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

Income Recognition Principle

- Income on non-performing assets (NPA) shall be recognized only when it is actually

realized.-Cash Basis of Accounting

- Income relating to hire purchase asset, where installments are overdue for more than 12 months, shall be recognized only when the hire charge is actually received.
- Income relating to leased asset, where lease rentals are overdue for more than 12 months, shall be recognised only when the lease rental is actually received.
- 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.

Standards Asset

A general provision of 0.25% of the outstanding standard assets shall be made. 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.

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.

"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.

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 finalising 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, 2012.

	₹'000
Opening Balance of net assets	*12,00,000*
Net Income for the year (Audited)	*85,000*
8,50,200 units issued during 2011-12	*96,500*
7,52,300 units redeemed during 2011-12	*71,320*
The par value per unit is ₹100	

Answer

Statement showing the Movement of Unit Holders' Funds
for the year ended 31st March, 2012

	(₹ '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, 2012)	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 1.4.2011, a mutual fund scheme had 18 lakh units of face value of ₹ 10 each was outstanding. The scheme earned ₹162 lakhs in 2011-12, out of which ₹ 90 lakhs was earned in the first half of the year. On 30.9.2011, 2 lakh unist were sold at a "NAV" of ₹ 70.

Pass Journal entries for sale of units and distribution of dividend at the end of 2011-12.

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*)
30.9.2011	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)			
31.3.2012	Dividend Equalization	Dr.	10.00	
	To Revenue A/c			10.00
	(Being the amount transferred to Revenue Account)			
30.9.2012	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, 2012 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, 2012, 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 30.04.2012 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

Non- Banking Finance Companies

Question 5

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;

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

(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:

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

(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 6

While closing its books of account on 31st March, 2012 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, 2012:

	Amount ₹ in lakhs	*Percentage of provision*	*Provision ₹ in lakhs*
Standard assets	16,800	0.25*	42
Sub-standard assets	1,340	10	134
Secured portions of doubtful debts–			
–upto one year	320	20	64
– one year to three years	90	30	27
–more than three years	30	50	15
Unsecured portions of doubtful debts	97	100	97
Loss assets	48	100	48
			427

Question 7

Anischit Finance Ltd. is a non-banking finance company. It makes available to you the costs and market price of various investments held by it as on 31.3.2012:

(Figures in ₹ lakhs)

Scripts:		*Cost*	*Market Price*
A.	*Equity Shares-*		
	A	*60.00*	*61.20*
	B	*31.50*	*24.00*
	C	*60.00*	*36.00*
	D	*60.00*	*120.00*
	E	*90.00*	*105.00*

* Vide notifications No. DNBS.222 CGM(US)2011 and No. DNBS. 223 CGM (US) 2011, NBFCs should make a general provision at 0.25 per cent of the outstanding standard assets.

	F	*75.00*	*90.00*
	G	*30.00*	*6.00*
B.	*Mutual funds-*		
	MF-1	*39.00*	*24.00*
	MF-2	*30.00*	*21.00*
	MF-3	*6.00*	*9.00*
C.	*Government securities-*		
	GV-1	*60.00*	*66.00*
	GV-2	*75.00*	*72.00*

(i) Can the company adjust depreciation of a particular item of investment within a category?

(ii) What should be the value of investments as on 31.3.2012?

(iii) Is it possible to off-set depreciation in investment in mutual funds against appreciation of the value of investment in equity shares and government securities?

Answer

(i) Quoted current investments for each category shall be valued at cost or market value, whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Therefore, depreciation of a particular item of investments can be adjusted within the same category of investments.

(ii) Value of Investments as on 31.3.2012

Type of Investment	*Valuation Principle*	*Value ₹ in lakhs*
Equity Shares (Aggregated)	Lower of cost or market Value	406.50
Mutual Funds	NAV (Market value, assumed)	54.00
Government securities	Cost	135.00
		595.50

As per para 14 of AS 13 "Accounting for Investments", the carrying amount for current investments is the lower of cost and market price. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not

with each individual investment, and accordingly, the investments may be computed at the lower of cost and market value computed category-wise.

(iii) Inter category adjustments of appreciation and depreciation in values of investments cannot be done. It is not possible to offset depreciation in investment in mutual funds against appreciation of the value of investments in equity shares and Government securities.

Merchant Bankers

Question 8

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 9

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.

**As amended by SEBI (Merchant Banker) (Third Amendment) Regulations, 2006.*

Stock and Commodity Market Intermediaries

Question 10

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.*

**Inserted by SEBI (Stock Brokers and Sub-Brokers) (Amendment) Regulations, 2003.*

Exercises

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 01.04.2011 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, 2011, 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 30.06.2011.

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