

10 NBFC Audit

Definition

- A Financial Institution which is a Company
- A non-banking institution (NBI) which is a Co. & principal business receiving deposits & lending
- Such other institution as RBI may with approval of CG & notification in official gazette specify

Co.= NBFC, if,

Financial Assets (FA) > 50% of total assets (netted off by intangible assets) & Income from FA > 50% of gross income. If both criteria fulfilled, qualify as NBFC & registered with RBI.

Compulsory Registration

Sec 45 IA of RBI Act 1997, no NBFC can do business of Non-Banking Financial Institution without

- Certificate of Registration (CoR) issued by RBI
- **Minimum Net owned Funds (NoF) of 2 Cr.**

NBFC Classification [Amendment]

NBFC classification based on **4 layers** based on their size, activity, and perceived riskiness.

Base Layer shall comprise of

- non-deposit taking NBFCs **below asset size of ₹1000 cr** &
- NBFCs undertaking following activities-
 - NBFC-Peer to Peer Lending Platform (NBFC-P2P),
 - NBFC-Account Aggregator (NBFC-AA),
 - Non-Operative Financial Holding Company (NOFHC) and
 - NBFCs not availing public funds and not having any customer interface.

Middle Layer shall consist of

- all **deposit taking NBFCs** (NBFC-Ds), irrespective of asset size,
- non-deposit taking NBFCs with **asset size of ₹1000 crore and above** and

(c)	NBFCs undertaking the following activities
	(i) Standalone Primary Dealers (SPDs),
	(ii) Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFCs),
	(iii) Core Investment Companies (CICs),
	(iv) Housing Finance Companies (HFCs) and
	(v) Infrastructure Finance Companies (NBFC-IFCs).
	Upper Layer
	NBFCs which are specifically identified by RBI warranting enhanced regulatory requirement based on a set of parameters and scoring methodology as provided in Appendix to this circular. Top 10 eligible NBFCs in terms of their asset size shall always reside in upper layer, irrespective of any other factor.
	Top Layer
	It'll ideally remain empty. This layer can get populated if RBI is of opinion that there is substantial increase in potential systemic risk from specific NBFCs in Upper Layer. Such NBFCs shall move to Top Layer from Upper Layer.
	Spl Points:
a)	NBFC-P2P, NBFC-AA, NOFHC and NBFCs w/o public funds and customer interface will always remain in Base Layer.
b)	NBFC-D, CIC, IFC and HFC will be included in Middle Layer or Upper Layer (not in Base layer), as case may be. SPD and IDF-NBFC will always remain in Middle Layer.
c)	Remaining NBFCs, <ul style="list-style-type: none"> • Investment and Credit Companies (NBFC-ICC), • Micro Finance Institution (NBFC-MFI), NBFC-Factors and • Mortgage Guarantee Companies (NBFC-MGC) could lie in any of layers of regulatory structure depending on parameters.
d)	Government owned NBFCs → Base Layer or Middle Layer. Not in Upper Layer till further notice.

	Cos exempt from RBI registration (Doing financial business but regulated by other regulators)
•	Housing Fin Institution (regulated by NHB)
•	Merchant banking cos. (SEBI)
•	Stock ex. (sebi)
•	Stock broking/sub-broking(sebi)
•	Venture cap fund (SEBI)
•	Nidhi (MCA, GOI)
•	Insurance (IRDA)
•	Chit (Chit fund Act)
•	Alt Inv Fund Cos.
•	Mutual Benefit Cos.
•	Mortgage Guarantee Cos.
•	Core investment Cos with asset size <100 Cr & other that are not accessing public funds

Diff b/w Bank & NBFC

a.	NBFC can't accept DD, but some NBFC can accept Term Deposits
b.	NBFCs don't form part of payment & settlement system & can't issue cheques drawn on itself
c.	Deposit insurance facility of DICGC not available to depositors of NBFC unlike banks
d.	No min. exposure to priority sector in case of NBFC

Prudential Norms

	Capital Adequacy Ratio
•	Min capital ratio consisting of tier I & II capital not less than 15% of agg. Risk weighted assets
•	Tier I not less than 10% at any point of time. In case of lending against Gold jewellery (such loans >= 50% of financial assets) → min tier I cap 12%

Risk Weights

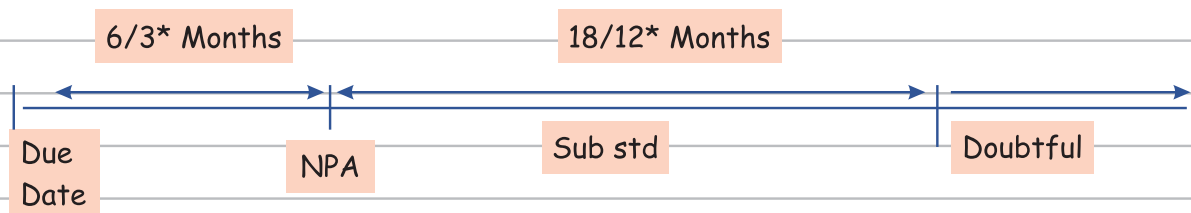
Nos	Head	Weight
1	Cash Bank	0

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2	Approved securities	0
3	Loan & advances fully secured + loans to employees	0
4	TDS Deducted	0
5	Advance tax	0
6	Intt on Govt security	0
7	Fund based claims on CG	0
8	CG Guarantee claims	0
9	SG securities	0
10	SG guarantee claims, not in default > 90 days	20
11	Bonds of PS Banks	20
12	Post commercial operations date (PCOD) projects exist over 1 yr operation	50
13	Others	100

1 **Income Recognition:** Based on recognised accounting principles. Income on NPAs to be recognised on realisation basis. Any such income, which was recognised before asset became NPA & is unrealised Reversed

Asset Classification:



*3/12 months in case of NBFC - ML/UL

Spl point for NPA: The lease rental and hire purchase instalment, which has become overdue for period of 12 months or more; (NBFC NBFC - ML/UL its 3 months only)

Provisioning:

Loss Assets: 100%

Doubtful Assets: Unsecured 100%

	for which Secured Asset has been	% of Provision
	considered as doubtful	
	Up to 1 year	20
	1-3 years	30
	More than 3 years	50
	Sub std asset: 10%	
	Std asset: 0.40% for NBFC- ML/UL & 0.25% for NBFC- BL	
	Audit Procedures	
1.	Ascertaining business of Co	
	<ul style="list-style-type: none"> • Check MOA & AOA (Memorandum & Articles) • Check business policy to ascertain main business of co. • Minutes of Board Meeting & discuss with top level mgt 	
2.	Evaluation of Internal Control System	
	<ul style="list-style-type: none"> • Understand a/c system & related internal controls • Review effectiveness of system of recovery • Periodical review of advances facilitate monitoring & follow up 	
3.	Registration with RBI	
	<ul style="list-style-type: none"> • Sec 45 IA, min Net owned fund of 2 cr • Obtain copy of Certificate of Reg, or copy of application • If NBFC holds Public Deposits then it should invest % in liquid assets as per RBI • Qtr return filed with RBI maintenance of liquid assets 	
4.	NBFC Acceptance of Public Deposit Directions (NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 2016)	
	<ul style="list-style-type: none"> i) Check NBFC appropriately classified. ii) Ceiling on quantum of deposits as per credit rating by approved credit rating agency <ul style="list-style-type: none"> • Obtain copy of cr. Rating & check PD as per the rating assigned • In event of up/downgrading → increase/decrease deposits → inform RBI 	
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•	If downgraded below min investment grade, regularise excess deposits as under:
	◇ Not accept fresh deposits & not renew existing ones
	◇ Existing deposits run off till maturity
	◇ Report within 15 days to Reg. office of RBI where its regd
	◇ no matured public deposit shall be renewed without express and voluntary consent of depositor
	ii) test check interest calculations, to check no excess intt paid
	iii) Acceptance/renewal only after written application from depositor on form supplied by NBFC
	iv) Verify deposit register & test check particulars with supporting receipts
	v) Check investments in liquid assets in safe custody with scheduled comm. Bank
	vi) Check filed prescribed returns in timely manner
	viii) NBFC not accepting/holding PD → BR passed
5.	NBFC Prudential Norms
i)	Check compliance with prudential norms (income recognition, a/c stds, asset classification, PDD, capital adequacy norms, prohibition of grant in loans against own shares)
ii)	Ensure BOD granting/ intending to grant demand/call loans shall frame & implement policy for Co.
iii)	Assess compliance with prudential norms advance properly classified as std, sub std, doubtful & loss assets & proper provisions made
iv)	In case of NPA → unrealised income not taken to p&l on accrual basis
v)	A/cs classified as NPA in previous year continue shown as such in CY also. If made regular, check with directions.
	Classification of Frauds by NBFC
(a)	Misappropriation & criminal breach of trust
(b)	Fraudulent encashment through forged instruments, manipulation of Books of a/c or fictitious a/cs
(c)	Unauthorised cr. Facilities extended for reward or illegal gratification
(d)	Negligence & cash shortages

(e)	Cheating & forgery
(f)	Irregularities in forex transn.
	Any other type of fraud
	<u>Case of (d) & (f) to be reported as fraud if intention proved/suspected.</u>
	In following cases it'll be fraud:
◇	Cash shortage > 10,000 &
◇	Cash shortage > 5,000 if detected by mgt/auditor/inspector & not reported by cashier.
Audit Check list -- NBFC - Investment and Credit Company (NBFC-ICC)	
(i)	Physically verify all shares & securities held by NBFC.
(ii)	Verify no loan advanced against security of its own shares .
(iii)	Verify dividend income wherever declared received by NBFC & interest wherever due (except NPA) accounted for.
(iv)	Dividend income on shares & units of MF recog. on cash basis.
(v)	Test check bills/contract notes recd from brokers with reference to prices vis-à-vis stock mkt quotations on respective dates.
(vi)	Verify Board minutes for purchase & sale of investments. Ascertain from BR long term/short term.
(vii)	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.
(viii)	Check whether requirements of AS 13 "Accounting for Investments" have been complied with.
(ix)	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.
Auditor's duty to Report	
(A)	In case of all NBFCs
I.	Examine whether Co. obtained CoR (Certificate of Registration)
II.	In case Co. holding CoR whether its entitled as per principal business criteria as on 31 st March of year.
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III.	Whether its meeting NOF criteria laid down in master direction
	Note: A certificate from Auditor required within 1 month of finalization of Balance Sheet not later than Dec 30th of year.
(b)	<u>NBFC holding/accepting public deposits</u>
i)	Whether PD held by it with other borrowings within limits of provisions of NBFC Acceptance of Public Deposits (RB) Directions, 2016
ii)	Whether PD in excess of permissible quantum, to be regularised in manner provided in Directions
iii)	Whether its accepting PD w/o min investment grade rating from approved institution as per Directions
iv)	Whether Cap Adequacy Ratio(CAR) correctly determined & compliance with min CRAR prescribed therein
v)	Whether Co has made default in paying intt/principal after they became due
vi)	Whether Co. has furnished to RBI within stipulated period return on deposits as specified in NBS 1 to - NBFC Returns (Reserve Bank) Directions, 2016;
vii)	Whether Co. has complied with Liquid Assets requirement & details of designated bank where securities are kept i.e. NBS-3 return filed with RBI
(C)	<u>NBFC not accepting deposits</u>
i)	BOD passed BR non-accept of deposits
ii)	Whether Co accepted any deposits during year
iii)	Whether Co. complied with prudential norms (I/R, a/c std, Asset classification, PDD)
iv)	In respect of NBFC - ML/UL
	(a) Whether capital adequacy ratio disclosed in NBS-7 correctly arrived & compliant with min CRAR
	(b) Whether Co has furnished to RBI, annual statement of capital funds, risk asset ratio in NBS 7
v)	Whether NBFC correctly classified as NBFC Micro Finance Institution (MFI) as per the Directions

Reasons for Unfavourable/ Qualified statements	
	Where, in auditor's report, statement regarding any of items referred to in paragraph 3 is unfavourable or qualified, auditor's report shall also state reasons for such unfavourable or qualified statement, as case may be. Where auditor is unable to express opinion on any of items referred to in para 3, report shall indicate such fact together with reasons therefor.
Obligation of auditor to submit an exception report to the RBI	
(I)	Where, in case of a NBFC, statement regarding any of items referred to in para 3 above, is unfavourable or qualified, or in opinion of auditor company has not complied with: <ul style="list-style-type: none"> a) provisions of Chapter III B of RBI Act (Act 2 of 1934); or b) NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or c) NBFC- Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016. <p>It shall be obligation of auditor to make report containing details of unfavourable or qualified statements and/or about non-compliance in respect of company to concerned Regional Office of Department of Non-Banking Supervision of RBI under whose jurisdiction regd office of company is located as per first Schedule to NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 2016.</p>
(II)	The duty of Auditor under sub-para (I) shall be to report only contraventions of provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub- paragraph (1) and such report shall not contain any statement with respect to compliance of any of provisions.
<u>Difference b/w Division II (Ind AS- Other than NBFC) & Division III (Ind AS NBFC) of Schedule III</u>	
a)	NBFC allowed present items of b/sheet in order of liquidity .
b)	NBFC shall disclose by way of note item of 'other income/expense' > 1% of total income. Division II requires disclosure of item > 1% of Revenue or 10 L (whichever is higher)
c)	NBFC separately disclose under receivables debt due from LLP where Director is partner/member

d)	Disclose items comprising Revenue from operations & other income on face of SPL instead of only notes
e)	Separate disclosure of T/R significant increase in cr risk or cr impaired
f)	Conditions or restrictions for distribution attached to stat reserves to be separately disclosed in notes
	<u>Ind AS Applicability: Accounting period beginning</u>
	1.4.18: NW 500 Cr or more
	1.4.19: NW 250 Cr or more
	CARO 2020 Reporting
	As per CARO 2020, auditor is required to report that -
I.	(a) Whether during year company has made investments in, provided any guarantee or security or granted any loans or advances in nature of loans, secured or unsecured, to companies, firms, LLPs or other parties, If so,
	(b) whether investments made, guarantees provided, security given and terms and conditions of grant of all loans and advances in nature of loans and guarantees provided are not prejudicial to company's interest;
	(c) in respect of loans and advances in nature of loans, whether schedule of repayment of principal and payment of interest has been stipulated and whether repayments or receipts are regular;
	(d) if amount is overdue, state total amount overdue for more than 90 days, and whether reasonable steps have been taken by company for recovery of principal and interest;
	(f) whether company has granted any loans or advances in nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify aggregate amount, percentage thereof to total loans granted, aggregate amount of loans granted to Promoters, related parties; [Paragraph 3(iii)]
(II)	(a) Whether company is required to be registered under section 45-IA of RBI Act, 1934 and if so, whether registration has been obtained.
	(b) Whether company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from RBI as per the RBI Act, 1934;
	(c) Whether company is a Core Investment Company (CIC) as defined in regulations made by RBI, if so, whether it continues to fulfil criteria of a CIC, and in case company is an

	exempted or unregistered CIC, whether it continues to fulfil such criteria;
(d)	Whether Group has more than one CIC as part of Group, if yes, indicate number of CICs which are part of the Group; [Paragraph 3(xvi)]
	Eg. AF Ltd. is a NBFC and was in business of accepting public deposits and giving loans since 2015. Co. was having net owned funds of ₹1.5 Cr & was not having registration certificate from RBI and applied for it on 30.03.21. The Co. appointed Mr. Kabra as its statutory auditors for the year 2020-21. Advise auditor with reference to auditor procedures to be taken and reporting requirements in view of CARO 2020 ?
	As per Clause (xvi) of Para 3 of CARO 2020, auditor is required to report that "whether the Co. is required to be regd. u/s 45-IA of RBI Act, 1934 and if so, whether registration has been obtained."
	Auditor is reqd to examine whether Co. is engaged in the business which attract the requirements of registration. Registration is required where financing activity is a principal business of Co. RBI restrict companies from carrying on business of a non-banking financial institution without obtaining certificate of registration.
	Audit Procedures and Reporting:
(i)	Auditor should examine transactions of Co. with relation to activities covered under RBI Act and directions related to NBFCs.
(ii)	F.S. should be examined to ascertain whether Co's financial assets constitute more than 50% of total assets and income from financial assets constitute > 50 % of gross income.
(iii)	Whether Co. has net owned funds as required for registration as NBFC.
(iv)	Whether Co. has obtained registration as NBFC, if not, reasons should be sought from management and documented.
(v)	The auditor should report incorporating the following:-
	(1) Whether the registration is required u/s 45-IA of the RBI Act, 1934.
	(2) If so, whether it has obtained the registration.
	(3) If registration not obtained, reasons thereof.
	In given case AF Ltd. is a NBFC and was in business of accepting public deposits and giving loans since 2015. Co.was having net owned funds of ₹1.5 Cr which is less than prescribed limit i.e. 2 Cr & was also not having registration certificate from RBI (thoug applied for it on 30.03.21). Auditor is required to report as per Clause (xvi) of Para 3 of CARO 2020.