Article

NBFC classification under IFRS financial statements

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03.11.2018

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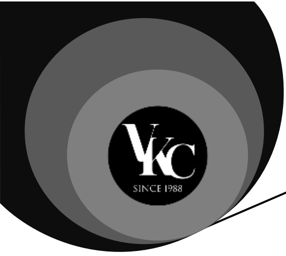


Several of the RBI's regulatory benchmarks, e.g., principal business criteria (PBC), threshold size for systemic importance, etc., are based on traditional financial statements. For example, the PBC applies the twin tests of principality to the income and assets of the entity. Similarly, for judging whether an entity is a systemically important (SI) status of an NBFC, reference is made to the value of assets as per the balance sheet of the NBFC.

With the application of IFRS/IndAS, financial statements of entities have undergone a major change. In several cases, we have moved away from historical cost accounting to fair value accounting. There are new presentation statements, new concepts, and indeed, the balance sheet of today is hardly comparable to the balance sheet of yesterday, and the same is the case with the good old profit and loss account.

The issue is, under the revised accounting framework, how do we reckon the benchmarks based on balance sheet and profit and loss account, as already existing? Surely enough, these benchmarks did not envisage the critical changes in the look and contents of financial statement.

Several NBFCs have already transitioned to IndASes. Several non-financial entities have also transitioned to IndASes. Hence, a question that is currently in the minds of several persons is – how will the erstwhile benchmarks for financial sector regulation apply to new-look IndAS statements[1].

The present note deals with one of the most critical issues pertaining to NBFC regulation – the very meaning of an NBFC. Depending on how the RBI's approach on the erstwhile benchmarks is applied to IndASes, several companies which were not NBFCs under the earlier accounting standards may have the potential of turning into NBFCs under IndAS financial statements. There is less likelihood of financial entities turning into non-financial ones, since the fair valuation approach under IndASes is mandatorily applicable to several financial assets, while in case of real assets, the entity still has the option of carrying on with the historical cost model.

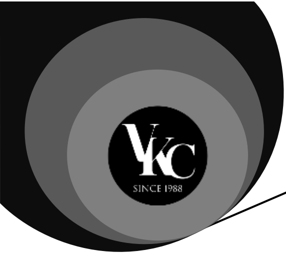
Principal business criteria

No entity can commence or carry on business as an NBFC without obtaining a certificate of registration issued by the Reserve Bank of India (RBI) and having the net owned fund of two hundred lakh rupees.

Section 45I (f) defines non-banking financial company as follows:

> *(f) "non-banking financial company" means–*
>
> *(i) a* ***financial institution which is a company****;*

[1] We have separately dealt with the disconnects between RBI Guidelines & Indian Accounting Standards w.r.t securitization accounting, the same can be read here- http://vinodkothari.com/wp-content/uploads/2018/08/Securitisation-Differences-between-RBI-Guidelines-and-Ind-AS.pdf



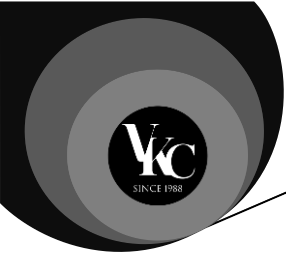
(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
(iii) such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;

Further, section 45I (c) defines a financial institution as-

(c) "financial institution" means any non-banking institution which carries on as its business or part of its business any of the following activities, namely:–
(i) ***the financing, whether by way of making loans or advances or otherwise,*** *of any activity other than its own:*
(ii) ***the acquisition of shares, stock, bonds, debentures or securities*** *issued by a Government or local authority or other marketable securities of a like nature:*
(iii) letting or delivering of any goods to a hirer under a ***hire-purchase agreement*** *as defined in clause (c) of section 2 of the Hire-Purchase Act, 1972:*
(iv) the carrying on of any class of insurance business; ***- excluded by notification***
(v) managing, conducting or supervising, as foreman, agent or in any other capacity, of chits or kuries as defined in any law which is for the time being in force in any State, or any business, which is similar thereto;
(vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lumpsum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner and awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other person,
but does not include any institution, which carries on as its principal business,–
****

Evidently, the definition stresses on the principality of business for determining whether an entity is actually a financial entity or a non-financial entity. The statute itself does not define what is to be regarded as the principal business.

Ideally, one cannot expect a statute to define or numerically lay the tests of principality. Principality is something which is indicative of the strategic focus, direction and level of activity in a business entity. Every entity, engaged in any real sector activity, has financial assets too. They are either supportive of the real sector activity, or represent investments made out of accumulated surpluses. Entities also have investments in entities within the group- such as subsidiaries and associates. If the purpose of regulation of non-banking financial companies by the RBI is regulation of the country's financial sector, there is no reason for the RBI to regulate such real sector entities which hold supportive financial assets, or investments in group entities, or merely an investment of accumulated surpluses out a real sector business.



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Legal Precedents

International Scenario

California Code of Regulations, Title 18, Reg 23183 sub-section (a) defines a "financial corporation" as a corporation which 'predominately' deals in money or moneyed capital in substantial competition with the business of national banks. Regs. 23183 subsection (b)(1) provides that:

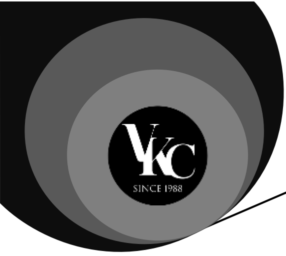
> *"Predominantly means over 50% of a corporation's total gross income is attributable to dealings in money or moneyed capital in substantial competition with the business of national banks. Generally, the determination of predominance will be made based upon the division of gross income for the year in issue. However, the classification of a corporation as a financial corporation or as a non-financial corporation* ***will not be changed based upon an occasional year in which its gross income does not exceed the 50% level****. For the classification of a corporation as a financial (or non-financial)corporation to be changed, there must be a shift in the predominant character of the gross income for two consecutive years and the average of the corporation's gross income in the current and the immediately preceding two years must fail (or satisfy) the predominance test. Where substantial amounts of gross income arise from an incidental or occasional sale of an asset of the taxpayers, such gross income shall be excluded for purposes of this subsection."*

The aforesaid definition clearly brings out that even though we take a numerical test, the classification cannot be changed very frequently- on a yearly basis. It is only when the flavour of the company changes and there is a predominant shift in its nature, that would require reclassification.

The Canadian Income Tax Rulings Directorate in the case 10 January 2012 External T.I. 2011-0409011E5 - Principal business test in 1100(12)(b) of the Regs[2] held as follows:

> *"….Ultimately, the determination of whether a corporation meets the PBREC* ***test is a question of fact*** *that involves the consideration of various factors, which might include,* ***but is not limited to, the principal source of the corporation's income****. In this regard, reference may be made to paragraph 7 of IT-371, Rental Property - Meaning of "Principal Business," which indicates that the significant factors of each case must be searched out and evaluated, including the following factors:*
> *(a) the profits realized by each of the businesses;*
> *(b) the volume and the value of the gross sales or transactions of each business;*
> *(c) the value of the assets of each business;(d) the capital employed in each business; and*
> *(e) the time, attention and effort expended by the employees, agents or officers in each business…"*

[2] https://taxinterpretations.com/node/393114



The rulings globally have emphasized that it is not merely a question of mechanical determination- the mathematical calculation might be a quick and handy guide but it cannot solely be based on that. For instance a flavor of a company can change in a particular financial year to year, but one cannot say that the position swings from year to year.

Definition of Investment Company

In Assistant Registrar of Companies vs H.C. Kothari and Others (Date of decision - 10/10/1991), the Chennai High Court in a case concerning section 372 (since repealed) of the Companies Act, 1956 held that-

> *"…an investment company is, therefore, a company whose principal business is the acquisition of shares, debentures or other securities.* ***It is clear that the income derived from the business is not the criteria****. The test would rather be, as to what the principal business of the company is. A balance-sheet should show what the principal business of the company is."*

In D.C. Kothari and Another vs Assistant Registrar of Companies (Date of decision: 24/4/1992), the Chennai High Court observed that regarding the term "Principal business" though there is no definition under the Act as commonly understood, principal business means the prime business carried on by the company at the relevant point of time and the major source of income, etc.

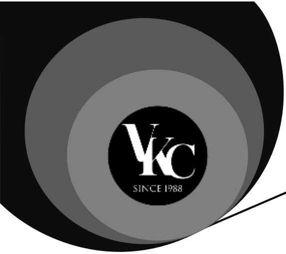
The Income Tax Appellate Tribunal – Ahmedabad in Barkha Investments And Trading Co. Pvt. Ltd. vs Income-Tax Officer (Date of decision: 7/10/1987) has considered the expression "**wholly or mainly in the dealing in or holding of investment" close to and somewhat akin to "principal business"** and cited from CIT v. Distributors (Baroda) P. Ltd.[3], wherein the Supreme Court said that, in the expression, "wholly or mainly in the dealing in or holding of investments", the word "mainly" in that clause must necessarily take its colour from the word "wholly" preceding that word in those provisions. In other words, the company which comes within the scope of those provisions must be one whose primary business must be in the dealing in or holding of investments. If a company engages itself in two or more equally or nearly equally important business activities, then it cannot be said that the company's business consists wholly or mainly in the dealing in a particular thing. Further, even in a case where a company has more than one business activity and one of its activities is more substantial than the others, **unless that activity is the primary activity of the company, it cannot be said that that company is engaged in wholly or mainly in any one of its business activities**.

Rulings under section 73 of the Income Tax Act, 1961

It is to be noted that Explanation to section 73 of the Income-tax Act, 1961 states as follows:

> ***Losses in speculation business.***

[3] [1972] 83 ITR 377 (SC)



> *Explanation.—Where any part of the business of a company (other than a company whose gross total income consists mainly of income which is chargeable under the heads "Interest on securities", "Income from house property", "Capital gains" and "Income from other sources", or* ***a company the principal business of which is the business of trading in shares or banking or the granting of loans and advances)*** *consists in the purchase and sale of shares of other companies, such company shall, for the purposes of this section, be deemed to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares.*

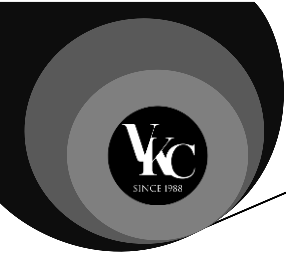
Accordingly, a company primarily engaged in the business of granting of loans and advances, was exempted from being classified as deemed to carrying on a speculation business for the purpose of section 73, even if any part of the business consists of purchase and sale of shares of other companies.
Special Bench decision of this tribunal in the case of DCIT vs Venkateswar Investment & Finance P Ltd (2005) 93 ITD 177 (Kol)(SB)[4] –

> *"10. We hold that to decide whether the case of an assessee falls in exceptions provided in Explanation to section 73 of the Act or not and to decide whether the* ***principal business of the assessee is that of granting of loans and advances, the decisive factor is the nature of the activities of the assessee and not the actual income from such activities during a particular year****. Merely because the numerical value of the profit/loss in purchase and sale of shares is more than the interest income during the relevant period, does not mean that the principal business of the assessee ceases to be that of granting of loans and advances. What constitutes the "principal business" has not been defined anywhere in the Act. What constitutes the principal business will depend on the facts and circumstances of each case. The Memorandum and the Articles of Association of the company past history of the assessee, current and past year's deployment of the capital of the assessee, break up of the income earned during the relevant and past years and the nature of activities of the assessee will all help in determining the principal business of the assessee. If any particular year, the assesse has nominal business income and has substantial interest income, it does not imply that the assessee's principal business is of finance or granting of loans and advances.*

It was discussed at length in the aforesaid ruling that merely because numerical value of the loss in purchase and sale of shares is more than the income of the assessee under the head "Income from other sources" during the relevant period, does not mean that the principal business of the assessee ceased to be that of granting of loans and advances.

Further, the counsel relied on another decision of the Kolkata Tribunal in the case of Mahaan Impex Ltd. v. ITO in Interest-tax Appeal Nos. 53 to 57/Kol/2003[5], wherein it was held that the use of the words "principal business" precludes an inference that a company could be a "financial company" for one year and not so for the others so that the mere accident of earning higher interest than the turnover of the company or due to temporary lull in the business of the assessee need not attract the provision of the Interest-tax Act, 1974.

[4] https://indiankanoon.org/doc/1283939/
[5] https://indiankanoon.org/doc/391719/



Rulings under Interest tax Act, 1974

Interest Tax Act was not applicable on Investment Companies, hence the rulings in this context also become important for analysis.
Rulings in context of investment companies:
In the case of **N.K. Leasing & Construction (P) ... vs Dy. Cit on 14 December, 2000**[6], it was held-

> *10.* Section 2(5A) *defines the "credit institution", inter alia, to mean "any other financial company, as mentioned in clause (iv) of that section. Financial company has been defined under sub-section (5B) of* section 2 *of the said Act, inter alia, to include a hire purchase finance company, that is to say, a company which carried on as its principal business, hire purchase transactions or the financing of such transactions. It includes inter alia, within its ambit a loan company, that is to say, a company which carries on as its principal business, the business of providing finance, whether by making loans or advances or otherwise. Therefore, whether assessee is treated as a hire purchase finance company, or a loan company as contended by revenue, it will be "financial company" and in turn,* ***it will be a "credit institution" if its principal business is shown to be one of hire purchase transactions or financing of such transactions or providing finance****. The term `principal Business" has not been defined under the* Interest Tax Act *nor under the* Income Tax Act*. Therefore, its meaning has to be understood in its grammatical sense,* **Principal denotes dominant or main or substantial, meaning thereby that *it shall have to be seen as to what constitutes dominant out of the total business activities carried on by the assessee*.** *There may be several parameters e.g. turnover, profits or capital employed with reference to which a finding can be recorded as to what was the principal business said to be carried on by the assessee in a given set of facts.*

The dominant nature of the business of an entity was the deciding factor to determine whether it will be classified as a 'credit institution' or not. The predominance was in turn determined based on several quantitative as well as qualitative factors.

RBI's administrative guidelines

Press Release 1998-99/1269 dated April 8, 1999 laid down the following-

> *"...in order to identify a particular company as a non-banking financial company (NBFC), it will consider both, the assets and the income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from financial assets should be more than 50 per cent of the gross income. Both these tests are required to be satisfied as the determinant factor for principal business of a company."*

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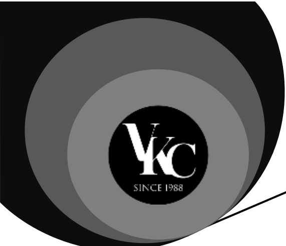
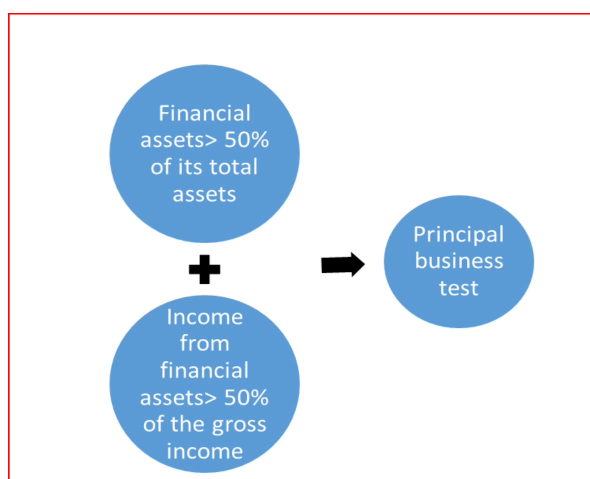
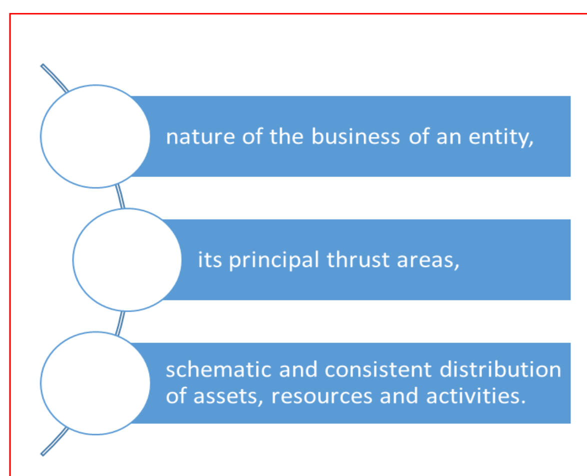
6 https://indiankanoon.org/docfragment/345521/?formInput=principal%20business%20activity



In another circular issued by RBI in 2006[7], the aforesaid Press Release was in a way revived from its ashes by the RBI, and a new credential was given to it in form of requirement of an annual certificate to be given by the auditor of the NBFC in support of commencement/ continuance of business of NBFI and fulfilling the criteria of "principal business".[8]

Quantitative factors **Qualitative factors**



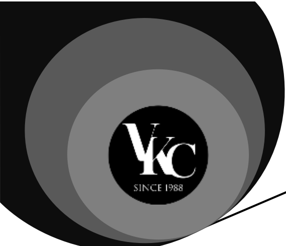


The term financial asset for this purpose includes the following – a) bank deposits including fixed deposits, saving deposits, recurring deposits and current deposits; b) Deposits with NBFCs; c) Structured Investment Product (SIP); d) Commercial Paper (CP); e) Certificate of Deposit (CD); f) Government Securities (Tradable); g) Equity Shares; h) Bonds; i) Debentures; j) Mutual Fund Units; k) ETFs; l) Indian Depository Receipts; m) CIS (Collective Investment Schemes) units; n) Alternate Investment Funds (AIF) units; o) Insurance Policies; p) Balances under the National Pension System (NPS); q) Units of Infrastructure Investment Trusts; r) Units of Real Estate Investment Trusts; Any other asset as may be identified by the Bank for the purposes of these directions, from time to time.
Further, it was also clarified by the RBI[9] that investments in fixed deposits cannot be treated as financial assets and receipt of interest income on fixed deposits with banks cannot be treated as income from financial assets as these are not covered under the activities mentioned in the definition of "financial Institution" in Section 45I(c) of the RBI Act 1934. Besides, bank deposits constitute near money and can be used only for temporary parking of idle funds, and/or in the above cases, till commencement of NBFI business.

Fair value changes and principality criteria

The key inspiration one gets from the legal precedents above is that principality of business is not something which can fit into strict mathematical tests. At the same time, the RBI could

[7] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=3128&Mode=0
[8] Definition of NBFCs – concept of Principality of business: This article by Payel Jain, then of Vinod Kothari & Company, discusses the definition of NBFCs and RBI circular requiring a certain percentage of assets and income, and was published in Chartered Secretary, August 2010.
[9] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=7063&Mode=0



not have left the determination entirely to subjectivity –hence, the RBI has chosen the twin criteria of principality of income and assets.

Changes in fair value occur due to directional movement in prices of listed securities, and value of unlisted securities. None of these have any contribution of the investor. Assume an investor, having turnover from real sector activities of Rs 200, and real sector assets of Rs 400, invests the surplus of Rs 100 in financial assets (say equities), such that the balance sheet of the investor looks as follows:

Real assets	400
Financial assets at cost	100
Total	500
Equity	100
Reserves and surpluses	200
Liabilities	200
Total	**500**

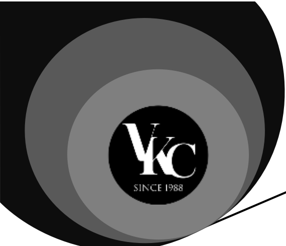
Assume, after 2 years of making the investment, the equities have appreciated in value to Rs 500, and the entity is required to fair value the equities through P/L account (see discussion below). Hence, the balance sheet emerges as follows:

Real assets (ignoring depn)	400
Equities at fair value	500
Total	900
Equity	100
Reserves and surpluses (including gain on equity)	600
Liabilities	200
Total	**900**

On the P/l account too, if the valuation gain of Rs 400 is routed through the P/l account, the gain will exceed the turnover from real sector. Hence, both by assets and income, the entity satisfies the principality criteria.

However, let us raise the basic question – the entity was carrying real sector activity all along. It continues to carry the same activity still. The gain on valuation of equity is a either a short term spike or may be a sustainable long term appreciation. In either case, how is it, that by a mere gain on a passive investment, the real sector activity of the company may be allowed to eclipse by the gain on an investment? Is it proper to say, that without doing anything at all, the entity has automatically slipped from being a real sector entity to a financial sector entity?

When IFRS/IndASes were not around, the RBI had fixed the criteria of principality based on the balance sheet. It had fixed the dual tests of financial assets and income. The financial



assets would indicate the extent of exposure the entity had in the financial sector, and the financial income indicates the accomplishment from the exposure. Mere exposure without accomplishment is inconsequential, and mere accomplishment without exposure is non-indicative of any commitment to the sector.

With the advent of IndASes, the balance sheet value of the financial assets does not indicate the extent of exposure – rather, it indicates the current value of the exposure. Likewise, the income statement does not indicate the realised or accrued gains – it reflects fair value changes, which, by very nature, may be completely transient.

Therefore, it is clear that one cannot attach the same value to financial statements under the IFRS regime as used to do under the IGAAP regime. At the same time, it is not possible to completely disregard the financial statements, lest entities should be burdened with the task of preparation of multiple statements, which would be cumbersome bordering on impracticality.

Whether OCI a relevant criteria for determination of composition of income?

One of the significant changes made by IFRS is the introduction of "other comprehensive income", as the lower tier of the conventional profit and loss a/c, for computation of what is now called "total comprehensive income".

"Other comprehensive income" is a part of "total comprehensive income". TCI is defined as "*Total Comprehensive Income is the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners."*

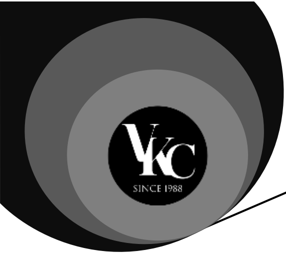
OCI is defined as "*Other comprehensive income (OCI) comprises items of income and expense (including reclassification adjustments) that is not recognized in profit or loss as required or permitted by other IFRSs."*

It is well understood that OCI is an addition to net income. That is, we determine the income/profits for the year, and then we go to the items of OCI. OCI by nature consists of those items which are non-current in nature. They do not reflect the results of the enterprise – they are simply changes in valuations, which may change the "total comprehensive income" of the entity, but not its GAAP income.

Thus, there is no sanctity is considering the items forming part of OCI while considering the principality of income for NBFC characterisation. The items forming part of the OCI remain parked there, and continue to carry from year to year, until they are either re-characterised to P/l account (based on the realisation of the gain/loss) or they are transferred to equity.

OCI gains transferred directly to Equity

When OCI gains are transferred directly to equity, will such gains be regarded as a part of income? It may be noted that the option of transferring OCI gains directly to equity, as per para B5.7.1. of Ind AS 109, is applicable only to an entity who has made an irrevocable



election to present in other comprehensive income changes in the fair value of an investment in an equity instrument that is not held for trading. (Paragraph 5.7.5 of Ind AS 109).

While adapting the regulatory criteria for NBFC determination to IndAS financial statements, it is important to note that there is no way to ensure a perfecting mapping of IndAS financial statements to IGAAP financial statements. Under IGAAP, a realised capital gain would have gone to the Profit and Loss a/c. Under IndAS, based on election by the entity, it is possible to keep equity gains parked into OCI, and upon realisation, transfer the same to equity directly. Now, the question comes, if such an accumulated gain, sitting all along in the OCI, is, upon de-recognition of the equity investment, transferred direct to equity without routing it through the P/l account, why should such a gain not be a part of the income for NBFC characterisation?

The answer may be as follows: the administrative criteria for NBFC determination is intended to be a quick and handy tool for characterisation. If such a tool leaves room for substantial re-computations, the very purpose of the test is lost.

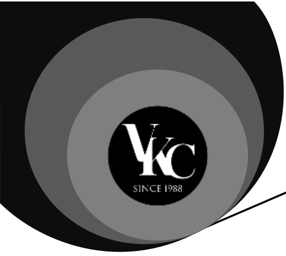
Secondly and significantly, the choice to keep and gains on certain equity investments in the OCI is made share-by-share by the entity. This is an irrevocable choice, made at the time of making of the investment or at the time of initial recognition as per IndAS. The intent in making this choice is that the investment in question is a strategic one, and variations in the value should not be allowed to affect the current earnings. Such a decision is taken by the entity only where the intent is not to cause disposal for a foreseeable future, as it is only in such cases that the fair value changes should not be reported as a part of the earnings. Since the choice is irrevocable, at all times to come, the entity gives up the option of reporting the gains/losses on such investments to current earnings. Therefore, the entity will also not be able to distribute dividends out of such gains. If the entity makes such conscious choice, which may involve several sacrifices on the part of the entity as well, the logical consequence will be that such gains will not be treated as a part of the income for NBFC classification as well.

Fair value of financial assets

Our recommendation above is that changes in fair value, to the extent the same are parked in the OCI and not released to Profit and loss a/c, should not be relevant for NBFC determination. A related question is – does it mean that for applying the financial asset test, the fair value of financial assets should not be taken?

Recently, the MCA has released the format of Schedule III to be adopted by the NBFCs that have transitioned to IndAS[10]. One would notice that the reporting of financial assets, where fair valuation is applicable, moves entirely to fair value information. The historical cost is not to be shown on the balance sheet at all, whether on the face of it, or by way of notes. Since we are not suggested any parallel reporting, one may opine that the balance sheet information may be taken as reported – that is, fair values where fair valuations are carried

[10] Our article on the relevant topic can be read here- http://vinodkothari.com/blog/gist-of-amended-schedule-iii/



out. In fact, for the purpose of consistency, the OCI gains on financial assets should have been removed from balance sheet values too – however, that information, at least for opening values in the balance sheet, will not be available at all. Thus, by way of compromise, the information from the balance sheet may be taken as it is.

The fact that the income test and asset test are cumulative, will assist in preventing an entity for acquiring the character of an NBFC for effortless changes in fair values.

Conclusion

The criteria laid down by the RBI to determine the principal business based on asset-income has been always interpreted in a manner to uphold substance over form. With the implementation of IndAS, the existing NBFCs, based on the new accounting standards, may be disqualified from holding their CoR based on that particular year's financial statement. On the other hand, certain entities may be required to obtain registration with the RBI based on the redrawn financial statements. Though the fair value presentation has only been implemented for reporting purpose, by way of IndAS, it is expected that RBI shall come up with a clarification regarding the financial asset principality test.
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[i] Our relevant articles on related subject can be read here:

- http://vinodkothari.com/nbfc-advisory/
- http://vinodkothari.com/blog/faqs-on-ind-as-116-the-new-lease-accounting-standard/
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