After studying this chapter, you will be able to:

- Understand the definition, regulations and types of Non-Banking Finance Companies (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 Checklist for NBFCs.
- Apply & analyse the above-mentioned concepts in moderately complex scenarios.
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. Therefore, a need is felt to address those 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 and keep these NBFCs under regulations for their efficient functioning.

Fig.: Audit of NBFCs

Fig.: NBFCs

* Source: Techno Legal Journalists
* Source: Inventicon
Definition of NBFC: 45 l(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”.

Further, 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 shall qualify as an NBFC and would require to be registered as NBFC by RBI.

* Source: Slideshare
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.
- having a net owned fund (NOF) of ₹ 25 lakhs (₹ 2 crore since April 1999) not exceeding ₹ 200 lakhs, as the RBI may, by notification in the Official Gazette, specify.

(The RBI (Amendment) Act (1997) provided an entry point norm of ₹ 25 lakh as the minimum net owned fund which was revised upwards to ₹ 2 crore for new NBFCs seeking grant of certificate of registration on or after 21 April 1999).

(Upper limit in relation to net owned fund requirement for commencing NBFC business has been increased from ₹ 2 crores to ₹ 100 crores as per Finance (No.2) Bill 2019).

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 the 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.
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 are further bifurcated on the basis of their asset size i.e. asset size of below ₹500 crore and ₹500 crore or more.

Under these two broad categories, the different NBFCs are as follows:

- **Investment and Credit Company (ICC)**
- **Infrastructure Finance Company (IFC)**
- **Systemically Important Core Investment Company (CIC-ND-SI)**
- **Infrastructure Debt Fund-Non - Banking Financial Company (IDF-NBFC)**
- **Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI)**
- **Non-Banking Financial Company - Factors (NBFC-Factors)**
- **Non-Operative Financial Holding Company - (NOFHC)**
Systemically important non-deposit taking non-banking financial company means a non-banking financial company not accepting / holding public deposits and having total assets of ₹ 500 crore and above as shown in the last audited balance sheet.

The Non-deposit taking NBFCs having asset size of ₹ 500 crore or more are denoted as NBFC-NDSI.

Investment and Credit Company (ICC): Investment and Credit Company means any company which is a financial institution carrying on as its principal business - asset finance, the providing of finance whether by making loans or advances or otherwise for any activity other than its own and the acquisition of securities; and is not any other category of NBFC as defined by the RBI in any of its Master Directions.

(Circular DBR.BP.BC.No.25/21.06.001/2018-19 dated 22 February 2019)

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% (with a minimum Tier I capital of 10 percent).

Systemically Important Core Investment Company (CIC-ND-SI): Core Investment Companies (CIC) having total assets of not less than ₹ 100 crores either individually or in aggregate along with other CICs in the group and which raises or holds public funds are called as Systemically Important Core Investment Companies (CICs-ND-SI).

Infrastructure Debt Fund (IDF-NBFC): IDF-NBFC means a non-deposit taking Non Banking Financial Company that has:

a) net owned funds of ₹ 300 crore or more; and

b) which invests only in Public Private Partnerships(PPP) and post commencement operations date (COD) infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.

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.

Non-Operative Financial Holding Company (NOFHC): means a non-deposit taking NBFC referred to in the "Guidelines for Licensing of New Banks in the Private Sector", issued by the RBI, which holds the shares of a banking company and the shares of all other financial services companies in its group, whether regulated by the Bank or by any other financial regulator, to the extent permissible under the applicable regulatory prescriptions.

[Note: Students may refer detailed description of types of NBFCs, given in CA. Intermediate Paper 5: Advanced Accounting Study Material.]

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 between the two 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 % 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 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 %.

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></td>
<td>(e) All assets covering PPP and post commercial operations date (COD) infrastructure projects in existence over a year of commercial operation</td>
<td>50</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 (in case of NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016);

The period ‘not exceeding 18 months’ stipulated in this sub-clause shall be ‘not exceeding 12 months’ for the financial year ended March 31, 2018 and thereafter for NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

(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’ (in case of NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016).

The period ‘exceeding 18 months’ stipulated in this sub-clause shall be ‘exceeding 12 months’ for the financial year ended March 31, 2018 and thereafter for NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

(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 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 for NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, period of ‘six months or more’ stipulated in sub-clauses (a) to (f) shall be ‘three months or more’, for the financial year ended March 31, 2018 and thereafter].

That is, for NBFCs covered in Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 6 months only.

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

[Provided that for NBFCs covered in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016, the period of ‘twelve months or more’ stipulated in this sub-clause shall be ‘three months or more’ for the financial year ended March 31, 2018 and thereafter].
It implies that as per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, the criteria is 12 months only.

(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.
(iv) **Standard asset provisioning:** Every NBFC (covered under Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016) shall make provisions for standard assets at 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.

**Note:** As per Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016, every applicable NBFC shall make provision for standard assets at 0.25 percent of the outstanding amount.

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 NBFC - Non-Systemically Important Non-deposit Taking Company (Updated as on February 22, 2019) and Master Direction NBFC - Systemically Important Non-deposit Taking Company and Deposit Taking Company (Updated as on May 16, 2019) for detailed guidelines on prudential norms relating to Non-Banking Financial Companies covered in these Directions.]

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 is engaged into. 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 would all depend upon its principal business activity. Based on the classification of a company, it will be required to comply with the provisions relating to limits on acceptance of public deposits as contained in the NBFC Public Deposit Directions.
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 their very inception which may ultimately result in the NBFC having an alarmingly high level of NPAs.

Registration with the RBI - Section 45-IA inserted in the RBI Act, 1934, w.e.f. 9th 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) for commencing/carrying on 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 9th 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-broking/sub-broking, 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 prescribed time limit 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 Acceptance of Public Deposit Directions (Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016)** - The auditors must ascertain whether the company properly classified as per the requirements of various regulations. 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 upgrading/downgrading of credit rating, the auditor should bear in mind that the NBFC will have to increase/reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame and should ensure that the NBFC has informed about the same to the RBI in writing.

In the event of downgrading of credit rating below the minimum specified investment grade, a non-banking financial company, being an investment and credit company or a factor, shall regularise the excess deposit as provided hereunder:

(a) with immediate effect, stop accepting fresh public deposits and renewing existing deposits;

(b) all existing deposits shall run off to maturity; and

(c) report the position within 15 working days, to the concerned Regional Office of the RBI where the NBFC is registered.
Provided no matured public deposit shall be renewed without the express and voluntary consent of the depositor.

(ii) Test check 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/ commission/ incentive calculations with the bills and vouchers for reimbursement of out of pocket expenses submitted by the parties to ascertain that the NBFC has not paid brokerage/ commission/ incentive/ reimbursement of expenses in excess as per specification.

(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 Acceptance of Public Deposits Directions and also whether. certificate was obtained from the RBI to that effect.

(vii) Check whether the NBFC has filed its prescribed returns in a timely manner.

(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 and implement a policy for the company.

(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 an 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**

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, covered in Master Direction - Monitoring of Frauds in NBFCs (Reserve Bank) Directions, 2016, 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.

Reporting of Frauds to the RBI as per Master Direction - Monitoring of Frauds in NBFC (Reserve Bank) Directions, 2016:

1. Frauds involving ₹ 1 lakh and above

   I. Fraud reports should be submitted in all cases of fraud of ₹ 1 lakh and above perpetrated through misrepresentation, breach of trust, manipulation of books of account, fraudulent encashment of FDRs, unauthorised handling of securities charged to the applicable NBFCs (i.e. NBFCs covered in Master Direction - Monitoring of Frauds in NBFCs (Reserve Bank) Directions, 2016), misfeasance, embezzlement, misappropriation of funds, conversion of property, cheating, shortages, irregularities, etc.

   II. Applicable NBFCs are advised to furnish case-wise quarterly progress reports on frauds involving ₹ 1 lakh and above in the prescribed format only to Regional Office of the Bank, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the applicable NBFC falls within 15 days of the end of the quarter to which it relates.

   III. Fraud reports should also be submitted in cases where central investigating agencies have initiated criminal proceedings suo moto and/or where the Bank has directed that they be reported as frauds.

   IV. Applicable NBFCs should also report frauds perpetrated in their subsidiaries and affiliates/joint ventures. Such frauds should, however, not be included in the report on outstanding frauds and the quarterly progress reports referred to in Paragraph (i) above.
V. Where the amount involved in fraud is less than ₹ 1 crore, reports in the prescribed format shall be sent to the Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the Registered Office of the applicable NBFC falls, within 3 weeks (21 days) from the date of detection of the fraud.

VI. Applicable NBFCs are permitted to close the fraud cases only where the actions are complete and prior approval is obtained from the respective Regional Offices of Department of Non-Banking Supervision.

2. Frauds committed by unscrupulous borrowers

i. Frauds committed by unscrupulous borrowers including companies, partnership firms/proprietary concerns and/or their directors/partners by various methods including the following:

   (a) Fraudulent discount of instruments;

   (b) Fraudulent removal of pledged stocks/disposing of hypothecated stocks without the NBFC’s knowledge/inflating the value of stocks in the stock statement and drawing excess finance;

   (c) Diversion of funds outside the borrowing units, lack of interest or criminal neglect on the part of borrowers, their partners, etc. and also due to managerial failure leading to the unit becoming sick and due to laxity in effective supervision over the operations in borrowal accounts on the part of the NBFC functionaries rendering the advance difficult of recovery;

ii. In respect of frauds in borrowal accounts, additional information as prescribed should be furnished.

3. Frauds involving ₹ 1 crore and above: Where the amount involved in fraud is ₹ 1 crore and above, the reports in the prescribed format shall be sent within 3 weeks from the date of detection of the fraud to Central Fraud Monitoring Cell, RBI and to the Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the Registered Office of the applicable NBFC falls.

In addition to the requirements given above, applicable NBFCs shall report the fraud by means of a D.O. letter addressed to the Chief General Manager-in-charge of the Department of Banking Supervision, RBI, Frauds Monitoring Cell, Central Office Bengaluru and a copy endorsed to the Chief General Manager-in-charge of the Department of Non-Banking Supervision, Reserve Bank of India, Central Office within a week of such frauds coming to the notice of the applicable NBFC.
The letter shall contain brief particulars of the fraud such as amount involved, nature of fraud, modus operandi in brief, name of the branch/office, names of parties involved (if they are proprietorship/partnership concerns or private limited companies, the names of proprietors, partners and directors), names of officials involved, and whether the complaint has been lodged with the Police. A copy of the D.O. letter should be endorsed to the Regional Office of the RBI, Department of Non-Banking Supervision under whose jurisdiction the Registered Office of the applicable NBFC is functioning.

4. Cases of attempted fraud: All individual cases involving ₹ 25 lakh or more should be continued to be placed before the Audit Committee of applicable NBFC’s Board.

6. AUDIT CHECK-LIST

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

(eg. NBFC - Investment and Credit Company (NBFC-ICC)

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

iii. Verify that dividend income wherever declared by a company, has been duly received by an 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 to receive the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.

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

v. 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.

vi. 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.

vii. 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.

viii. 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.

ix. An auditor will have to ascertain whether the requirements of AS 13 “Accounting for Investments” or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

x. 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.

xi. 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).

xii. Verify charges received or paid in respect of securities lend/borrowed.

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

xiv. 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.

xv. 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.

xvi. Obtain balance confirmations from the concerned parties.

xvii. 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.

xviii. 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.
xx. **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.**

*(Note: The above checklist is not exhaustive. It is only illustrative. There could be various other audit procedures which may be performed for audit of an NBFC.)*

### 7. **AUDITOR’S DUTY**

The following are the important duties of an auditor -

#### 7.1 **Compliance with NBFC Auditor’s Report - RBI Directions**

The RBI Directions 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, 1934 was 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 has 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 be furnished under Chapter IIIB of the Reserve Bank of India Act, 1934. 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 of India 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 of India 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**
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.

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.

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 –

(A) In the case of all non-banking financial companies:

| I. | Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the RBI 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 RBI’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 RBI. |
| II. | In case of a company holding CoR issued by the RBI, 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. |
| 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-Deposit taking Company (Reserve Bank) Directions, 2016 and Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016. |

Note: 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 RBI in terms of NBS 3; Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(x) Whether the company has furnished to the RBI 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 RBI 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-Delay taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Delay taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;
4. In respect of Systemically Important Non-delay taking NBFCs as defined in Non-Banking Financial Company - Systemically Important Non-Delay taking Company and Deposit taking Company (Reserve Bank) Directions, 2016:
   a. Whether the capital adequacy ratio as disclosed in the return submitted to the RBI in form NBS-7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the RBI;
   b. Whether the company has furnished to the RBI 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-Delay taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Delay 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 RBI that it is not required to hold CoR from the RBI, the
auditor shall include a statement that the company is complying with the conditions stipulated as advised by the RBI.

(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 RBI**

(1) 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 RBI 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 (1) 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)]

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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.

(c) 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.”

(d) 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) **Owned funds** the aggregate of the paid-up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, 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, 2013)

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>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1) Financial Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Cash and cash equivalents</td>
<td></td>
<td></td>
<td></td>
</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>
<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>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>
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</tr>
<tr>
<td>(2) Other Receivables</td>
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<tr>
<td>(e) Loans</td>
<td></td>
<td></td>
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<tr>
<td>(f) Investments</td>
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<td></td>
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<tr>
<td>(g) Other Financial assets</td>
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<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>
<td></td>
</tr>
<tr>
<td>(b) Current tax assets (net)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>(c) Deferred tax assets (net)</td>
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<td></td>
</tr>
<tr>
<td>(d) Investment property</td>
<td></td>
<td></td>
<td></td>
</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>
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<td></td>
<td></td>
</tr>
<tr>
<td>(j) Other intangible assets</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(k) Other non-financial assets (to be specified)</td>
<td></td>
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<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**LIABILITIES 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
<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>
</tr>
</thead>
<tbody>
<tr>
<td>micro enterprises and small enterprises</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(II) Other Payables</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) total outstanding dues of micro enterprises and small enterprises</td>
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<td></td>
<td></td>
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<tr>
<td>(ii) total outstanding dues of creditors other than micro enterprises and small enterprises</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Debt Securities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Borrowings (other than debt securities)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Deposits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Subordinated liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Other financial liabilities (to be specified)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) Non-financial Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Current tax liabilities (net)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Provisions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Deferred Tax Liabilities (net)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Other non-financial liabilities (to be specified)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(3) Non-financial Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Equity share capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Other equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Liabilities and Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## 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 for the current reporting period (₹)</th>
<th>Figures for the previous reporting period (₹)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue from operations</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Interest Income</td>
<td></td>
<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>(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>
<tr>
<td><strong>Total revenue from operations (I)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other income (to be specified) (II)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Income (III= I + II)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Finance costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Fees and commission expense</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Net loss on fair value changes</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(d) Net loss on derecognition of financial instruments under amortised category</td>
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<td></td>
</tr>
<tr>
<td>(e) Impairment on financial instruments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) Cost of material consumed</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(g) Purchases of stock-in-trade</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>(h) Changes in Inventories of finished goods, stock-in-trade and work-in-progress</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Particulars</td>
<td>Notes No.</td>
<td>Figures for the current reporting period (₹)</td>
<td>Figures for the previous reporting period (₹)</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
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<td>---------------------------------------------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>(i) Employee Benefits Expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(j) Depreciation, amortization and impairment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(k) Other expenses (to be specified)</td>
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<td></td>
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<tr>
<td>Total Expenses (IV)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Profit / (loss) before exceptional items and tax (V= III - IV)</td>
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<tr>
<td>Exceptional items (VI)</td>
<td></td>
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<tr>
<td>Profit / (loss) before tax (VII= V - VI)</td>
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<tr>
<td>Tax Expense (VIII):</td>
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<td></td>
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<tr>
<td>(1) Current tax</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>(2) Deferred tax</td>
<td></td>
<td></td>
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<tr>
<td>Profit / (loss) for the period from continuing operations (IX= VII - VIII)</td>
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</tr>
<tr>
<td>Profit / (loss) for the period from discontinued operations (X)</td>
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<tr>
<td>Tax Expense of discontinued operations (XI)</td>
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<tr>
<td>Profit / (loss) for the period from discontinued operations after tax (XII= X - XI)</td>
<td></td>
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<tr>
<td>Profit / (loss) for the period (XIII= IX + XII)</td>
<td></td>
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<tr>
<td>Other Comprehensive Income (XIV)</td>
<td></td>
<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>
<td></td>
<td></td>
<td></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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<tr>
<td>SUB-TOTAL (A)</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Particulars</td>
<td>Notes No.</td>
<td>Figures for the current reporting period (₹)</td>
<td>Figures for the previous reporting period (₹)</td>
</tr>
<tr>
<td>---------------------------------------------------------------------------</td>
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<td>---------------------------------------------</td>
<td>---------------------------------------------</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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<td></td>
<td></td>
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<tr>
<td>SUB-TOTAL (B)</td>
<td></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>
<td></td>
<td></td>
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</tr>
<tr>
<td>Earnings per equity share (for continuing operations) (XVI)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Basic (₹)</td>
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<tr>
<td>Diluted (₹)</td>
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<tr>
<td>Earnings per equity share (for discontinued operations) (XVII)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic (₹)</td>
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<td></td>
<td></td>
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<tr>
<td>Diluted (₹)</td>
<td></td>
<td></td>
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<tr>
<td>Earnings per equity share (for continuing and discontinued operations) (XVIII)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Basic (₹)</td>
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<td></td>
<td></td>
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<tr>
<td>Diluted (₹)</td>
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</tbody>
</table>

Note: Student may also 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 showing those only as part of the notes.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. Define NBFC. Also give a brief description about types of NBFCs covering any five NBFCs.

2. Shubham & Associates are going to start the audit of NBFCs. They have not performed much work for the NBFCs in the past years. You are required to explain the requirements related to registration and regulation of NBFCs which an auditor needs to keep in his mind while planning the audit of NBFC which would help this firm.

3. Shivam & Co LLP are the auditors of NBFC (Investment and Credit Company). Some of the team members of the audit team who audited this NBFC have left the firm and the new team members are in discussion with the previous team members who are still continuing with the firm regarding the verification procedures to be performed. In this context, please explain what verification procedures should be performed in relation to audit of NBFC - Investment and Credit Company (NBFC-ICC).

4. You are appointed as the auditor of a NBFC registered with the RBI and which is accepting and holding public deposits. You are considering your reporting requirement in addition to your report made under Section 143 of the Companies Act, 2013 on the accounts of this NBFC as per the prescribed Directions.
Please explain what points are required to be known in respect of separate report to be given by you to the Board of Directors of this NBFC.

5. Kamna & Co LLP, a firm of Chartered Accountants, was appointed as auditor of an NBFC. The audit work has been completed. The audit team which was involved in the fieldwork came across various observations during the course of audit of this NBFC and have also an limited understanding about the exceptions which are required to be reported in the audit report. They would like to understand in detail regarding the obligations on the part of an auditor in respect of exceptions in his report so that they can conclude their work. Please explain.

Multiple Choice Questions

1. RCE Ltd was set up under the Companies Act 2013 and got itself registered as non-banking financial company with the Reserve Bank of India, fulfilling the required criteria. During the financial year ended 31 March 2019, the company’s operations have started. The company’s total assets were rupees 298 crores out of which trade receivables, loans receivable in cash, cash and bank balances comprised of rupees 199 crores. During the financial year ended 31 March 2019, the company’s operations generated total income of rupees 99.50 crores. The management also did an assessment and observed that income from its financial assets was not much during the year and amounted to only rupees 60 crores. The management is looking at various alternatives to improve its operations, if required, to generate better income in the coming years.

Further, the company during the year also accepted and gave demand deposits which have been very efficient for the company. Management has a plan to significantly increase these deposits in the next 2 years as that would help in the overall functioning of the company.

In the context of the above, please answer which of the following options would be correct.

(a) The company does not meet the criteria of financial assets and hence would not be considered as NBFC. Further, it cannot accept and give demand deposits and the same thing should be reported by the statutory auditors of the company.

(b) The company does not meet the criteria of income and hence would not be considered as NBFC. Further, it cannot accept and give demand deposits and the same thing should be reported by the statutory auditors of the company.

(c) The company meets the criteria of financial assets and income. An NBFC can only accept demand deposits but cannot give demand deposits. Hence in this case, the statutory auditors should report regarding the same.
(d) The company meets the criteria of financial assets and income. An NBFC can only give demand deposits but it cannot accept demand deposits. Hence in this case, the statutory auditors should report regarding this matter.

2. CER Ltd is a non-banking financial company and has been operating for the last 10 years. The company is duly registered as per the requirements of the Reserve Bank of India. The company’s assets base has been very strong over the years due to its efficient management function. The company is also planning to get listed for which required work is going on.

For the financial year ended 31 March 2019, the company has closed its books of accounts and prepared the financial statements for the purpose of statutory audit in a timely manner. The auditors of the company have started their fieldwork. It has been observed by the auditors that the company’s various term loans which have been given to various parties have become overdue in terms of instalment including interest for a period of 5 months. As per the auditors these terms loans should be considered by the company for making provision at the rate of 20% of total outstanding amount, however, the management has considered a provision at the rate of 0.30%. Please advise the auditors and the management regarding this matter considering that “Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016” are applicable to this NBFC.

(a) Provision should be made at 10%.
(b) Provision should be made 0.30%
(c) Provision should be made at 20%.
(d) Provision should be made at 0.40%

3. CRE Ltd is a non-banking financial company and registered with the Reserve Bank of India as per the requirements of Section 45-IA of the Reserve Bank of India Act, 1934. The company was established with a net owned fund of Rs. 2 crores. The company’s management had a great focus on the internal controls and processes. To make them robust, in the initial years of set up of the company, the management involved consultants who helped the management in setting up those processes and controls. The company’s operations have grown considerably over the years and their assets base is huge.

The management has in-house function which reviews these processes regularly and any improvements required are actioned upon in no time.
With this kind of set up, the management was assured of the functioning of the NBFC as per right principles, however, despite this during the year ended 31 March 2019, the management came across instance of fraudulent encashment through forged instruments and fictitious accounts involving an amount of Rs. 5 lakhs. Though the amount was not significant but still the management discussed the same with the statutory auditors for their knowledge.

The statutory auditors after discussion told the management that the management needs to report this matter to RBI with which the management is not comfortable considering the amount involved in this matter and the size of the company.

(a) Management need not report this matter considering the nature of fraud.
(b) Management need not report this matter considering the amount involved.
(c) Management should report this matter to RBI.
(d) Management should not report this to RBI, however, it will be their responsibility to report this matter to SEBI.

4. NBB Ltd is a non-banking financial company on which provisions of “Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016” are applicable. The company has been accepting as well as holding the public deposits. During the financial year ended 31 March 2017, the company obtained specified credit rating for its fixed deposits from CRISIL. However, during the financial year ended 31 March 2018, the company obtained minimum investment grade for its fixed deposits from ICRA Ltd. During the financial year ended 31 March 2019, no such grade/ rating was obtained. The reports of the statutory auditors for the past years have always been clean.

The statutory auditors of NBB Ltd have completed their audit for the financial year ended 31 March 2019 as well and finalizing their audit report. The auditors discussed with the management that for the financial year ended 31 March 2019, they would have to include matter regarding acceptance of public deposits by the company without obtained required specified credit rating during the year ended 31 March 2019. The auditors further explained that even during the year ended 31 March 2018, instead of specified credit rating, the management obtained minimum investment grade which was ignored by them but it cannot continue for 2 years. The management is of the view that this requirement was fulfilled as the same was obtained in the previous year and for one year if that is not taken then it should be fine. Please advise how to deal with this matter.
(a) It would have been fine if the rating was obtained in the financial year ended 31 March 2018 instead of minimum investment grade. Hence the auditor should report this matter.

(b) It does not make any difference whether rating or grade was obtained. Moreover the same should have been obtained in the current year also and hence the auditor should report this matter.

(c) It does not make any difference whether rating or grade was obtained. And hence management is correct that only up to last year it was obtained and hence no reporting is required by the auditor on this matter.

(d) If the rating was not obtained in the previous year, it requires that NBFC obtains rating in the current year twice i.e. every half year. Accordingly, it should be reported by the auditor.

5. Kshitij Ltd is a non-banking financial company other than Nidhi company and is covered under “Master Direction - Non-Banking Financial Companies Auditor’s Report (Reserve Bank) Directions, 2016”. The NBFC has been in existence for the last 11 years and its operations are considerable in size having a net worth of ₹ 299 crores.

The NBFC has new statutory auditors for the financial year ended 31 March 2019. The audit report (including CARO) of the NBFC was clean for the financial year ended 31 March 2018. The company had a planning discussion with the auditors of the company for the financial year ended 31 March 2019 who raised a point regarding the applicability of new set of accounting standards, Indian Accounting Standards (Ind AS), on the NBFC for the financial year ended 31 March 2019 and have asked the management to ensure that its financial statements should be according to that. This comes as a big surprise to the management who had assessed that Ind AS would not be applicable to this NBFC because of the fact that CARO is applicable on this NBFC. There is a big disconnect on this matter between the auditor and the management. Please help by resolving this matter.

(a) Both the management and statutory auditors are not correct because Ind AS is not applicable to any NBFC covered under “Master Direction - Non-Banking Financial Companies Auditor’s Report (Reserve Bank) Directions, 2016”.

(b) Management is correct because Ind AS is only applicable to NBFC which are also a Nidhi company. In this case, CARO being applicable, Ind AS cannot apply to this NBFC.

(c) If the management does not agree with the view of statutory auditors then they should give adverse opinion in their report and also report this to RBI.
(d) Ind AS would not be applicable for financial year ended 31 March 2019 and hence the view of statutory auditors is not correct.

Answers to Theoretical Questions

1. Refer Para 1 – Definition and Types of NBFCs.

2. An auditor should know following points regarding registration and regulation of NBFCs: Under Section 45–IA of the RBI Act, 1934, no NBFC shall commence or carry on the business of a non-banking financial institution without

- obtaining a certificate of registration issued by the RBI; and
- having a net owned fund (NOF) of ` 25 lakhs (` Two crore since April 1999) not exceeding two hundred lakhs rupees, as the RBI may, by notification in the Official Gazette, specify.

(The RBI (Amendment) Act (1997) provided an entry point norm of ` 25 lakh as the minimum NOF which was revised upwards to ` 2 crore for new NBFCs seeking grant of certificate of registration (CoR) on or after 21 April 1999).

[Upper limit in relation to NOF requirement for commencing NBFC business has been increased from ` 2 crores to ` 100 crores as per Finance (No.2) Bill 2019].

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 the RBI in prescribed form along with necessary documents for registration. The RBI issues CoR 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 CoR 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 RBI has issued directions to NBFCs 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.

3. Refer Para 6
4. Refer Para 7.1(3), (4)
5. Refer Para 7.1(5)

Answers to Multiple Choice Questions

1. (d)  2. (a)  3. (c)  4. (b)  5. (d)