to harmonise the limit for acceptance of deposits across the sector by reducing the same for rated AFCs from 4 times to 1.5 times of NOF, with effect from the date of this circular.

c. Systemic Significance

The threshold for defining systemic significance for NBFCs-ND has been revised in the light of the overall increase in the growth of the NBFC sector with asset size of ₹ 500 crore and above as per the last audited balance sheet.

With this revision in the threshold for systemic significance, NBFCs-ND shall be categorized into two broad categories viz.,

i. NBFCs-ND (those with assets of less than ₹ 500 crore) and

ii. BFCs-ND-SI (those with assets of ₹ 500 crore and above).

d. Multiple NBFCs

NBFCs that are part of a corporate group or are floated by a common set of promoters will not be viewed on a standalone basis. The total assets of NBFCs in a group including deposit taking NBFCs, if any, will be aggregated to determine if such consolidation falls within the asset sizes of the above two categories.

e. Prudential Norms

The regulatory approach in respect of NBFCs-ND with an asset size of less than ₹ 500 crore will be as under:

(i) They shall not be subjected to any regulation either prudential or conduct of business regulations if they have not accessed any public funds and do not have a customer interface.

(ii) Those having customer interface will be subjected only to conduct of business regulations if they are not accessing public funds.

(iii) Those accepting public funds will be subjected to limited prudential regulations but not conduct of business regulations if they have no customer interface.

(iv) Where both public funds are accepted and customer interface exist, such companies will be subjected both to limited prudential regulations and conduct of business regulations.

(v) Registration under Section 45 IA of the RBI Act will be mandatory.

All NBFCs-ND with assets of ₹ 500 crore and above, irrespective of whether they have accessed public funds or not, shall comply with prudential regulations as applicable to NBFCs-ND-SI. They shall also comply with conduct of business regulations if customer interface exists.

Prudential Regulations Applicable to NBFCs-ND with Assets less than ₹ 500 crore

NBFCs-ND with asset size of less than ₹ 500 crore are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms.

A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities / Owned Funds.

Prudential Regulations Applicable to NBFCs-ND-SI (asset of ₹ 500 crore and above) and all NBFCs-D

Tier 1 Capital

All NBFCs-ND which have an asset size of ₹ 500 crore and above, and all NBFCs-D, shall maintain minimum Tier 1 Capital of 10%. The compliance to the revised Tier 1 capital will be phased in as follows:

- 8.5% by end of March 2016.
- 10% by end of March 2017.

"Tier I Capital" means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;

"Tier II capital" includes the following:

(a) preference shares other than those which are compulsorily convertible into equity;

(b) revaluation reserves at discounted rate of fifty five percent;

(c) general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;

(d) hybrid debt capital instruments; and

(e) subordinated debt to the extent the aggregate does not exceed Tier I capital.

Asset Classification

In the interest of harmonisation, the asset classification norms for NBFCs-ND-SI and NBFCs-D are being brought in line with that of banks, in a phased manner, as given below.

<u>Lease Rental and Hire-Purchase Assets shall become NPA:</u>

i. if they become overdue for 9 months (currently 12 months) for the financial year ending March 31, 2016;

ii. if overdue for 6 months for the financial year ending March 31, 2017; and

iii. if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

<u>Assets other than Lease Rental and Hire-Purchase Assets shall become NPA:</u>

i. if they become overdue for 5 months for the financial year ending March 31, 2016;

ii. if overdue for 4 months for the financial year ending March 31, 2017; and

iii. if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, sub-standard asset would mean:

i. an asset that has been classified as NPA for a period not exceeding 16 months (currently 18 months) for the financial year ending March 31, 2016;

ii. an asset that has been classified as NPA for a period not exceeding 14 months for the financial year ending March 31, 2017; and

iii. an asset that has been classified as NPA for a period not exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, doubtful asset would mean:

i. an asset that has remained sub-standard for a period exceeding 16 months (currently 18 months) for the financial year ending March 31, 2016;

ii. an asset that has remained sub-standard for a period exceeding 14 months for the financial year ending March 31, 2017; and

iii. an asset that has remained sub-standard for a period exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

For the existing loans, a one-time adjustment of the repayment schedule, which shall not amount to restructuring will, however, be permitted.

- Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis.
- However, income from dividend on shares of corporate bodies may be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the NBFC's right to receive payment is established. Income from bonds and debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis.
- Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

The assets are classified as:

(a) Standard assets;

(b) Sub-standard assets;

(c) Doubtful assets; and

(d) Loss assets.

Provisioning Requirements

Loss Assets

100% of the outstanding should be provided for.

Doubtful Assets

(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the NBFC has a valid recourse shall be made.

(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis :

Period for which the asset has been considered as doubtful	% of provision
Upto one year	20
One to three years	30
More than three years	50

Sub-standard asset

A general provision of 10% of total outstanding shall be made.

Standard Assets

The provision for standard assets for NBFCs-ND-SI and for all NBFCs-D has being increased to 0.40% (at present 0.25%). The compliance to the revised norm will be phased in as given below:

- 0.30% by the end of March 2016
- 0.35% by the end of March 2017
- 0.40% by the end of March 2018

This provision towards standard asset need not be netted from gross advances but shown separately as 'Contingent provision against standard assets' in the Balance Sheet.

MERCHANT BANKERS

Merchant bankers are the specialised agency which manages the capital issues. They are also called the managers to the issue. A merchant banker is an organisation that acts as an intermediary between the issuers and the ultimate purchasers of securities in the primary security market. In addition to managing an issue for a client, the services offered by a merchant banker includes underwriting and providing advice on complex financings arrangements, mergers and acquisitions, and at times direct equity investments in corporations.

STOCK AND COMMODITY MARKET INTERMEDIARIES

A stock broker is a member of a recognised stock exchange(s) and is engaged in buying, selling and dealing in securities. A stock broker can deal in securities only after getting registration with SEBI. A stock broker can function as a proprietorship firm, partnership firm or a corporate. Stock brokers are also eligible to act as underwriters without obtaining a separate registration as an underwriter. He may or may not appoint sub-brokers. A sub-broker is subordinate to main stock broker and acts on behalf of a stock broker as an agent or otherwise, for assisting the investors in buying, selling or dealing in securities through such stock brokers. The stock broker as a principal, is responsible to the investor for his sub-brokers' conduct and acts.

In addition to acting as agents for others, a stockbroker may also trade directly by buying and selling securities as principals. If a stockbroker enters into a contract to buy or sale securities as principal with any person other than another stockbroker, he must secure the consent or authorization from the other party and must disclose in the agreement for buying or selling of securities that he is acting as a principal.

Mutual Funds

Question1

What do you mean by "Net asset value" (NAV) in case of mutual fund units?

Answer

Mutual funds sell their shares to public and redeem them at current Net Asset Value (NAV) which is calculated as under:

$$\frac{\text{Total market value of all Mutual Fund holdings - All Mutual Fund liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. Simply stated, NAV is the value of the assets of each unit of the scheme, or even simpler value of one unit of the scheme. Thus, if the NAV is more than the face value (₹ 10), it means your money has appreciated and vice versa. NAV also includes dividends, interest accruals and reduction of liabilities and expenses, besides market value of investments. NAV is the value of net assets under a mutual fund scheme. The NAV per unit is NAV of the scheme divided by number of units outstanding. NAV of a scheme keeps on changing with change in market value of portfolio under the scheme.

Question 2

Investors Mutual Fund is registered with SEBI and having its registered office at Pune. The fund is in the process of finalizing the annual statement of accounts of one of its open ended mutual fund schemes. From the information furnished below you are required to prepare a statement showing the movement of unit holders' funds for the financial year ended 31st March, 2015.

	₹ '000
Opening Balance of net assets	*12,00,000*
Net Income for the year (Audited)	*85,000*
8,50,200 units issued during 2014-15	*96,500*
7,52,300 units redeemed during 2014-15	*71,320*
The par value per unit is ₹ 100	

Answer

Statement showing the Movement of Unit Holders' Funds for the year ended 31st March, 2015

	(₹ '000)
Opening balance of net assets	12,00,000
Add: Par value of units issued (8,50,200 × ₹ 100)	85,020
Net Income for the year	85,000
Transfer from Reserve/Equalisation fund (Refer working note)	15,390
	13,85,410
Less: Par value of units redeemed (7,52,300 × ₹ 100)	(75,230)
Closing balance of net assets (as on 31st March, 2015)	13,10,180

Working Note:

Particulars	*Issued*	*Redeemed*
Units	8,50,200	7,52,300
	₹ ' 000	*₹ ' 000*
Par value	85,020	75,230
Sale proceeds / Redemption value	96,500	71,320
Profit transferred to Reserve / Equalisation Fund	11,480	3,910
Balance in Reserve / Equalisation Fund (Issued & Redeemed)	15,390	

Question 3

On 1.4.2014, a mutual fund scheme had 18 lakh units of face value of ₹ 10 each was outstanding. The scheme earned ₹ 162 lakhs in 2014-15, out of which ₹ 90 lakhs was earned in the first half of the year. On 30.9.2014, 2 lakh units were sold at a "NAV" of ₹ 70.

Pass Journal entries for sale of units and distribution of dividend at the end of 2014-15.

Answer

Allocation of Earnings	*Old Unit Holders*	*New Unit Holders*	*Total*
	[18 lakhs units]	*[2 lakhs units]*	
	₹ in lakhs	*₹ in lakhs*	*₹ in lakhs*
First half year (₹ 5 per unit)	90.00	Nil	90.00
Second half year (₹ 3.60 per unit)	64.80	7.20	72.00
	154.80	7.20	162.00
Add: Equalization payment recovered	-	-	10.00
Total available for distribution			172.00
Equalization Payment:-₹ 90 lakhs ÷ 18 lakhs = ₹ 5 per unit.			
		Old Unit Holders	New Unit Holders
		₹	₹
Dividend distributed		8.60	8.60
Less: Equalization payment		-	(5.00)
		8.60	3.60

Journal Entries

				(*₹ in lakhs*)
30.9.2014	Bank A/c	Dr.	150.00	
	To Unit Capital			20.00
	To Reserve			120.00
	To Dividend Equalization			10.00
	(Being the amount received on sale of 2 lakhs unit at a NAV of ₹ 70 per unit)			
31.3.2015	Dividend Equalization	Dr.	10.00	
	To Revenue A/c			10.00
	(Being the amount transferred to Revenue Account)			
30.9.2015	Revenue A/c	Dr.	172.00	
	To Bank			172.00
	(Being the amount distributed among 20 lakhs unit holders @ ₹ 8.60 per unit)			

Question 4

A Mutual Fund raised 100 lakh on April 1, 2015 by issue of 10 lakh units of ₹ 10 per unit. The fund invested in several capital market instruments to build a portfolio of ₹ 90 lakhs. The initial expenses amounted to ₹ 7 lakh. During April, 2015, the fund sold certain securities of cost ₹ 38 lakhs for ₹ 40 lakhs and purchased certain other securities for ₹ 28.20 lakhs. The fund management expenses for the month amounted to ₹ 4.50 lakhs of which ₹ 0.25 lakh was in arrears. The dividend earned was ₹ 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2015 was ₹ 101.90 lakh.

Determine NAV per unit.

Answer

	₹ in lakhs	*₹ in lakhs*	
Opening bank balance [₹ (100 – 90 - 7) lakhs]	3.00		
Add: Proceeds from sale of securities	40.00		
Dividend received	1.20	44.20	
Less: Cost of securities	28.20		
Fund management expenses [₹ (4.50–0.25) lakhs]	4.25		
Capital gains distributed [75% of ₹ (40.00 – 38.00) lakhs]	1.50		
Dividends distributed (75% of ₹ 1.20 lakhs)	0.90	(34.85)	
Closing bank balance		9.35	
Closing market value of portfolio		101.90	
		111.25	
Less: Arrears of expenses		(0.25)	
Closing net assets		111.00	
Number of units			10,00,000
Closing Net Assets Value (NAV)			₹ 11.10

Question 5

Ramesh Goyal has invested in three mutual funds. From the details given below, find out effective yield on per annum basis in respect of each of the schemes to Ramesh Goyal upto 31-03-2015.

Mutual Fund	*X*	*Y*	*Z*
Date of Investment	*1-12-2014*	*1-1-2015*	*1-3-2015*

Amount of investment (₹)	*1,00,000*	*2,00,000*	*1,00,000*
NAV at the date of investment (₹)	*10.50*	*10.00*	*10.00*
Dividend received upto 31-3-2015 (₹)	*1,900*	*3,000*	*Nil*
NAV as on 31-3-2015 (₹)	*10.40*	*10.10*	*9.80*

Answer

Calculation of effective yield on per annum basis in respect of three mutual fund schemes of Ramesh Goyal upto 31.03.2015

		X	Y	Z
1	Amount of Investment (₹)	1,00,000	2,00,000	1,00,000
2	Date of investment	1.12.2014	1.1.2015	1.3.2015
3	NAV at the date of investment (₹)	10.50	10.00	10.00
4	No. of units on date of investment [1/3]	9,523.809	20,000	10,000
5	NAV per unit on 31.03.2015 (₹)	10.40	10.10	9.80
6	Total NAV of mutual fund investments on 31.03.2015 [4 x 5]	99,047.61	2,02,000	98,000
7	Increase/ decrease of NAV [6-1]	(952.39)	2,000	(2,000)
8	Dividend received upto 31.3.2015	1,900	3,000	Nil
9	Total yield [7+8]	947.61	5,000	(2,000)
10	Yield % [9/1] x 100	0.95%	2.5%	(2%)
11	Number of days	121	90	31
12	Effective yield p.a. [10/11] x 365 days	2.87%	10.14%	(23.55%)

Question 6

The investment portfolio of a mutual fund scheme includes 5,000 shares of X Ltd. and 4,000 shares of Y Ltd. acquired on 31-12-2013. The cost of X Ltd.'s shares is ₹ 40 while that of Y Ltd.'s shares is ₹ 60. The market value of these shares at the end of 2013-14 were ₹ 38 and ₹ 64 respectively. On 30-06-2014, shares of both the companies were disposed off realizing ₹ 37 per X Ltd. shares and ₹ 67 per Y Ltd. shares. Show important accounting entries in the books of the fund for the accounting years 2013-14 and 2014-15.

Answer

Accounting Entries in the books of fund

		₹	₹
31.12.2013	Investment in X Ltd.'s shares A/c (5,000 x ₹ 40) Dr.	2,00,000	

	Investment in Y Ltd.'s shares A/c (4,000 x ₹ 60)	Dr.	2,40,000	
	To Bank A/c			4,40,000
	(Being investment made in X Ltd. and Y Ltd.)			
31.3.2014	Revenue A/c [5,000 x ₹ (40-38)]	Dr.	10,000	
	To Provision for Depreciation A/c			10,000
	(Being provision created for the reduction in the value of X Ltd.'s shares)			
31.3.2014	Investment in Y Ltd.'s shares A/c [4,000 x ₹ (64-60)]	Dr.	16,000	
	To Unrealised Appreciation Reserve A/c			16,000
	(Being appreciation in the market value of Y Ltd.'s shares transferred to Unrealised Appreciation Reserve A/c)			
01.04.2014	Unrealised Appreciation Reserve A/c	Dr.	16,000	
	To Investment in Y Ltd.'s shares A/c			16,000
	(Being last year's unrealised appreciation reserve balance reversed at the beginning of the current year)			
30.6.2014	Bank A/c (5,000 x ₹ 37)	Dr.	1,85,000	
	Loss on disposal of Investment A/c	Dr.	15,000	
	To Investment in X Ltd.'s shares A/c (5,000 x ₹ 40)			2,00,000
	(Being shares of X Ltd. disposed off at a loss of ₹ 15,000)			
30.6.2014	Provision for Depreciation A/c	Dr.	10,000	
	Revenue A/c	Dr.	5,000	
	To Loss on disposal of Investment A/c			15,000
	(Being net loss on disposal of X Ltd.'s shares charged to revenue account)			
30.6.2014	Bank A/c (4,000 x ₹ 67)	Dr.	2,68,000	
	To Investment in Y Ltd.'s shares A/c (4,000 x ₹ 60)			2,40,000
	To Revenue A/c			28,000
	(Being shares of Y Ltd. disposed off at a profit of ₹ 28,000)			

Question 7

A Mutual Fund has launched a new scheme "All Purpose Scheme". The Mutual Fund's Asset management company wishes to invest 25% of the NAV of the Scheme in an unrated debt instrument of a company Y Ltd. which has been paying above average returns for the past many years. The promoters of the company seek your professional advice in light of the Regulations of SEBI. Will the position change in case the debt instruments of the company Y Ltd., is a rated.

Answer

The Seventh Schedule of SEBI (Mutual funds) Regulations, 1996 states that a mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of Asset Management Company. It also states that a mutual fund scheme shall not invest more than 15% of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by an authorised credit rating agency. Such investment limit may be extended to 20% of the NAV of the scheme with the prior approval of the Board of Trustees and the Board of Asset Management Company.

Accordingly,

(i) If the debts instruments of Y Ltd. unrated then Mutual fund's Asset Management Company (AMC) cannot invest more than 10% of its NAV in it.

(ii) If the debts instruments of Y Ltd are rated, then also, Mutual Fund's AMC cannot invest more than 20% of its NAV in it. Therefore, investment of 25% of its NAV of the scheme in debts instrument of Y Ltd. by Mutual Fund's AMC is not permissible as per the SEBI (Mutual Fund) Regulation 1996.

Non- Banking Finance Companies

Question 8

Write short notes on:

(i) "Non-Performing Assets" as per NBFC Prudential Norms (RBI) directions.

(ii) Capital adequacy ratio.

(iii) Earning value (Equity share).

Answer

(i) "Non–Performing Asset" as per NBFC Prudential Norms (RBI) directions means:

(a) an asset, in respect of which, interest has remained overdue for a period of six months or more;

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;

(c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;

(d) a bill which remains overdue for a period of six months or more;

(e) the interest in respect of a debt or the income on receivables under the head 'other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

Note: The above six months criteria for the assets covered under (a) to (f) is till the financial year ending March 31, 2015. However, in future, these assets (other than Lease Rental and Hire-Purchase Assets) shall become NPA:

(i) if they become overdue for 5 months for the financial year ending March 31, 2016;

(ii) if overdue for 4 months for the financial year ending March 31, 2017; and

(iii) if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

(g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

Note: The above twelve months criteria for the assets covered under (g) is till the financial year ending March 31, 2015. However, in future, such lease rental and hire-purchase assets shall become NPA:

(i) if they become overdue for 9 months (currently 12 months) for the financial year ending March 31, 2016;

(ii) if overdue for 6 months for the financial year ending March 31, 2017; and

(iii) if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset:

Provided that in the case of lease and hire purchase transactions, a non-banking financial company may classify each such account on the basis of its record of recovery.

(ii) Non-Banking Financial Companies (NBFC) are required to maintain adequate capital. Every NBFC shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 12% of its aggregate risk-weighted assets on balance sheet and of risk adjusted value of off-balance sheet items.

The total of Tier II capital, at any point of time, shall not exceed 100% of Tier I capital. Capital adequacy is calculated as under:

$$\frac{\text{Tier I} + \text{Tier II Capital}}{\text{Risk Adjusted Assets}} \times 100$$

NBFCs-ND with asset size of less than ₹ 500 crore, are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms.

A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities / Owned Funds.

At present, all NBFCs-D and NBFCs-ND-SI are required to have minimum CRAR of 15%. Consequently, Tier 1 capital cannot be less than 7.5%. For Infrastructure Finance Companies (IFCs), however, Tier 1 capital cannot be less than 10%. Similarly, NBFCs primarily engaged in lending against gold jewellery have to maintain a minimum Tier 1 capital of 12% w.e.f. April 01, 2014. However, after revision of Regulatory Framework for NBFCs, all NBFCs-ND-SI and all NBFCs-D, shall maintain minimum Tier 1 Capital of 10% instead of 7.5%. The compliance to the revised Tier 1 capital will be phased in as follows:

- 8.5% by end of March 2016
- 10% by end of March 2017.

The minimum Tier 1 capital requirement for NBFCs primarily engaged in lending against gold jewellery remains unchanged for the present.

(iii) "Earning value" means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years and further divided by the number of equity shares of the investee company and capitalised at the following rate:

(a) in case of predominantly manufacturing company, eight per cent;

(b) in case of predominantly trading company, ten per cent; and

(c) in case of any other company, including non-banking financial company, twelve percent;

Note: If, an investee company is a loss making company, the earning value will be taken at zero.

Question 9

While closing its books of account on 31st March, 2016 a Non-Banking Finance Company has its advances classified as follows:

	₹ in lakhs
Standard assets	*16,800*
Sub-standard assets	*1,340*
Secured portions of doubtful debts:	
– upto one year	*320*
– one year to three years	*90*
– more than three years	*30*
Unsecured portions of doubtful debts	*97*
Loss assets	*48*

Calculate the amount of provision, which must be made against the Advances.

Answer

Calculation of provision required on advances as on 31st March, 2016:

	Amount ₹ in lakhs	*Percentage of provision*	*Provision ₹ in lakhs*
Standard assets	16,800	0.30	50.40
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			427.00

Question 10

Samvedan Limited is a non-banking finance company. It accepts public deposit and also deals in hire purchase business. It provides you with the following information regarding major hire purchase deals as on 31-03-2014. Few machines were sold on hire purchase basis. The hire purchase price was set as ₹ 100 lakhs as against the cash price of ₹ 80 lakhs. The amount *was payable as ₹ 20 lakhs down payment and balance in 5 equal instalments. The hire vendor collected first instalment as on 31-03-2015, but could not collect the second instalment which was due on 31-03-2016. The company was finalising accounts for the year ending 31-03-2016. Till 15-05-2016, the date on which the Board of Directors signed the accounts, the second instalment was not collected. Presume IRR to be 10.42%.*

Required :

(i) What should be the principal outstanding on 1-4-2015? Should the company recognize finance charge for the year 2015-16 as income?

(ii) What should be the net book value of assets as on 31-03-16 so far Samvedan Ltd. is concerned as per NBFC prudential norms requirement for provisioning?

(iii) What should be the amount of provision to be made as per prudential norms for NBFC laid down by RBI?

Answer

(i) Since, the hire-purchaser paid the first instalment due on 31.3.2015, the notional principal outstanding on 1-4-2015 was ₹ 50.25 lakhs (refer W.N.).

In the year ended 31.03.2016, the instalment due of ₹ 16 lakhs has not been received. However, it was due on 31.3.2016 i.e on the balance sheet date, and therefore, it will be classified as standard asset. Samvedan Ltd. will recognise ₹ 5.24 lakhs as interest income included in that due instalment as this should be treated as finance charge.

(ii) The net book value of the assets as on 31.3.2016

	₹ in lakhs
Overdue instalment	16.00
Instalments not due (₹ 16 lakhs x 3)	48.00
	64.00
Less: Finance charge not matured and hence not credited to Profit and loss account (4.11 + 2.88 + 1.52)	(8.51)
	55.49
Less: Provision as per para 9(2)(i) of NBFC prudential norms (Refer point (iii))	7.49
Net book value of assets for Samvedan Ltd.	48.00

(iii) **Amount of Provision**

	₹ in lakhs
Overdue instalment	16.00
Instalments not due (₹ 16 lakhs x 3)	48.00
	64.00

Less: Finance charge not matured and hence not credited to Profit and loss account (4.11 + 2.88 + 1.52)	(8.51)
	55.49
Less: Depreciated value (cash price less depreciation for two years on SLM @ 20%*)	(48.00)
Provision to be created as per para 9(2)(i) of NBFC prudential norms	7.49

Since, the instalment of ₹ 16 lakhs not paid, was due on 31.3.16 only, the asset is classified as standard asset. Therefore, no additional provision has been made for it.

Working Note:

It is necessary to segregate the instalments into principal outstanding and interest components by using I.R.R. @ 10.42%. *(₹ in lakhs)*

Time	*Opening outstanding amount (a)*	*Cash flow (b)*	*Interest @ 10.42% (c) = (a x 10.42%)*	*Principal repayment (d) = (b – c)*	*Closing outstanding (e) = (a – d)*
31-3-2014		(60)	-----	---	60.00
31-3-2015	60.00	16	6.25	9.75	50.25
31-3-2016	50.25	16	5.24	10.76	39.49
31-3-2017	39.49	16	4.11	11.89	27.60
31-3-2018	27.60	16	2.88	13.12	14.48
31-3-2019	14.48	16	1.52	14.48	0.00

Question 11

Peoples Financiers Ltd. is an NBFC providing Hire Purchase Solutions for acquiring consumer durables. The following information is extracted from its books for the year ended 31st March, 2015:

Asset Funded	*Interest Overdue but recognized in Profit & loss*		*Net Book Value of Assets outstanding*
	Period Overdue	*Interest Amount*	
		(₹ in crore)	*(₹ in crore)*
LCD Televisions	*Upto 12 months*	*480.00*	*20,123.00*
Washing Machines	*For 24 months*	*102.00*	*2,410.00*
Refrigerators	*For 30 months*	*50.50*	*1,280.00*
Air Conditioners	*For 45 months*	*26.75*	*647.00*

You are required to calculate the amount of provision to be made.

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* As per NBFC prudential norms laid down by the RBI.

Answer

On the basis of the information given, in respect of hire purchase and leased assets, additional provision shall be made as under:

			(₹ *in crore)*
(a)	Where hire charges are overdue upto 12 months	Nil	-
(b)	Where hire charges are overdue for more than 12 months but upto 24 months	10% of the net book value 10% x 2,410	241
(c)	Where hire charges are overdue for more than 24 months but upto 36 months	40 percent of the net book value 40% x 1,280	512
(d)	Where hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value 70% x 647	452.90
		Total	1,205.90

Merchant Bankers

Question 12

For what purposes inspection of records and documents of Merchant Banker is ordered by SEBI?

Answer

SEBI has the right to appoint one or more persons as inspecting authority to undertake inspection of the books of account, records and documents of the merchant banker for any of the following purposes:

(i) To see that books of account are being maintained in the required manner;

(ii) To ensure that provisions of SEBI Act, rules and regulations are complied with;

(iii) To investigate into complaints received from investors, other merchant bankers, or any other person on any matter having a bearing on the activities of merchant banker;

(iv) To investigate suo moto in the interest of securities business or investors' interest into the affairs of merchant bankers.

Question 13

Write short note on Capital adequacy requirements of merchant bankers.

Answer

Capital adequacy requirements have been specified by SEBI under the SEBI (Merchant Bankers) Regulations, 1992. Regulation 7 specifies that the requirement of capital adequacy shall be a net worth of not less than five crore rupees. For the purpose of this regulation, ' Net worth' means the sum of paid-up capital and free reserves of the applicant at the time of making application under sub-regulation (1) of regulation 3.

Stock and Commodity Market Intermediaries

Question 14

Write short note on Books of account required to be maintained by a Stock Broker.

Answer

Every stock broker is required to maintain the following books of account, records and documents as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Rules, 1992:

(a) Register of transactions (Sauda book);

(b) Clients ledger;

(c) General ledger;

(d) Journals;

(e) Cash book;

(f) Bank Pass Book;

(g) Documents register, containing, inter alia, particulars of securities received and delivered in physical form and the statement of account and other relating to receipt and delivery of securities provided by the depository participants in respect of dematerialized securities;

(h) Members' contract book showing details of all contracts entered into by him with other members of the stock exchange or counterfoils or duplicates of memos of confirmation issued to such other members;

(i) Counterfoils or duplicates of contract notes issued to clients;

(j) Written consent of clients in respect of contracts entered into as principals;

(k) Margin deposit book;

(l) Register of accounts of sub-brokers;

(m) An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock broker and such sub-brokers.

(n) An agreement with the sub-broker and with the client of sub-broker to establish privities of the contract between the stock broker and the client of the stock broker.

Exercise

Question 1

Write short notes on:

(i) Dividend Equalization for a mutual fund.

(ii) Asset liability management for a NBFC.

(iii) Closing out by a member broker.

(iv) Open ended and close ended schemes of mutual funds.

Question 2

A Mutual Fund raised funds on 01.04.2014 by issuing 10 lakhs units @ 17.50 per unit. Out of this Fund, ₹ 160 lakhs invested in several capital market instruments. The initial expenses amount to ₹ 9 lakhs. During June, 2014, the fund sold certain securities worth ₹ 100 lakhs for ₹ 125 lakhs and it bought certain securities for ₹ 90 lakhs. The Fund Management expenses amount to ₹ 5 lakhs per month. The dividend earned was ₹ 3 lakhs. 80% of the realised earnings were distributed among the unit holders. The market value of the portfolio was ₹ 175 lakhs. Determine Net Asset value (NAV) per unit as on 30.06.2014.

[Answer: Total funds raised by Mutual Fund = ₹ 175 lakhs; Closing Net Assets ₹ 181.60 lakhs; Closing NAV ₹ 18.16].