Audit of Non Banking Financial Companies

Question 1
What is a Non-Banking Financial Company (NBFC)?

Answer

Definition of Non-Banking Financial Company (NBFC): Section 45-I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

(i) A financial institution which is a company;

(ii) A non banking institution which is a company with principal business of 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 Reserve Bank with the previous approval of the Central Government may specify by notification in the Official Gazette.

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”.

Question 2
What are the different types of NBFCs registered with RBI?

Answer

Categories of Non-Banking Financial Company: In terms of the Section 45-I(f) read with Section 45-I (c) of the RBI Act, 1934, as amended in 1997, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing. Consequent upon to RBI Circular December 6, 2006, companies financing real/physical assets for productive/ economic activity will be classified as Asset Finance Company (AFC) as per the specified criteria. The remaining companies would be continued to be classified as loan/investment companies/Infrastructure Finance Company. In the proposed structure the following categories of NBFCs will emerge:
Currently, NBFCs registered with RBI are being classified as:

- Asset Finance Company (AFC)
- Investment Company (IC)
- Loan Company (LC)
- Infrastructure Finance Company (IFC)
- Core Investment Company (CIC)
- Infrastructure Debt Fund - Non-Banking Financial Company (IDF-NBFC)
- Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI).

**Question 3**

*You are the auditor of IJK Ltd., a NBFC registered with RBI. How would you proceed to ensure the compliance of Prudential Norms directions by it.*

**Answer**

**Compliance of Prudential Norms by NBFC**

(i) The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.

(ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.

(iii) The auditor should verify the classification of advances and loans as standard/substandard/doubtful/loss and that proper provision has been made in accordance with the directions.

(iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to Statement of Profit and Loss.

(v) The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.

**Question 4**

*Enumerate the verification procedures in relation to audit of a Hire-Purchase Finance Company.*

**Answer**

**Verification Procedures in relation to audit of a Hire Purchase Finance company (HPFC):**

(i) Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining
information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.

(ii) Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.

(iii) In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.

(iv) If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.

(v) The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.

(vi) Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.

(vii) Examine the method of accounting followed by the hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.

(viii) Verify that the assets given on hire purchase have been adequately insured against.

(ix) In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

Question 5

Write a short note on the special points that may be covered in the audit of equipment leasing finance company.

Answer

Special Points in the Audit of equipment leasing finance company: The auditor should-

(i) Ascertain whether the Non Banking Financial Companies (NBFC) has an adequate appraisal system for extending equipment leasing finance.

(ii) Verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In some major transactions, arrange for physical verification of the leased assets so as to dispel any doubts that equipment leasing finance was not extended without the corresponding assets being created.
(iii) Ascertain that the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased asset is being carried out by the lessee.

(iv) Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.

(v) Verify whether the Accounting Standard issued by the Institute of Chartered Accountants of India in respect of “Accounting for Lease” has been compulsorily followed.

Question 6

Write a short note on - Classification of frauds by NBFC.

**Answer**

**Classification of Frauds by NBFC:** In order to have uniformity in reporting, frauds have been classified as under -

(i) Misappropriation and criminal breach of trust.

(ii) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

(iii) Unauthorised credit facilities extended for reward or for illegal gratification.

(iv) Negligence and cash shortages.

(v) Cheating and forgery.

(vi) Irregularities in foreign exchange transactions.

(vii) Any other type of fraud not coming under the specific heads as above.

Cases of ‘negligence and cash shortages’ and ‘irregularities in foreign exchange transactions’ referred to in items (iv) and (v) above are to be reported as fraud if the intention to cheat/defraud is suspected/proved. However, the following cases where fraudulent intention is not suspected/proved, at the time of detection, will be treated as fraud and reported accordingly:

(i) cases of cash shortages more than ₹ 10,000/- and

(ii) cases of cash shortages more than ₹ 5000/- if detected by management/auditor/inspecting officer and not reported on the occurrence by the persons handling cash.

NBFCs having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the prescribed format and procedures.

Question 7

You are appointed as the auditor of a NBFC which is an Investment company registered with RBI. What shall be the special points to be covered for the audit of NBFC in case of Investment companies?

**Answer**

**Special points that may be covered in the audit of NBFCs in case of Investment Companies are given below:**
(i) Physically verify all the shares and 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.

(ii) NBFC Prudential Norms stipulates that NBFCs should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. Verify that the credit facilities extended and investments made by the concerned NBFC are in accordance with the prescribed ceiling.

(iii) Verify whether the NBFC has not advanced any loans against the security of its own shares.

(iv) Verify that dividend income wherever declared by a company, has been duly received by a NBFC and interest wherever due [except in case of NPAs] has been duly accounted for.

(v) Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

(vi) Verify the Board Minutes for purchase and sale of investments. 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.

(vii) 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.

(viii) Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.

(ix) Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.

(x) An auditor will have to ascertain whether the requirements of AS 13 “Accounting for Investments” (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

(xi) 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.

(xii) In the case of securities lent/borrowed under the Securities Lending Scheme of SEBI, verify the agreement entered into with the approved intermediary (i.e. the person through whom the lender will deposit and the borrower will borrow the securities for
lending/borrowing) with regards to the period of depositing/lending securities, fees for depositing/lending, collateral securities and provision for the return including pre-mature return of the securities deposited/lent.

(xiii) Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon.)

(xiv) Verify charges received or paid in respect of securities lent/borrowed.

(xv) Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.