AUDIT OF NON-BANKING FINANCIAL COMPANIES

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the definition, regulations and types of NBFCs.
- Difference between Banks and NBFCs.
- Gain the knowledge of the Prudential norms- Capital Requirements, Income Recognition, and Provisioning requirements.
- Know the concepts of Classification of Frauds.
- Learn the audit procedures and Audit Check List for NBFCs.
- Apply & analyse the above-mentioned concepts in moderately complex scenarios.
CHAPTER OVERVIEW

Audit of NBFCs

1. INTRODUCTION

Non-Banking Finance Company sector has evolved considerably in terms of its size, operations, technological sophistication, and entry into new areas of financial services and products. NBFCs are now deeply interconnected with the entities in the financial sector, on both sides of their balance sheets. Being financial entities, they are exposed to risks arising out of counterparty failures, funding and asset concentration, interest rate movement and risks pertaining to liquidity and solvency, as any other financial sector player. At the same time there are segments within the sector that do not pose any significant risks to the system. There is therefore, a felt need to address the risks, without impeding the dynamism displayed by NBFCs in delivering innovation and last mile connectivity for meeting the credit needs of the productive sectors of the economy.

Fig.: Audit of NBFCs

Fig.: NBFCs

* Source: Techno Legal Journalists
* Source: Inventicon

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Further, the RBI (Amendment) Act, 1997 provides for compulsory registration with the Reserve Bank of all NBFCs, irrespective of their holding of public deposits, for commencing and carrying on business, minimum entry point norms, maintenance of a portion of deposits in liquid assets, creation of Reserve Fund and transfer of 20 per cent of profit after tax annually to the Fund. The Amendment Act also conferred powers on Reserve Bank to issue directions to companies and its auditors, prohibit deposit acceptance and alienation of assets by companies and effect winding up of companies.

Accordingly, the Reserve Bank issued directions to companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, exposure norms and other measures to monitor the financial solvency and reporting by NBFCs. Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of directors and shareholders.

**Definition of 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”.

**Fig. : What is NBFC**

* Source: Slideshare
Further, Financial activity as principal business also happens when a company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by RBI.

**Registration and Regulation of NBFC:**

Under Section 45–IA of the Reserve Bank of India (Amendment) Act, 1997, 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.

A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to Reserve Bank of India in prescribed form along with necessary documents for registration. The RBI issues Certificate of Registration after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock Broking Companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi Companies as notified under Section 406 of the Companies Act, 2013, Chit Companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

The Reserve Bank of India has issued directions to non-banking financial companies on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs. Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders.

**Types of NBFCs- Compliance and Regulatory Perspective:**

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.

Currently, NBFCs registered with RBI are being classified as:
All NBFCs are either deposit taking or non-deposit taking. If they are non-deposit taking, ND is suffixed to their name (NBFC-ND). The NBFCs which have asset size of ₹500 Crore or more are known as Systematically Important NBFC. They have been classified so because they can have bearing on financial stability of the country. The Non-deposit taking NBFCs are denoted as NBFC-NDSI. Under these two broad categories, the different NBFCs are as follows:

<table>
<thead>
<tr>
<th>Types of NBFCs</th>
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<tbody>
<tr>
<td>Asset Finance Company (AFC)</td>
</tr>
<tr>
<td>Investment Company (IC)</td>
</tr>
<tr>
<td>Loan Companies (LC)</td>
</tr>
<tr>
<td>Infrastructure Finance Company (IFC)</td>
</tr>
<tr>
<td>Core Investment Company (CIC)</td>
</tr>
<tr>
<td>Infrastructure Debt Fund (IDF-NBFC)</td>
</tr>
<tr>
<td>Systematically Important Core Investment Company (CIC-ND-SI)</td>
</tr>
<tr>
<td>Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI)</td>
</tr>
<tr>
<td>Non-Banking Financial Company – Factors (NBFC-Factors)</td>
</tr>
</tbody>
</table>
Asset Finance Company (AFC): The principal business of these companies is to finance the assets such as machines, automobiles, generators, material equipments, industrial machines etc. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.

Investment Company (IC): The main business of these companies is to deal in securities.

Loan Companies (LC): The main business of such companies is to make loans and advances (not for assets but for other purposes such as working capital finance etc.)

Infrastructure Finance Company (IFC): A company which has net owned funds of at least ₹ 300 Crore and has deployed 75% of its total assets in Infrastructure loans is called IFC provided it has credit rating of A or above and has a CRAR of 15%.

Systemically Important Core Investment Company (CIC-ND-SI): A systematically important NBFC (assets ₹ 500 crores and above) which has deployed at least 90% of its assets in the form of investment in shares or debt instruments or loans in group companies is called CIC-ND-SI. Out of the 90%, 60% should be invested in equity shares or those instruments which can be compulsorily converted into equity shares. Such companies do accept public funds.

Infrastructure Debt Fund (IDF-NBFC): IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 years maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.

Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI): NBFC-MFI is a non-deposit taking NBFC which has at least 85% of its assets in the form of microfinance. Such microfinance should be in the form of loan given to those who have annual income of ₹ 1,00,000 in rural areas and ₹ 160,000 in urban or semi urban areas. Such loans should not exceed ₹ 1,00,000 and its tenure should not be less than 24 months. Further, the loan has to be given without collateral. Loan repayment is done on weekly, fortnightly or monthly installments at the choice of the borrower.

Others

Non-Banking Financial Company – Factors (NBFC-Factors): Factoring business refers to the acquisition of receivables by way of assignment of such receivables or financing, there against either by way of loans or advances or by creation of security interest over such receivables but does not include normal lending by a bank against the security of receivables etc.

NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.

Mortgage Guarantee Companies (MGC): MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is ₹100 crores.
2. DIFFERENCES BETWEEN BANKS AND NBFCs

NBFCs lend and make investments and hence, their activities are akin to that of banks, however, there are a few differences as given below:

i. NBFC cannot accept demand deposits;

ii. NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;

iii. deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation (DICGC) is not available to depositors of NBFCs, unlike in case of banks.

3. PRUDENTIAL NORMS

3.1 Capital Requirements

Every applicable NBFC shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 15 percent of its aggregate risk weighted assets on-balance sheet and of risk adjusted value of off-balance sheet items.

The Tier I capital in respect of applicable NBFCs (other than NBFC-MFI and IDF-NBFC), at any point of time, shall not be less than 8.5% by March 31, 2016 and 10% by March 31, 2017.

Applicable NBFCs primarily engaged in lending against gold jewellery (such loans comprising 50 percent or more of their financial assets) shall maintain a minimum Tier I capital of 12 percent.

Explanations: In these Directions, degrees of credit risk expressed as percentage weightages have been assigned to balance sheet assets. Hence, the value of each asset/item requires to be multiplied by the relevant risk weights to arrive at risk adjusted value of assets. The aggregate shall be taken into account for reckoning the minimum capital ratio. The risk weighted asset shall be calculated as the weighted aggregate of funded items as detailed hereunder:
<table>
<thead>
<tr>
<th>S. No.</th>
<th>Weighted risk assets - On-Balance Sheet items</th>
<th>Percentage weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i)</td>
<td>Cash and bank balances including fixed deposits and certificates of deposits with banks</td>
<td>0</td>
</tr>
<tr>
<td>(ii)</td>
<td><strong>Investments:</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(a) Approved securities [Except at (c) below]</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>(b) Bonds of public sector banks</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>(c) Fixed deposits/certificates of deposits/bonds of public financial institutions</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>(d) Shares of all companies and debentures / bonds/ commercial papers of all companies and units of all mutual funds</td>
<td>100</td>
</tr>
<tr>
<td>(iii)</td>
<td><strong>Current assets:</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(a) Stock on hire (net book value)</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>(b) Intercorporate loans/deposits</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>(c) Loans and advances fully secured against deposits held</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>(d) Loans to staff</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>(e) Other secured loans and advances considered good [Except at (vi) below]</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>(f) Bills purchased/discounted</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>(g) Others (To be specified)</td>
<td>100</td>
</tr>
<tr>
<td>(iv)</td>
<td><strong>Fixed Assets (net of depreciation):</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(a) Assets leased out (net book value)</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>(b) Premises</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>(c) Furniture &amp; Fixture</td>
<td>100</td>
</tr>
<tr>
<td>(v)</td>
<td><strong>Other assets:</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(a) Income tax deducted at source (net of provision)</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>(b) Advance tax paid (net of provision)</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>(c) Interest due on Government securities</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>(d) Others (to be specified)</td>
<td>100</td>
</tr>
</tbody>
</table>

### 3.2 Income Recognition

The income recognition shall be based on recognised accounting principles. Income including interest/ discount/ hire charges/ lease rentals or any other charges on NPA shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed.
Asset classification: The asset classification norms as given below shall apply to every applicable NBFC (except NBFC-MFIs):

(1) Every NBFC shall, after taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation, classify its lease/hire purchase assets, loans and advances and any other forms of credit into the following classes, namely:

(i) Standard assets;
(ii) Sub-standard assets;
(iii) Doubtful assets; and
(iv) Loss assets.

(2) The class of assets referred to above shall not be upgraded merely as a result of rescheduling, unless it satisfies the conditions required for the upgradation.

(3) (i) Standard asset shall mean the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem or carry more than normal risk attached to the business;

(ii) “Sub-Standard Asset” shall mean:

(a) an asset which has been classified as non-performing asset for a period not exceeding 18 months;

Provided that the period ‘not exceeding 18 months’ stipulated in this sub-clause shall be ‘not exceeding 16 months’ for the financial year ending March 31, 2016, ‘not exceeding 14 months’ for the financial year ending March 31, 2017, and ‘not exceeding 12 months’ for the financial year ending March 31, 2018 and thereafter.

(b) an asset where the terms of the agreement regarding interest and / or principal have been renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms;

Provided that the classification of infrastructure loan as a sub-standard asset shall be in accordance with the provisions of paragraph 24 of these Directions.

(iii) Doubtful Asset shall mean:

(a) a term loan, or
(b) a lease asset, or
(c) a hire purchase asset, or
(d) any other asset,
which remains a sub-standard asset for a period ‘exceeding 18 months’ for the financial year ended March 31, 2015; ‘exceeding 16 months’ for the financial year ended March 31, 2016; ‘exceeding 14 months’ for the financial year ending March 31, 2017 and ‘exceeding 12 months’ for the financial year ending March 31, 2018 and thereafter.

(iv) Loss Asset shall mean:
(a) an asset which has been identified as loss asset by the applicable NBFC or its internal or external auditor or by the Bank during the inspection of the applicable NBFC, to the extent it is not written off by the applicable NBFC; and
(b) an asset which is adversely affected by a potential threat of non-recoverability due to either erosion in the value of security or non-availability of security or due to any fraudulent act or omission on the part of the borrower.

(v) Non-Performing Asset (referred to in these Directions as “NPA”) shall mean:
(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;

[Provided that the period of ‘six months or more’ stipulated in sub-clauses (a) to (f) shall be ‘five months or more’ for the financial year ending March 31, 2016; ‘four months or more’ for the financial year ending March 31, 2017 and ‘three months or more’, for the financial year ending March 31, 2018 and thereafter].

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

[Provided that the period of ‘twelve months or more’ stipulated in this sub-clause shall be ‘nine months or more’ for the financial year ending March 31, 2016; ‘six
months or more’ for the financial year ending March 31, 2017; and ‘three months or more’ for the financial year ending March 31, 2018 and thereafter].

(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, an applicable NBFC shall classify each such account on the basis of its record of recovery].

3.3 Provisioning Requirements

The provisioning requirements as given below shall apply to every applicable NBFC (except NBFC-MFIs): Every applicable NBFC shall, after taking into account the time lag between an account becoming non-performing, its recognition as such, the realisation of the security and the erosion over time in the value of security charged, make provision against sub-standard assets, doubtful assets and loss assets as provided hereunder:

The provisioning requirement in respect of loans, advances and other credit facilities including bills purchased and discounted shall be as under:

(i) **Loss Assets**: The entire asset shall be written off. If the assets are permitted to remain in the books for any reason, 100% of the outstanding shall be provided for;

(ii) **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 applicable NBFC has a valid recourse shall be made. The realisable value is to be estimated on a realistic basis;

(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:

<table>
<thead>
<tr>
<th>Period for which the asset has been considered as doubtful</th>
<th>Percent of provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to one year</td>
<td>20</td>
</tr>
<tr>
<td>One to three years</td>
<td>30</td>
</tr>
<tr>
<td>More than three years</td>
<td>50</td>
</tr>
</tbody>
</table>

(iii) **Sub-standard assets**: A general provision of 10 percent of total outstanding shall be made.

**Standard asset provisioning**: Every applicable NBFC shall make provisions for standard assets at 0.30 per cent by the end of March 2016; 0.35 per cent by the end of March 2017 and 0.40 per cent by the end of March 2018 and thereafter, of the outstanding, which shall not be reckoned for arriving at net NPAs. The provision towards standard assets need not be netted
from gross advances but shall be shown separately as ‘Contingent Provisions against Standard Assets’ in the balance sheet.

Students may refer **Master Direction DNBR. PD. 008/03.10.119/2016-17** dated September 01, 2016 for detailed guidelines on prudential norms relating to Non-Banking Financial Company-Systemically Important Non-Deposit taking Company and Deposit taking Company

### 4. AUDIT PROCEDURES

The following are the necessary steps involved -

1. **Ascertaining the Business of the Company** - The first step in carrying out the audit of a NBFC is to scan through the Memorandum and Articles of Association of the company, so as to acquaint oneself with the type of business that the company proposes to engage itself in. Normally, the Memorandum of Association of any company would be very wide in scope thereby permitting it to undertake a host of business activities, but companies generally lend to specialise in and focus on a few select activities. An auditor should therefore make a careful study of the business policy of the company so as to ascertain its principal business activities. For this purpose, an auditor may also scan through the minutes of the Board/Committee Meetings and hold discussions with the top level management to ascertain the corporate business plan/strategy which would give him a clear picture as to the principal objects of the company. An auditor should then independently corroborate his findings with the actual business done by the company, as reflected by the company’s financial results.

The task of ascertaining the principal business activity of any NBFC is of paramount importance (More so with the recent amendments made to the RBI Act) since the very classification of a company as a NBFC and its further classification into a loan company or an investment company or an equipment leasing/hire purchase finance company would all depend upon its principal business activity. Based on the classification of a company into a loan Company/Investment company etc., it will be accordingly required to comply with the provisions relating to limits on acceptance of public deposits as contained in the NBFC Public Deposit Directions.

2. **Evaluation of Internal Control System** - The responsibility of maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of its business vests with the management. A sound internal control system would enable an organisation to plug loopholes in its workings, particularly in the detection of frauds and would also aid in timely decision making. An auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures. An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.
In particular, an auditor should review the effectiveness of the system of recovery prevalent at the NBFC. He should ascertain whether the NBFC has an effective system of periodical review of advances in place which would facilitate effective monitoring and follow up. The absence of a periodical review system could result in non-detection of sticky advances at its very inception which would ultimately result in the NBFC having an alarmingly high level of NPAs.

(3) **Registration with the RBI** - Section 45-IA inserted by the RBI Act, w.e.f. 9\(^{th}\) January, 1997, has made it incumbent on the part of all NBFCs to comply with registration requirements and have minimum net owned funds (NOF) of ₹ 2 Crore (Although the requirement of minimum NOF at present stands at ₹ 200 lakh, the minimum NOF for companies that were already in existence before April 21, 1999 was retained at ₹ 25 lakh. However, for strengthening the financial sector and technology adoption, and in view of the increasing complexities of services offered by NBFCs, it shall be mandatory for all NBFCs to raise minimum NOF to ₹ 2 crore by 2017) for commencing/continuing its business. An auditor should obtain a copy of the certificate of registration granted by the RBI or in case the certificate of registration has not been granted, a copy of the application form filed with the RBI for registration. It may particularly be noted that NBFCs incorporated after 9\(^{th}\) January, 1997 are not entitled to commence business without first obtaining a registration certificate from the RBI. An auditor should therefore verify whether the dual conditions relating to registration with the RBI and maintenance of minimum net owned funds have been duly complied with by the concerned NBFC. Housing Finance Companies, Merchant Banking Companies, Stock Exchanges, Companies engaged in the business of stock-brokering/sub-brokering, Venture Capital Fund Companies, Nidhi Companies, Insurance Companies and Chit Fund Companies are NBFCs but they have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

Every NBFC holding public deposits is required to invest a specified percentage (as the RBI may specify from time to time). The RBI has also prescribed a format for reporting to ensure compliance with the requirement of maintenance of liquid assets on a quarterly basis. This quarterly return (duly signed by an officer of the NBFC) is required to be submitted within 30 days from the end of the relevant quarter and with reference to investments held in approved securities during the relevant quarter. The auditor should ascertain whether investment in prescribed liquid assets have been made and whether quarterly returns as mentioned above have been regularly filed with the RBI by the concerned NBFC.
(4) **NBFC Public Deposit Directions** - The auditors must ascertain whether the company is a loan company or an investment company or a hire purchase finance company or an equipment leasing company as per the classification, if any, assigned to the NBFC by the RBI. In case, the NBFC has not been classified by the RBI, the classification of a company will have to be determined after a careful consideration of various factors such as particulars of earlier registration granted, if any, particulars furnished in the application form for registration, company’s Memorandum of Association and its financial results. Thereafter, it must be ascertained whether the company has complied with the following aspects in relation to the activity of mobilisation of public deposits:

(i) The ceiling on quantum of public deposits has been linked to its credit rating as given by an approved credit rating agency. Obtain a copy of the credit rating assigned to NBFC and check whether the public deposits accepted/held by it are in accordance with the level of credit rating assigned to it.

In the event of a downgrading of credit rating, the auditor should bear in mind that the NBFC will have to reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame.

(ii) Test checks the interest calculations in respect of public deposits mobilised by a NBFC to ascertain that the NBFC has not paid interest in excess as per specification. Likewise, test check the brokerage calculations with the bills and vouchers for reimbursement of out of pocket expenses submitted by a broker to ascertain that the NBFC has not paid brokerage in excess by way of reimbursement of expenses to brokers.

(iii) Ascertain whether the NBFC has accepted or renewed any public deposit only after a written application form the depositor in the form to be supplied by the company, and shall contain all particulars specified in the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977. Further ensure whether it contain the specific category of depositor, i.e., whether depositor is a shareholder or a director or a promoter or a member of public.

(iv) Verify the deposit register maintained by a NBFC and test check the particulars that have been entered therein in respect of each depositor with supporting receipts issued to the depositors. Also check whether the NBFC is regularly paying its deposits on due dates and in the case of a delay/default, the reasons for the delay/default and the actual date of payment.

(v) Check whether the investments made in approved liquid assets by a NBFC holding public deposits have been lodged in safe custody with a designated scheduled commercial bank as required by the NBFC Public Deposit Directions. Obtain a certificate from the bank to that effect.

(vi) In the case of NBFCs accepting/holding public deposits ascertain whether audited statement of accounts together with a copy of the auditor’s report and director’s report
thereon have been submitted within prescribed time limit from the date of holding the Annual General Meeting.

(vii) Check whether the NBFC has filed its annual return as specified in the First Schedule before the 30th June with reference to its position as on the 31st March of each year.

(viii) In the case of NBFCs not accepting/holding public deposits, check whether a board resolution has been passed by the NBFC to the effect that it has neither accepted any public deposits nor would it accept any public deposits during the year.

(ix) In the case of Group Holding Investment Companies, check whether the NBFC has passed a board resolution to the effect that the company has invested or would invest/hold its investments in share and securities of group companies specifying the names of the companies. In addition to the above, group holding investment companies are required to give a further undertaking that it would not trade in such shares/securities and that it has neither accepted nor would it accept any public deposits during the year.

(5) NBFC Prudential Norms Directions -

(i) Check compliance with prudential norms encompassing income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy norms, prohibition on granting of loans by a NBFC against its own shares, prohibition on loans and investments for failure to repay public deposits and norms for concentration of credit/investments.

(ii) An auditor should ensure that the Board of Directors of every NBFC granting/intending to grant demand/call loans shall frame a policy for the company and shall implement too.

(iii) An auditor should assess on the basis of examinations conducted by him whether the NBFC has complied with the prudential norms. In particular, he should verify that advances and other credit facilities have been properly classified as standard/sub standard/doubtful/loss and that proper provision has been made in accordance with the Directions.

(iv) In respect of Non-Performing Assets, an auditor should check whether the unrealised income in respect of such assets has not been taken to the Profit & Loss Account on an accrual basis. Income from NPAs should be accounted for on realisation basis only.

(v) Check whether all accounts which have been classified as NPAs in the previous year also continue to be shown as such in the current year also. If the same is not treated as a NPA in the current year, the auditor should specifically examine such accounts to ascertain whether the account has become regular and the same can be treated as performing as per the Directions.
5. CLASSIFICATION OF FRAUDS BY NBFC (RBI CIRCULAR JULY, 2015)

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

(a) Misappropriation and criminal breach of trust.
(b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
(c) Unauthorised credit facilities extended for reward or for illegal gratification.
(d) Negligence and cash shortages.
(e) Cheating and forgery.
(f) Irregularities in foreign exchange transactions.
(g) 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 (d) and (f) 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:

(a) cases of cash shortages more than ₹ 10,000/- and
(b) 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.

6. AUDIT CHECK-LIST

Some special points that may be covered in the audit of NBFCs are given below:

A. Investment Companies

   (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. 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 Annual General Meeting and its right receives 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.

(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 lend/borrowed.

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

B. **Loan Company**

(i) An auditor should examine whether each loan or advance has been properly sanctioned. He should 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.

(ii) An auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must 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.

(iii) Obtain balance confirmations from the concerned parties.

(iv) As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.

(v) 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.

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

(vii) In case of companies which are engaged in the business of providing short term funds in the ICD market, the auditor should ascertain whether the NBFC has a regular system for ascertaining the credit worthiness of the clients prior to placed by the company are being rolled over and whether there is any risk of non-recovery. In addition, he should ascertain that the NBFC is receiving interest regularly in respect of these ICDs. Roll over of ICDs and non-realisation of interest and principal amounts should be thoroughly checked to determine whether the ICD is required to be treated as a NPA.
(viii) An auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.

(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 Directions.

(x) An auditor should also verify whether provision for bad and doubtful debts has been disclosed separately in the Balance Sheet and the same have not been netted off against the income or against the value of assets as required by the NBFC Prudential Norms Directions.

C. Asset Finance Company

1. Hire Purchase Finance Company

(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.

2. Equipment Leasing Finance Company

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

(ii) The auditor should verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In respect of some major transactions, an auditor should 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 whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased assets 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) An auditor should verify whether the AS issued by the Institute of Chartered Accountants of India, in respect of "Accounting for Lease" has been compulsorily followed.

7. AUDITOR’S DUTY

The following are the important duties of an auditor -

7.1 Compliance with NBFC Auditors Report-RBI Directions - The recent RBI regulations have considerably increased the responsibility of auditors of NBFCs. A very onerous task of reporting to the Board of Directors on certain specified matters and to the RBI on an exception basis has been imposed upon him. This reporting requirement is in addition to the normal reporting requirements to the shareholders under section 143 of the Companies Act, 2013. Auditors will thus, have to be very careful whilst carrying out audits of NBFCs to ensure that all matters which they are required to take into consideration for the purposes of reporting to the RBI have been taken due care of.

Section 45MA of the Reserve Bank of India Act has been introduced with effect from 13.12.1974. Under this provision the auditor of a non-banking financial company or a non-banking miscellaneous company which as accepted public deposits, has to inquire whether or not the company has
furnished to the Reserve Bank of India statements, information of particulars relating to the deposits as are required to the furnished under Chapter IIIB of the Reserve Bank of India Act. The provision further states that if on inquiry the auditor is not satisfied about the compliance by the company, it is his duty to make to the Reserve Bank giving the aggregate amount of deposits held by the company. The auditor is also required to incorporate the report or intended to be made to the Reserve Bank in his report to the company under Section 143 of the Companies Act, 2013.

Report to Board of Directors under RBI Directions as per Master Direction No. DNBS. PPD.03/66.15.001/2016-17 dated September 29, 2016

1. The Reserve Bank of India (RBI) has issued Non-Banking Financial Companies Auditor’s Report (Reserve Bank) Directions, 2016 (the Directions) to auditor of every non-banking financial companies.

2. The Directions shall apply to every auditor of a non-banking financial company as defined in section 45 I(f) of the Reserve Bank of India Act, 1934.

Auditors to submit additional Report to the Board of Directors: In addition to the Report made by the auditor under Section 143 of the Companies Act, 2013 or section 227 of the Companies Act, 1956 (Act 1 of 1956) on the accounts of a non-banking financial company examined for every financial year ending on any day on or after the commencement of these Directions, the auditor shall also make a separate report to the Board of Directors of the Company on the matters specified in paragraphs 3 and 4 below.

3. Material to be included in the Auditor’s report to the Board of Directors: The auditor’s report on the accounts of a non-banking financial company shall include a statement on the following matters, namely –

<table>
<thead>
<tr>
<th>(A) In the case of all non-banking financial companies:</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the Bank is an offence under chapter V of the RBI Act, 1934. Therefore, if the company is engaged in the business of non-banking financial institution as defined in section 45-I (a) of the RBI Act and meeting the Principal Business Criteria (Financial asset/income pattern) as laid down vide the Bank’s press release dated April 08, 1999, and directions issued by DNBR, auditor shall examine whether the company has obtained a Certificate of Registration (CoR) from the Bank.</td>
</tr>
<tr>
<td>II. In case of a company holding CoR issued by the Bank, whether that company is entitled to continue to hold such CoR in terms of its Principal Business Criteria (Financial asset/income pattern) as on March 31 of the applicable year.</td>
</tr>
<tr>
<td>III. Whether the non-banking financial company is meeting the required net owned fund requirement as laid down in Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Demat taking Company (Reserve</td>
</tr>
</tbody>
</table>
Every non-banking financial company shall submit a Certificate from its Statutory Auditor that it is engaged in the business of non-banking financial institution requiring it to hold a Certificate of Registration under Section 45-IA of the RBI Act and is eligible to hold it. A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31 may be submitted to the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the non-banking financial company is registered, within one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year. The format of Statutory Auditor’s Certificate (SAC) to be submitted by NBFCs has been issued vide DNBS. PPD.02/66.15.001/2016-17 Master Direction- Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016.

(B) In the case of a non-banking financial companies accepting/holding public deposits:

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely -

(i) Whether the public deposits accepted by the company together with other borrowings indicated below viz.
   (a) from public by issue of unsecured non-convertible debentures/bonds;
   (b) from its shareholders (if it is a public limited company); and
   (c) which are not excluded from the definition of ‘public deposit’ in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016, are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(ii) Whether the public deposits held by the company in excess of the quantum of such deposits permissible to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 are regularised in the manner provided in the said Directions;

(iii) Whether the non-banking financial company is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency as per the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(iv) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial Company - Systemically Important Non-
Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;

(v) In respect of non-banking financial companies referred to in clause (iii) above,

(a) whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies listed in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 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 the such Credit Rating Agency;

(vi) Whether the company has violated any restriction on acceptance of public deposit as provided in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(vii) Whether the company has defaulted in paying to its depositors the interest and /or principal amount of the deposits after such interest and/or principal became due;

(viii) Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the Directions issued by the Bank in terms of the Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;

(ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the Bank in terms of NBS 3; Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(x) Whether the company has furnished to the Bank within the stipulated period the return on deposits as specified in the NBS 1 to – Non- Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(xi) Whether the company has furnished to the Bank within the stipulated period the quarterly return on prudential norms as specified in the Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(xii) 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 contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.
### (C) In the case of a non-banking financial company not accepting public deposits:

Apart from the aspects enumerated in (A) above, the auditor shall include a statement on the following matters, namely:

1. **Whether the Board of Directors has passed a resolution for non-acceptance of any public deposits;**
2. **Whether the company has accepted any public deposits during the relevant period/year;**
3. **Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial Company – 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;**
4. **In respect of Systemically Important Non-deposit taking NBFCs as defined in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016:**
   - **Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in form NBS-7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;**
   - **Whether the company has furnished to the Bank the annual statement of capital funds, risk assets/exposures and risk asset ratio (NBS-7) within the stipulated period.**
5. **Whether the non-banking financial company has been correctly classified as NBFC Micro Finance Institutions (MFI) as defined in the Non-Banking Financial Company – 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.**

### (D) In the case of a company engaged in the business of non-banking financial institution not required to hold CoR subject to certain conditions:

Apart from the matters enumerated in (A)(I) above where a company has obtained a specific advice from the Bank that it is not required to hold CoR from the Bank, the auditor shall include a statement that the company is complying with the conditions stipulated as advised by the Bank.

4. **Reasons to be stated for unfavourable or qualified statements**

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. 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 therefor.

5. **Obligation of auditor to submit an exception report to the Bank**

(I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:

   (a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or
   
   (b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or
   
   (c) Non-Banking Financial Company – 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.

   It shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, 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 as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the 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 those provisions.

7.2 **Compliance with CARO 2016: As per CARO 2016, the auditor is required to report that –**

(I) “Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.” [Paragraph 3(xvi)]

1. **Relevant Provisions:**

   (a) The auditor is required to examine whether the company is engaged in the business which attract the requirements of the registration. The registration is required where the financing activity is a principal business of the company.

   (b) The Reserve Bank of India restrict companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration.
A Non-Banking Financial Company (NBFC) is a company registered under the Act, engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

As per response to an FAQ as given by Reserve Bank of India, “Financial activity as principal business is when a company’s financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria will be registered as NBFC by RBI. The term ‘principal business’ is not defined by the Reserve Bank of India Act. The Reserve Bank has defined it so as to ensure that only companies predominantly engaged in financial activity get registered with it and are regulated and supervised by it. Hence if there are companies engaged in agricultural operations, industrial activity, purchase and sale of goods, providing services or purchase, sale or construction of immovable property as their principal business and are doing some financial business in a small way, they will not be regulated by the Reserve Bank. Interestingly, this test is popularly known as 50-50 test and is applied to determine whether or not a company is into financial business.”

NBFCs are doing functions similar to banks, however there exist difference between banks & NBFCs. NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as discussed in Heading No. 2.

As per Reserve Bank of India Act, 1934 Section 45 I Clause (c) any company carries on as its business or part of its business any activity considered as carrying on the business of Financial Institution.

The Reserve Bank of India defined “net owned fund” as (a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance-sheet of the company after deducting there from (i) accumulated balance of loss; (ii) deferred revenue expenditure; and (iii) other intangible assets; and (b) further reduced by the amounts representing – (1) investments of such company in shares of– (i) its subsidiaries; (ii) companies in the same group; (iii) all other non-banking financial companies; and (2) the book value of debentures,
bonds, outstanding loans and advances (including hire-purchase and lease finance) made to, and deposits with, – (i) subsidiaries of such company; and (ii) companies in the same group, to the extent such amount exceeds ten per cent of (a) above. (“Subsidiaries” and “companies in the same group” shall have the same meanings assigned to them in the Companies Act, 1956.)

2. Audit Procedures and Reporting:
   (a) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.
   (b) The financial statements should be examined to ascertain whether company’s financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.
   (c) Whether the company has net owned funds as required for the registration as NBFC.
   (d) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.
   (e) The auditor should report incorporating the following:
      (i) Whether the registration is required under section 45-IA of the RBI Act, 1934.
      (ii) If so, whether it has obtained the registration.
      (iii) If the registration not obtained, reasons thereof.

(II) “Whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability.” [Paragraph 3(xii)]

1. Relevant Provisions:
   (a) This clause requires the auditor to report whether, in the case of a Nidhi Company, net-owned funds to deposit liability ratio is more than 1:20 and the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules 2014 to meet out the liability.
   (b) Section 406(1) of the Act defines “Nidhi” to mean a company which has been incorporated as a Nidhi with the object of cultivating the habit of thrift and savings amongst its members, receiving deposits from, and lending to, its members only, for their mutual benefit, and which complies with such rules as are prescribed by the Central Government for regulation of such class of companies.
   (c) It may be noted that Ministry of Corporate Affairs on 31st March 2014, vide its Notification No. GSR 258(E) notified the ‘Nidhi Rules 2014’, which came into force on the first day of April 2014. The said Rules are reproduced in the Guidance Note on CARO 2016. These Rules apply to Nidhi company incorporated as a Nidhi.
pursuant to the provisions of Section 406 of the Act and also to the Nidhi companies declared under sub-section (1) of section 620A of the Companies Act 1956.

2. Audit Procedures and Reporting:

(a) It may be noted that Rule 5(1) prescribes the requirements for minimum number of members, net owned fund etc. As per Rule 5(1) every Nidhi shall, within a period of one year from the commencement of these rules, ensure that it has—

(i) not less than two hundred members;

(ii) net owned funds of ten lakh rupees or more;

(iii) unencumbered term deposits of not less than ten per cent of the outstanding deposits as specified in Rule 14; and

(iv) ratio of net owned funds to deposits of not more than 1:20.

The auditor should note that as such a Nidhi Company can accept deposits not exceeding twenty times of its net owned funds as per last audited balance sheet. Furthermore, as per Rule 14, every Nidhi is to invest and continue to keep invested, in encumbered term deposits with a Scheduled commercial bank (other than a co-operative bank or a regional rural bank), or post office deposits in its own name an amount which shall not be less than ten per cent of the deposits outstanding at the close of business on the last working day of the second preceding month, which needs to be examined.

(b) As per Rule 3(d) Net Owned Funds are defined as the aggregate of paid up equity share capital and free reserves as reduced by accumulated losses and intangible assets appearing in the last audited balance sheet.

It may be noted that the amount representing the proceeds of issue of preference shares, shall not be included for calculating Net Owned Funds.

(c) A Nidhi company can accept fixed deposits, recurring deposits accounts and savings deposits from its members in accordance with the directions notified by the Central Government. The aggregate of such deposits is referred to as “deposit liability”.

(d) The auditor should ask the management to provide the computation of the deposit liability and net owned funds on the basis of the requirements contained herein above. This would enable him to verify that the ratio of deposit liability to net owned funds is in accordance with the requirements prescribed in this regard. The auditor should verify the ratio using the figures of net owned funds and deposit liability computed in accordance with what is stated above. The comments of the auditor should be based upon such a statement provided by the management and verification of the same by the auditor.

(e) The auditor may report, incorporating the following as at the balance sheet date:

(i) In case of shortfall in the ratio of net owned funds to the deposits, report the amount of shortfall and state the actual ratio of net owned funds to the deposits.
(ii) In case of shortfall with regard to the minimum amount of 10% as unencumbered term deposits, as specified in Nidhi Rules 2014, report the amount thereof.

(Note: Students are required to refer Guidance Note on CARO, 2016 for more details).

8. INDIAN ACCOUNTING STANDARDS (IND-AS)

8.1 Applicability of Indian Accounting Standards (Ind-AS) on NBFCs – As per Rule 4 (1)(iv) of the Companies (Indian Accounting Standards) Rules, 2015 and as amended by Companies (Indian Accounting Standards) (Amendment) Rules, 2016, NBFCs are required to comply with Indian Accounting Standards (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.

The net worth shall be calculated in accordance with the standalone financial statements of the NBFCs as on 31st March 2016 or the first audited financial statements for accounting period which ends after that date.

8.2 Format for preparation of financial statements by NBFCs under Ind-AS – The Ministry of Corporate Affairs (MCA) vide notification dated October 11, 2018 introduced Division III under Schedule III of the Companies Act, 2013, wherein a format for preparation of financial statements by NBFCs complying with Ind-AS has been prescribed.

Every NBFC required to comply with Ind-AS shall prepare its financial statements as per below format:

Illustrative format of Balance Sheet under Division III of Schedule III-

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Notes No.</th>
<th>Figures as at the end of current reporting period (₹)</th>
<th>Figures as at the end of previous reporting period (₹)</th>
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<tr>
<td>ASSETS</td>
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<td></td>
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</tr>
<tr>
<td>(1) Financial Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Cash and cash equivalents</td>
<td></td>
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</tr>
<tr>
<td>(b) Bank balance other than (a) above</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Derivative financial instruments</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Particulars</td>
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<td>Figures as at the end of previous reporting period (₹)</td>
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<tr>
<td>------------------------------------------------</td>
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<td>------------------------------------------------------</td>
<td>------------------------------------------------------</td>
</tr>
<tr>
<td>(d) Receivables</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) Trade Receivables</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Other Receivables</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Investments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Other Financial assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Non-Financial Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Inventories</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>(b) Current tax assets (net)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>(c) Deferred tax assets (net)</td>
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<td></td>
</tr>
<tr>
<td>(d) Investment property</td>
<td></td>
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</tr>
<tr>
<td>(e) Biological assets other than bearer plants</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Property, Plant and Equipment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Capital work-in-progress</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(h) Intangible assets under development</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Goodwill</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(j) Other intangible assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(k) Other non-financial assets (to be specified)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**LIABILITES AND EQUITY**

**LIABILITIES**

(1) Financial Liabilities

(a) Derivative financial instruments

(b) Payables

(I) Trade Payables

(i) total outstanding dues of micro enterprises and small enterprises

(ii) total outstanding dues of creditors other than micro enterprises and small enterprises

(II) Other Payables
### Particulars

<table>
<thead>
<tr>
<th>Notes No.</th>
<th>Figures as at the end of current reporting period (₹)</th>
<th>Figures as at the end of previous reporting period (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) total outstanding dues of micro enterprises and small enterprises</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(ii) total outstanding dues of creditors other than micro enterprises and small enterprises</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Debt Securities</td>
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<td></td>
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<tr>
<td>(d) Borrowings (other than debt securities)</td>
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<td></td>
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<tr>
<td>(e) Deposits</td>
<td></td>
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<tr>
<td>(f) Subordinated liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Other financial liabilities (to be specified)</td>
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### (2) Non-financial Liabilities

<table>
<thead>
<tr>
<th>Notes No.</th>
<th>Figures as at the end of current reporting period (₹)</th>
<th>Figures as at the end of previous reporting period (₹)</th>
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</thead>
<tbody>
<tr>
<td>(a) Current tax liabilities (net)</td>
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<td></td>
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<tr>
<td>(b) Provisions</td>
<td></td>
<td></td>
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<tr>
<td>(c) Deferred Tax Liabilities (net)</td>
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<tr>
<td>(d) Other non-financial liabilities (to be specified)</td>
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### (3) Non-financial Liabilities

<table>
<thead>
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<tbody>
<tr>
<td>(a) Equity share capital</td>
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<td></td>
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<tr>
<td>(b) Other equity</td>
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### Total Liabilities and Equity

### Illustrative format of Statement of Profit and Loss prescribed under Division III of Schedule III

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Notes No.</th>
<th>Figures as at the end of current reporting period (₹)</th>
<th>Figures as at the end of previous reporting period (₹)</th>
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<tbody>
<tr>
<td>Revenue from operations</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>(a) Interest Income</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>(b) Dividend income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Rental income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Fee and commission income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Particulars</td>
<td>Notes No.</td>
<td>Figures as at the end of current reporting period (₹)</td>
<td>Figures as at the end of previous reporting period (₹)</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>-----------</td>
<td>------------------------------------------------------</td>
<td>------------------------------------------------------</td>
</tr>
<tr>
<td>(e) Net gain on fair value changes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Net gain on derecognition of financial instruments under amortised category</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Sale of products (including Excise duty)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(h) Sale of services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Others (to be specified)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total revenue from operations (I)**

**Other income (to be specified) (II)**

**Total Income (III= I + II)**

**Expenses**

(a) Finance costs

(b) Fees and commission expense

(c) Net loss on fair value changes

(d) Net loss on derecognition of financial instruments under amortised category

(e) Impairment on financial instruments

(f) Cost of material consumed

(g) Purchases of stock-in-trade

(h) Changes in Inventories of finished goods, stock-in-trade and work-in- progress

(i) Employee Benefits Expenses

(j) Depreciation, amortization and impairment

(k) Other expenses (to be specified)

**Total Expenses (IV)**

**Profit / (loss) before exceptional items and tax (V= III - IV)**

**Exceptional items (VI)**

**Profit / (loss) before tax (VII= V - VI)**
<table>
<thead>
<tr>
<th>Particulars</th>
<th>Notes No.</th>
<th>Figures as at the end of current reporting period (₹)</th>
<th>Figures as at the end of previous reporting period (₹)</th>
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</thead>
<tbody>
<tr>
<td>Tax Expense (VIII):</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>(1) Current tax</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>(2) Deferred tax</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit / (loss) for the period from continuing operations (IX= VII - VIII)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Profit / (loss) for the period from discontinued operations (X)</td>
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</tr>
<tr>
<td>Tax Expense of discontinued operations (XI)</td>
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<td></td>
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</tr>
<tr>
<td>Profit / (loss) for the period from discontinued operations after tax (XII= X - XI)</td>
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<tr>
<td>Profit / (loss) for the period (XIII= IX + XII)</td>
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<tr>
<td>Other Comprehensive Income (XIV)</td>
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<td></td>
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</tr>
<tr>
<td>(A) (i) Items that will not be reclassified to profit or loss (specify items and amounts)</td>
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<tr>
<td>(ii) income tax relating to items that will not be reclassified to profit or loss</td>
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<td></td>
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<tr>
<td>SUB-TOTAL (A)</td>
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<tr>
<td>(B) (i) Items that will be reclassified to profit or loss (specify items and amounts)</td>
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<tr>
<td>(ii) income tax relating to items that will be reclassified to profit or loss</td>
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<tr>
<td>SUB-TOTAL (B)</td>
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<tr>
<td>Other Comprehensive Income (A+B)</td>
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<tr>
<td>Total Comprehensive Income for the period (XV = XIII + XIV) (Comprising Profit (Loss) and other Comprehensive Income for the period)</td>
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</tr>
<tr>
<td>Earnings per equity share (for continuing operations) (XVI)</td>
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<tr>
<td>Basic (₹)</td>
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<tr>
<td>Diluted (₹)</td>
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</tr>
<tr>
<td>Particulars</td>
<td>Notes No.</td>
<td>Figures as at the end of current reporting period (₹)</td>
<td>Figures as at the end of previous reporting period (₹)</td>
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<tr>
<td>----------------------------------------------------------------------------</td>
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</tr>
<tr>
<td>Earnings per equity share (for discontinued operations) (XVII)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Basic (₹)</td>
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<td></td>
</tr>
<tr>
<td>Diluted (₹)</td>
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<tr>
<td>Earnings per equity share (for continuing and discontinued operations) (XVIII)</td>
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</tr>
<tr>
<td>Basic (₹)</td>
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<td></td>
</tr>
<tr>
<td>Diluted (₹)</td>
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</tr>
</tbody>
</table>

**Note**: Student may refer illustrative format of Statement of Changes in equity prescribed under Division III of Schedule III for more understanding.

### 8.3 Differences between Division II (Ind-AS- Other than NBFCs) and Division III (Ind-AS- NBFCs) of Schedule III

The 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 per cent of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1 per cent 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 as part of the notes.
Theoretical Questions

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

2. 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?

Answers to Theoretical Questions

1. Refer Para 6

2. Refer Para 6