

# 19

# Audit of NBFC

## 19.1 - Basics of NBFC

### NBFC - Intro

- A company whose principal business is of financial activity is classified as NBFC.
- Financial activity will be considered as principal business if the company's financial assets constitute more than 50% of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50% of the gross income.

### Registration & regulation of NBFC

- Sec. 45-IA of RBI (Amendment) Act, 1997 provides that no NBFC is allowed to commence or carry on the business of a NBFC without
  - (a) obtaining a certificate of registration issued by the RBI; and
  - (b) having net owned fund of ₹ 25 lakh or such other amount, not exceeding ₹ 100 crore, as notified by RBI.

**Note: Net Owned funds as prescribed for this purpose is ₹ 200 lakhs.**
- Registration is required where the financing activity is a principal business.
- To obviate dual regulation, certain NBFC which are regulated by other regulators are exempted from requirement of registration.

### Types of NBFC

- (a) Investment and Credit Company (ICC).
- (b) Infrastructure Finance Company.
- (c) Systemically Important Core Investment Company.
- (d) Infrastructure debt Fund-NBFC.
- (e) NBFC-Micro Finance Institution.
- (f) Non-Banking Financial Company – Factors.
- (g) Non-Operative Financial Holding Company.

### Prudential Norms

|                                 |   |
|---------------------------------|---|
| <b>Capital Requirement</b>      | <ul style="list-style-type: none"> <li>• Every NBFC shall maintain a capital ratio consisting of Tier I &amp; Tier II capital of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items, which shall not be less than 15%.</li> <li>• Tier I Capital shall not be less than 10%.</li> </ul>  |
| <b>Income Recognition</b>       | <ul style="list-style-type: none"> <li>• It shall be based on recognised accounting principles.</li> <li>• In case of NPA, income including interest/discount/hire charges etc. shall be recognised only when actually realised.</li> <li>• Any income recognised before the asset became NPA and remaining unrealised shall be reversed.</li> </ul>  |
| <b>Asset Classification</b>     | <p>Every NBFC shall, classify its loans and advances and any other forms of credit into the following classes, namely:</p> <ol style="list-style-type: none"> <li>(a) Standard assets;</li> <li>(b) Sub-standard assets;</li> <li>(c) Doubtful assets; and</li> <li>(d) Loss assets.</li> </ol>   |
| <b>Non-Performing Assets</b>    | <ol style="list-style-type: none"> <li>(a) Asset, in respect of which, interest remained overdue for <math>\geq 6</math> months*;</li> <li>(b) Term loan inclusive of unpaid interest, when instalment is overdue for <math>\geq 6</math> months* or on which interest amount remained overdue for <math>\geq 6</math> months*;</li> <li>(c) demand or call loan, which remained overdue for <math>\geq 6</math> months* from the date of demand or call or on which interest amount remained overdue for <math>\geq 6</math> months*;</li> <li>(d) a bill which remains overdue <math>\geq 6</math> months*;</li> <li>(e) the interest in respect of a debt or the income on receivables under head 'other current assets' in the nature of short term advances, which facility remained overdue for <math>\geq 6</math> months*;</li> <li>(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for <math>\geq 6</math> months*;</li> <li>(g) the lease rental and hire purchase instalment, which has become overdue for a period of <math>\geq 12</math> months*.</li> </ol> <p><i>*3 Months in case of NBFC-SI-Non deposit &amp; deposit taking Co.</i></p> |
| <b>Provisioning Requirement</b> | <ul style="list-style-type: none"> <li>• <b>Standard Assets</b> – 0.40%</li> <li>• <b>Sub-Standard Assets</b> – 10%</li> <li>• <b>Doubtful Assets:</b> Unsecured portion - 100%</li> <li>• <b>Doubtful Assets:</b> Secured Portion – 20% (One year), 30% (one to three years), 50% (&gt;3 years).</li> <li>• <b>Loss Assets</b> – 100%.</li> </ul>  |

## 19.2 – Audit Procedures and Classification of Fraud

### Aspects of Audit Procedure

|                                       |  |
|---------------------------------------|--|
| <b>Ascertain the business of NBFC</b> | Study the following:<br>MOA & AOA<br>Business Policies<br>Minutes of Board/Committee meetings  |
| <b>Evaluation of I.C. System</b>      | <ul style="list-style-type: none"> <li>• Examine whether Internal Control exist, effective and continued.</li> <li>• Review the effectiveness of system of recovery and periodical review of advances.</li> </ul>  |
| <b>Registration</b>                   | Obtain a copy of certificate of registration granted by the RBI  |
| <b>Public Deposit Directions</b>      | <ol style="list-style-type: none"> <li>1. <b>Credit Rating:</b> Obtain a copy of credit rating assigned to NBFC.</li> <li>2. <b>Interest and Brokerage payments:</b> To ensure that it is not paid in excess.</li> <li>3. <b>Written application:</b> Ensure that deposits has accepted with written application.</li> <li>4. <b>Deposit register:</b> Examine that correct particulars entered in the register.</li> <li>5. <b>Repayment of deposits:</b> Examine regularity of repayment of deposits on due date.</li> <li>6. <b>Custody of investments:</b> Obtain certificate that investments are kept in safe custody.</li> <li>7. <b>Submission of accounts:</b> Audited accounts, F.S. &amp; Auditor's report submitted on time.</li> <li>8. <b>Filing of annual return:</b> Annual Return is filed in specified time.</li> <li>9. <b>Board Resolution in case of non-acceptance of deposits.</b></li> </ol> |
|                                       | <b>Change of credit rating</b> <ul style="list-style-type: none"> <li>• In the event of downgrading of credit rating, NBFC will have to reduce its public deposits in accordance with revised credit rating within specified time frame and informed the same to the RBI in writing.</li> <li>• If credit rating in as of Investment Credit Company (ICC) is downgraded below the minimum specified investment grade, ICC, shall regularise excess deposit as below:               <ol style="list-style-type: none"> <li>(a) with immediate effect, stop accepting fresh public deposits and renewing existing deposits;</li> <li>(b) all existing deposits shall run off to maturity; and</li> <li>(c) report the position within 15 working days, to the Regional Office of RBI where the NBFC is registered.</li> </ol> </li> </ul>  |
| <b>Prudential Norms</b>               | <ol style="list-style-type: none"> <li>1. Verification of compliance of prudential norms w.r.t.           <ul style="list-style-type: none"> <li>• Income recognition</li> <li>• Income from investments</li> <li>• Asset classification</li> <li>• Capital Adequacy norms</li> <li>• Granting loan against own shares</li> <li>• Norms for concentration of credit</li> </ul> </li> <li>2. <b>Policy for granting Demand loans:</b> has been framed by BOD.</li> <li>3. <b>Classification of advances:</b> Has been made in accordance with the directions.</li> <li>4. <b>Income from NPA:</b> Ensure that income from NPA has not been recognized.</li> <li>5. <b>Recovery from NPA:</b> Check the recovery made in the NPAs account.</li> </ol>  |

### Classification of Frauds

In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of IPC:

- (a) Misappropriation and criminal breach of trust.
- (b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts.
- (c) Unauthorised credit facilities extended for reward or for illegal gratification.
- (d) Negligence and cash shortages (Only if the intention to cheat/defraud is suspected/proved). If fraudulent intention is not suspected/proved, at the time of detection, cases of negligence and cash shortage will be treated as fraud and reported, if:
  - Cash shortages are more than Rs. 10,000/- and
  - Cash shortages are more than Rs. 5000/- and detected by management/auditor/inspecting officer and not reported on the occurrence by the persons handling cash.
- (e) Cheating and forgery.
- (f) Irregularities in foreign exchange transactions (only if the intention to cheat/ defraud is suspected/proved).
- (g) Any other type of fraud not coming under the specific heads as above.

## 19.3 – Audit Check List in case of NBFC – Investment and Credit Company

| Points related to investment  | Points related to Credit   |
|---|--|
| <ul style="list-style-type: none"> <li> <p><b>• Physical Verification:</b><br/>Auditor should physically verify the securities held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.</p> </li> <li> <p><b>• Income recognition:</b><br/>Verify that dividend income wherever declared by a company, has been duly received and accounted for. NBFC Prudential Norms directions require dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its AGM and its right to receive the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.</p> </li> <li> <p><b>• Authorisation:</b><br/>Verify the Board Minutes for purchase and sale of investments.</p> </li> <li> <p><b>• Classification:</b><br/>Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.</p> </li> <li> <p><b>• Valuation:</b><br/>Check whether the investments have been valued in accordance with the NBFC Prudential Norms Directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.</p> </li> <li> <p><b>• Compliance of AS 13:</b><br/>Ascertain whether the requirements of AS 13 “Accounting for Investments” or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.</p> </li> <li> <p><b>• External Confirmations:</b><br/>In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC. Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.</p> </li> </ul> | <ul style="list-style-type: none"> <li> <p><b>• Sanctioning:</b><br/>Examine whether each loan or advance has been properly sanctioned. Verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.</p> </li> <li> <p><b>• Security:</b><br/>Verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. Ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.</p> </li> <li> <p><b>• Loan against own shares:</b><br/>Verify whether the NBFC has not advanced any loans against the security of its own shares.</p> </li> <li> <p><b>• Compliance of prudential norms:</b><br/>Check whether the NBFC has not lent/invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms Directions.</p> </li> <li> <p><b>• Appraisal and follow up System:</b><br/>Verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.</p> </li> <li> <p><b>• Classification:</b><br/>Check the classification of loans and advances (including bills purchased and discounted) made by a NBFC into Standard Assets, Sub-Standard Assets, Doubtful Assets and Loss Assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.</p> </li> </ul> <div style="text-align: center; border: 1px solid black; background-color: yellow; padding: 5px; margin-top: 10px;"> <p><i>Compiled by: CA. Pankaj Garg</i></p> </div> |

## 19.4 – NBFC Auditor’s Report (Reserve Bank) Directions, 2016

|               |  |   |
|---------------|--|---|
| <b>Para 3</b> | <b>All NBFC</b>  | <ol style="list-style-type: none"> <li>Whether the company has obtained a Certificate of Registration (CoR) from the Bank (RBI).</li> <li>In case the company holding CoR issued by the Bank, whether company is entitled to continue to hold CoR in terms of its asset/income pattern.</li> <li>Whether NBFC is meeting the required net owned funds requirement as laid down in directions issued by RBI.</li> </ol>  |
|               | <b>NBFC accepting Public Deposits</b>                                | <ol style="list-style-type: none"> <li>Whether public deposits accepted by the company are within the limits as per NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 2016;</li> <li>Whether the public deposits held in excess of permissible amount are regularised.</li> <li>Whether the NBFC is accepting "public deposit" without minimum investment grade credit rating from approved agency;</li> <li>Whether the Capital Adequacy Ratio as disclosed in the return submitted to the Bank has been correctly determined.</li> <li>Whether the credit rating, for each of the fixed deposits schemes that has been assigned by Credit Rating Agencies (a) is in force; and (b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by Credit Rating Agency;</li> <li>Whether company has violated any restriction on acceptance of public deposit as provided in NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 2016.</li> <li>Whether the company has defaulted in paying to its depositors the interest and /or principal amount of the deposits after it became due;</li> <li>Whether the company has complied with the prudential norms on income recognition, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments.</li> <li>Whether the company has complied with the liquid assets requirement as prescribed.</li> <li>Whether the company has furnished to the Bank within the stipulated period the return on deposits.</li> <li>Whether the company has furnished to the Bank within the stipulated period the quarterly return on prudential norms.</li> <li>Whether, in the case of opening of new branches or offices to collect deposits or in the case of closure of existing branches/offices or in the case of appointment of agent, the company has complied with the requirements.</li> </ol> |
|               | <b>NBFC not accepting public deposits</b>                            | <ol style="list-style-type: none"> <li>Whether the BOD has passed a resolution for non-acceptance of any public deposits.</li> <li>Whether the company has accepted any public deposits during the relevant period/year</li> <li>Whether the company has complied with the prudential norms relating to income recognition, asset classification and provisioning for bad and doubtful debts.</li> <li>In respect of Systemically Important Non-deposit taking NBFCs:               <ol style="list-style-type: none"> <li>whether the capital adequacy ratio as disclosed in the return submitted to the Bank, has been correctly arrived at; and</li> <li>whether the company has furnished to the Bank the annual statement of capital funds, risk asset ratio within the stipulated period.</li> </ol> </li> <li>Whether the NBFC has been correctly classified as NBFC Micro Finance Institution.</li> </ol>   |
| <b>Para 4</b> | <b>Reasons to be stated for unfavourable or qualified statements</b> | <ul style="list-style-type: none"> <li>Where, in the auditor’s report, the statement regarding any of the items referred to in paragraph 3 above is unfavourable or qualified, the auditor’s report shall also state the reasons for such unfavourable or qualified statement, as the case may be.</li> <li>Where the auditor is unable to express any opinion on any of the items referred to in paragraph 3 above, his report shall indicate such fact together with reasons therefore.</li> </ul>  |
| <b>Para 5</b> | <b>Exception Report</b>  | <p>Where, in the case of a NBFC, the statement regarding any of the items referred to in Para 3, is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:</p> <ol style="list-style-type: none"> <li>the provisions of Chapter III B of Reserve Bank of India Act, 1934; or</li> <li>the NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or</li> <li>NBFC–Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and NBFC-Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016</li> </ol> <p>it shall be the obligation of auditor to make a report containing details of such unfavourable/qualified statements and non-compliance in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the Bank under whose jurisdiction the registered office of the company is located.</p>  |

## 19.5 – Miscellaneous – CARO, Ind-AS, Schedule III

### Compliance with CARO – Para 3 (xvi)

#### Reporting Requirement

Clause (xvi) of Para 3 of CARO requires the company auditor to report

- Whether the company is required to be registered u/s 45-IA of the RBI Act, 1934 and if so,
- whether the registration has been obtained”

#### Related Provisions

- Sec. 45-IA of RBI (Amendment) Act, 1997 provides that no NBFC is allowed to commence or carry on the business of a NBFC without obtaining a certificate of registration from RBI.
- Registration is required if the financing activity is a principal business of the company.
- Financial activity will be considered as principal business if the company's financial assets constitute more than 50% of the total assets and income from financial assets constitute more than 50% of the gross income.
- This test is popularly known as 50-50 test.

#### Audit Procedure and Reporting

- (i) Examine the transactions of the company with relation to the activities covered under the RBI Act and directions to determine whether it is engaged in financial activity.
- (ii) Examine the F.S. to ascertain whether financial assets constitute more than 50% of total assets & income from financial assets constitute more than 50% of the gross income.
- (iii) Ascertain whether the net owned funds of the company exceed such amount so as to require the company to get itself registered as NBFC with RBI.
- (iv) Ascertain whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.
- (v) Auditor's Report under CARO shall incorporate the following:
  - ⇒ Whether the registration is required under section 45-IA of the RBI Act, 1934.
  - ⇒ If so, whether it has obtained the registration.
  - ⇒ If the registration not obtained, reasons thereof.

### Applicability of Ind-AS

As per Rule 4 (1)(iv) of the Companies (Ind AS) Rules, 2015, NBFCs are required to comply with Ind AS as under-

- (i) **Accounting periods beginning 1 April 2018:**  
Listed and unlisted NBFCs having a net worth of ₹ 500 crore or more and holding, subsidiary, joint venture or associate companies of such NBFCs;
- (ii) **Accounting periods beginning 1 April 2019:**  
All other listed NBFCs, unlisted NBFCs having a net worth of ₹250 crore or more but less than ₹ 500 crore and holding, subsidiary, joint venture or associate companies of such NBFCs.

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### Schedule III

#### Division of Schedule III

- Schedule III to the Companies Act, 2013 has been divided into three divisions vide notification dated 11.10.2018.
- Division I deals with F.S. for a company whose F.S. are required to comply with the Companies (AS) Rules, 2006.
- Division II deals with F.S. for a company whose F.S. are drawn up in compliance of the Companies (Ind AS) Rules, 2015.
- Division III deals with F.S. for a NBFC whose F.S. are drawn up in compliance of the Companies (Ind AS) Rules, 2015.

#### Differences between Division II and Division III

Presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent except for the following:

- (a) NBFCs have been allowed to present the items of the balance sheet in order of their liquidity which is not allowed to companies required to follow Division II. Additionally, NBFCs are required to classify items of the balance sheet into financial and non-financial whereas other companies are required to classify the items into current and non-current.
- (b) An NBFC is required to separately disclose by way of a note any item of 'other income' or 'other expenditure' which exceeds 1% of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1% of the revenue from operations or ₹10 lakhs, whichever is higher.
- (c) NBFCs are required to separately disclose under 'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member.
- (d) NBFCs are also required to disclose items comprising 'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss instead of showing those only as part of the notes.
- (e) Separate disclosure of trade receivable which have significant increase in credit risk & credit impaired.
- (f) The conditions or restrictions for distribution attached to statutory reserves have to be separately disclose in the notes as stipulated by the relevant statute.