

## AUDIT OF NON BANKING FINANCIAL COMPANIES

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### 14.1 Introduction

Non-banking financial companies (NBFCs) have been the subject of focussed attention during the nineties. In particular, the rapid growth of NBFCs, especially in the nineties, has led to a gradual blurring of dividing lines between banks and NBFCs, with the exception of the exclusive privilege that commercial banks exercise in the issuance of cheques. Owing to certain disquieting developments in the NBFC sector, the RBI Act was amended in 1997, providing for a comprehensive regulatory framework for NBFCs. The RBI (Amendment) Act, 1997 provides for compulsory registration with the Reserve Bank of all NBFCs, irrespective of their holding of public deposits, for commencing and carrying on business, minimum entry point norms, maintenance of a portion of deposits in liquid assets, creation of Reserve Fund and transfer of 20 per cent of profit after tax annually to the Fund. The Amendment Act also conferred powers on Reserve Bank to issue directions to companies and its auditors, prohibit deposit acceptance and alienation of assets by companies and effect winding up of companies.

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

**14.1.1** Classification of NBFCs - NBFCs, normally fall into following categories:

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

- (i) Asset Finance Company (AFC)
- (ii) Investment Company
- (iii) Loan Company

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### *Specified Criteria:*

- (i) Asset Financed Company would be defined as any company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines.
- (ii) Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.

The onus of including only eligible assets for the purpose of classification as Asset Finance Company shall be that of the company concerned.

### ***Mortgage Guarantee Company to be NBFC***

As per RBI Notification dated January 15, 2008, a mortgage guarantee company would be treated as NBFC. The relevant notification is reproduced as below:

"The Reserve Bank of India, on being satisfied that it is necessary so to do, in exercise of the powers conferred on it under section 45-I(f)(iii) of the Reserve Bank of India Act, 1934 (2 of 1934) (the Act), with the prior approval of the Central Government hereby specifies that a Mortgage Guarantee Company, that is, a company registered with the Bank under the scheme for registration of Mortgage Guarantee Companies notified by the Bank in this regard, will be treated as Non-Banking Financial Company under the provisions of the Act."

### **(A): Investment Policy for Mortgage Guarantee Companies**

- (i) A mortgage guarantee company shall invest only in the following instruments:
  - (a) Government Securities;
  - (b) Securities of corporate bodies / public sector undertakings guaranteed by Government;
  - (c) Fixed Deposit/Certificate of Deposits/bonds of Scheduled Commercial banks/PFIs;
  - (d) listed and rated debentures/bonds of corporates;
  - (e) fully debt oriented Mutual Fund Units;
  - (f) unquoted Government securities and Government guaranteed bonds.
- (ii) No other investment including investment in subsidiaries and joint ventures would be permitted. However, a mortgage guarantee company may hold investments in equity shares of any company which may be quoted or unquoted or other unquoted investments acquired in satisfaction of its debts which shall be disposed of by the mortgage guarantee company within a period of three years or within such period as extended by the Bank, from the date of such acquisition.

***Pattern of Investment:***

(i) A mortgage guarantee company shall hold not less than 25% of its total investment portfolio in Central and State Government securities.

(ii) The remaining investments may be invested as the Board considers prudent, but with a ceiling of 25% in any one category *i.e.* listed and rated corporate bonds and debentures or debt oriented mutual fund units, etc.

(iii) The Board may fix an appropriate sub-limit for individual investments within each category of instruments as specified in paragraph 3(i) above of these directions.

(iv) The Minimum Investment Grade Rating (MIGR) assigned by the SEBI registered Rating Agencies would be the requirement for investment by MGC in bonds/debentures and debt oriented Mutual Funds.

***(B): Income recognition:***

(i) Mortgage Guarantee Companies may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.

(ii) Mortgage Guarantee Companies may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by the corporate body in its Annual General Meeting and the owner's right to receive payments is established.

(iii) Mortgage Guarantee Companies may book income from Government securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided interest is serviced regularly and as such is not in arrears.

(iv) Mortgage Guarantee Companies should book income from units of mutual funds on cash basis.

***(C): Accounting of investments:***

(1) All investments shall be marked to market;

Quoted investments shall, for the purposes of valuation, be grouped into the following categories, *viz.*,

(a) Government securities including treasury bills,

(b) Government guaranteed bonds/securities;

(c) bonds of banks/ PFIs;

(d) debentures/bonds of corporates; and

(e) Units of mutual fund.

Quoted investments for each category shall be valued at cost or market value whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds

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the aggregate cost for the category, the net appreciation shall be ignored. Depreciation in one category of investments shall not be set off against appreciation in another category.

(2) Investments in unquoted Government securities or Government guaranteed bonds shall be valued at carrying cost.

(3) Unquoted investments acquired in satisfaction of its debts shall be valued as under:

- (a) Unquoted investments in the units of mutual funds shall be valued at the net asset value declared by the mutual fund in respect of each particular scheme;
- (b) Unquoted equity shares shall be valued at cost or break up value, whichever is lower. However, mortgage guarantee companies may substitute fair value for the break up value of the shares, if considered necessary. Where the balance sheet of the investee company is not available for two years, such shares shall be valued at Rupee one per company;
- (c) Unquoted preference shares shall be valued at cost or face value, whichever is lower.

**Note:** Unquoted debentures shall be treated as term loans or other type of credit facilities depending upon the tenure of such debentures for the purpose of income recognition and asset classification.

The MGC with the approval of the Board shall frame an investment policy in tune with these directions.

### ***Infrastructure Finance Company[IFC] (RBI Circular dated February 12, 2010)***

Currently, the Reserve Bank has classified NBFCs under three categories, viz., Asset Finance Companies, Loan companies and Investment Companies. It has now been decided to introduce a fourth category of NBFCs as "Infrastructure Finance Companies"(IFCs).

Accordingly, it is advised that the present classification of NBFCs stands modified to include IFCs. An IFC is defined as non deposit taking NBFC that fulfills the criteria mentioned below:

- (i) a minimum of 75 per cent of its total assets should be deployed in infrastructure loans as defined in Para 2(viii) of the Non Banking Financial (Non Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;
- (ii) Net owned funds of ₹ 300 crore or above;
- (iii) minimum credit rating 'A' or equivalent of CRISIL, FITCH, CARE, ICRA or equivalent rating by any other accrediting rating agencies;
- (iv) Capital to Risk Asset Ratio (CRAR) of 15 percent (with a minimum Tier I capital of 10 percent).

### ***Core Investment Companies [CICs] (RBI Circular August 12, 2010)***

Core Investment Company means a NBFC carrying on the business of acquisition of shares and securities which satisfies the following conditions:

- it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;

- its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;
- it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
- it does not carry on any other financial activity referred to in section 45-I(c) and 45-I(f) of the RBI Act, 1934 except investment in bank deposits, money market instruments, government securities, loans and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

Core Investment Companies (CIC) with an asset size of less than ₹ 100 crores will not be required to register themselves with RBI.

Core Investment Companies (CIC) with an asset size of ₹ 100 crores or more, will be regarded as Systemically Important Core Investment Companies (CICs-ND-SI). Systemically Important Core Investment Companies will be required to get themselves registered with Reserve Bank of India.

A CIC-ND-SI which fulfills the following conditions, will not be required to meet the requirement for maintaining Net Owned Funds & capital adequacy and exposure norms as required under Non-Banking Financial (Non-Deposit Accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007:

- Maintenance of minimum Capital Ratio where Adjusted Net Worth shall not be less than 30% of its Aggregate Risk Weighted Assets on Balance Sheet and risk adjusted value off-balance sheet items as on the date of the last audited Balance Sheet at the end of the financial year.
- Ensuring that its outside liabilities at all times doesn't not exceed 2.5 times of the Adjusted Net Worth as on last audited Balance Sheet date.

CICs-ND-SI will be required to submit an Annual Certificate from their statutory auditors regarding compliance with the above guidelines within one month from the date of finalisation of the Balance-Sheet.

The above mentioned categories may further have the following sub-categories depending upon their business functions :

- (i) Equipment leasing company engaged in equipment leasing or financing of such activity.
- (ii) Hire purchase finance company engaged in hire purchase transaction or financing of such transactions.
- (iii) Investment company engaged in acquisition of securities and trading in such securities to earn a profit.
- (iv) Loan company engaged in providing finance by making loans or advances, or otherwise for any activity other than its own; excludes EL/HP/Housing finance Companies (HFCs).

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- (v) Residuary non-banking company (RNBC) which receives deposits under any scheme or arrangement, by whatever name called, in one lump-sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any manner. These companies do not belong to any of the categories as stated above.

## 14.2 Audit Procedure

The following are the necessary steps involved -

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

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

**(2) Evaluation of Internal Control System** - The responsibility of maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of its business vests with the management. A sound internal control system would enable an organisation to plug loopholes in its workings, particularly in the detection of frauds and would also aid in timely decision making. An auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures. An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.

In particular, an auditor should review the effectiveness of the system of recovery prevalent at the NBFC. He should ascertain whether the NBFC has an effective system of periodical review of advances in place which would facilitate effective monitoring and follow up. The absence of a periodical review system could result in non-detection of sticky advances at its very inception which would ultimately result in the NBFC having an alarmingly high level of NPAs.

**(3) Registration with the RBI** - Section 45-IA inserted by the RBI Act, w.e.f. 9<sup>th</sup> January, 1997, has made it incumbent on the part of all NBFCs to comply with registration

requirements. and have minimum net owned funds of ₹ 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 9<sup>th</sup> 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 30 days from the end of the relevant quarter and with reference to investments held in approved securities during the relevant quarter. The auditor should ascertain whether investment in prescribed liquid assets have been made and whether quarterly returns as mentioned above have been regularly filed with the RBI by the concerned NBFC.

**(4) NBFC Public Deposit Directions** - The auditors must ascertain whether the company is a loan company or an investment company or a hire purchase finance company or an equipment leasing company as per the classification, if any, assigned to the NBFC by the RBI. In case, the NBFC has not been classified by the RBI, the classification of a company will have to be determined after a careful consideration of various factors such as particulars of earlier registration granted, if any, particulars furnished in the application form for registration, company's Memorandum of Association and its financial results. Thereafter, it must be ascertained whether the company has complied with the following aspects in relation to the activity of mobilisation of public deposits.

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

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

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

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- (iii) Ascertain whether the NBFC has accepted or renewed any public deposit only after a written application form from 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 contains the specific category of depositor, i.e., whether depositor is a shareholder or a director or a promoter or a member of public.
  - (iv) Verify the deposit register maintained by a NBFC and test check the particulars that have been entered therein in respect of each depositor with supporting receipts issued to the depositors. Also check whether the NBFC is regularly paying its deposits on due dates and in the case of a delay/default, the reasons for the delay/default and the actual date of payment.
  - (v) Check whether the investments made in approved liquid assets by a NBFC holding public deposits have been lodged in safe custody with a designated scheduled commercial bank as required by the NBFC Public Deposit Directions. Obtain a certificate from the bank to that effect.
  - (vi) In the case of NBFCs accepting/holding public deposits ascertain whether audited statement of accounts together with a copy of the auditor's report and director's report thereon have been submitted within prescribed time limit from the date of holding the Annual general meeting.
  - (vii) Check whether the NBFC has filed its annual return as specified in the First Schedule before the 30<sup>th</sup> June with reference to its position as on the 31<sup>st</sup> March of each year.
  - (viii) In the case of NBFCs not accepting/holding public deposits, check whether a board resolution has been passed by the NBFC to the effect that it has neither accepted any public deposits nor would it accept any public deposits during the year.
  - (ix) In the case of Group Holding Investment Companies, check whether the NBFC has passed a board resolution to the effect that the company has invested or would invest/hold its investments in share and securities of group companies specifying the names of the companies. In addition to the above, group holding investment companies are required to give a further undertaking that it would not trade in such shares/securities and that it has neither accepted nor would it accept any public deposits during the year.
- (5) NBFC Prudential Norms Directions -**
- (i) Check compliance with prudential norms encompassing income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy norms, prohibition on granting of loans by a NBFC against its own shares, prohibition on loans and investments for failure to repay public deposits and norms for concentration of credit/investments.
  - (ii) An auditor should ensure that the Board of Directors of every NBFC granting/intending to grant demand/call loans shall frame a policy for the company and shall implement too.
  - (iii) An auditor should assess on the basis of examinations conducted by him whether the NBFC has complied with the prudential norms. In particular, he should verify that



advances and other credit facilities have been properly classified as standard/sub standard/doubtful/loss and that proper provision has been made in accordance with the Directions.

- (iv) In respect of Non Performing Assets, an auditor should check whether the unrealised income in respect of such assets has not been taken to the Profit & Loss Account on an accrual basis. Income from NPAs should be accounted for on realisation basis only.
- (v) Check whether all accounts which have been classified as NPAs in the previous year also continue to be shown as such in the current year also. If the same is not treated as a NPA in the current year, the auditor should specifically examine such accounts to ascertain whether the account has become regular and the same can be treated as performing as per the Directions.

### 14.3 Audit Check-List

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

#### A. Investment Companies

- (i) Physically verify all the shares and securities held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.
- (ii) NBFC Prudential Norms stipulates that NBFCs should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. Verify that the credit facilities extended and investments made by the concerned NBFC are in accordance with the prescribed ceiling.
- (iii) Verify whether the NBFC has not advanced any loans against the security of its own shares.
- (iv) Verify that dividend income wherever declared by a company, has been duly received by a NBFC and interest wherever due [except in case of NPAs] has been duly accounted for. NBFC Prudential Norms directions require dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General meeting and its right receives the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.
- (v) Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

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- (vi) Verify the Board Minutes for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.
- (vii) Check whether the investments have been valued in accordance with the NBFC Prudential Norms Directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.
- (viii) Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.
- (ix) Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.
- (x) An auditor will have to ascertain whether the requirements of AS 13 "Accounting for Investments" (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.
- (xi) In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC.
- (xii) In the case of securities lent/borrowed under the Securities Lending Scheme of SEBI, verify the agreement entered into with the approved intermediary (i.e. the person through whom the lender will deposit and the borrower will borrow the securities for lending/borrowing) with regards to the period of depositing/lending securities, fees for depositing/lending, collateral securities and provision for the return including pre-mature return of the securities deposited/lent.
- (xiii) Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon.)
- (xiv) Verify charges received or paid in respect of securities lend/borrowed.
- (xv) Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.

### **B. Loan Company**

- (i) An auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.
- (ii) An auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.
- (iii) Obtain balance confirmations from the concerned parties.

- (iv) As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.
- (v) Check whether the NBFC has not lent/invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms Directions.
- (vi) Check whether the NBFC has not advanced any loans against the security of its own shares.
- (vii) In case of companies which are engaged in the business of providing short term funds in the ICD market, the auditor should ascertain whether the NBFC has a regular system for ascertaining the credit worthiness of the clients prior to placed by the company are being rolled over and whether there is any risk of non-recovery. In addition, he should ascertain that the NBFC is receiving interest regularly in respect of these ICDs. Roll over of ICDs and non-realisation of interest and principal amounts should be thoroughly checked to determine whether the ICD is required to be treated as a NPA.
- (viii) An auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.
- (ix) Check the classification of loans and advances (including bills purchased and discounted) made by a NBFC into Standard Assets, Sub-Standard Assets, doubtful assets and loss assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.
- (x) An auditor should also verify whether provision for bad and doubtful debts has been disclosed separately in the Balance Sheet and the same have not been netted off against the income or against the value of assets as required by the NBFC Prudential Norms Directions.

### **C. Asset Finance Company**

#### **1. Hire Purchase Finance Company**

- (i) Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.
- (ii) Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.
- (iii) In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession

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of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.

- (iv) If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.
- (v) The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.
- (vi) Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.
- (vii) Examine the method of accounting followed by the hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.
- (viii) Verify that the assets given on hire purchase have been adequately insured against.
- (ix) In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

### 2. Equipment Leasing Finance Company

- (i) Ascertain whether the NBFC has an adequate appraisal system for extending equipment leasing finance.
- (ii) The auditor should verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In respect of some major transactions, an auditor should arrange for physical verification of the leased assets so as to dispel any doubts that equipment leasing finance was not extended without the corresponding assets being created.
- (iii) Ascertain whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased assets is being carried out by the lessee.
- (iv) Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.
- (v) An auditor should verify whether the AS issued by the Institute of Chartered Accountants of India in respect of "Accounting for Lease" has been compulsorily followed.

## 14.4 Auditor's Duty

The following are the important duties of an auditor -

**Compliance with NBFC Auditors Report RBI Directions** - The recent RBI regulations have considerably increased the responsibility of auditors of NBFCs. A very onerous task of reporting to

the Board of Directors on certain specified matters and to the RBI on an excepting basis has been imposed upon him. This reporting requirement is in addition to the normal reporting requirements to the shareholders under section 227 as well as the reporting under CARO, 2003 under section 227(4A) of the Companies Act, 1956. Auditors will thus have to be very careful whilst carrying out audits of NBFCs to ensure that all matters which they are required to take into consideration for the purposes of reporting to the RBI have been taken due care of.

Section 45MA of the Reserve Bank of India Act has been introduced with effect from 13.12.1974. Under this provision the auditor of a non-banking financial company or a non-banking miscellaneous company which 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. The provision further states that if on inquiry the auditor is not satisfied about the compliance by the company, it is his duty to make to the Reserve Bank giving the aggregate amount of deposits held by the company. The auditor is also required to incorporate the report or intended to be made to the Reserve Bank in his report to the company under Section 227 of the Companies Act. Report to Board of Directors under RBI Directions as per notification No. DNBS. 201 /DG(VL)-2008 dated September 18, 2008, in exercise of the powers conferred by sub-section (1A) of Section 45MA of the Reserve Bank of India Act, 1934 (Act 2 of 1934) and of all the powers enabling it in this behalf, and in supersession of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 1998, issues to every auditor of every non-banking financial company, the Directions hereinafter specified.

### **1. Short title, application and commencement of the Directions**

- (i) These Directions shall be known as "Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2008."
- (ii) These 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 (2 of 1934) hereinafter referred to as non-banking financial company.
- (iii) These Directions shall come into force with immediate effect.

### **2. Auditors to submit additional Report to the Board of Directors**

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

### **3. Matters to be included in the auditor's report**

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. Whether the company is engaged in the business of non-banking financial institution and whether it has obtained a Certificate of Registration (CoR) from the Bank

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- II. In the case of a company holding CoR issued by the Bank, whether that company is entitled to continue to hold such CoR in terms of its asset/income pattern as on March 31 of the applicable year.

**(B) In the case of a non-banking financial company 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, 1998 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, 1998;
- (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, 1998 are regularised in the manner provided in the said Directions;
- (iii) Whether an Asset Finance Company having Capital to Risk Assets Ratio (CRAR) less than 15% or an Investment Company or a Loan Company as defined in paragraph 2(1)(ia), (vi) and (viii) respectively of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998 is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency;
- (iv) In respect of NBFCs referred to in clause (iii) above, 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, 1998
- (a) is in force; and
  - (b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;
- (v) In case of NBFCs having Net Owned Funds of ₹ 25 lakh and above but less than ₹ 200 lakhs, whether the public deposit held by the companies is in excess of the quantum of such deposit permissible to it in terms of Notification No. DNBS. 199/CGM (PK) - 2008 dated June 17, 2008 and whether such company :
- (a) has frozen its level of deposits as on the date of that Notification; or
  - (b) has brought down its level of deposits to the level of revised ceiling of deposits in terms of that Notification.

- (vi) 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;
- (vii) 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 Reserve Bank of India in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- (viii) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;
- (ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the Bank in terms of NOTIFICATION NO.DNBS.172/CGM(OPA)-2003 dated July 31, 2003;
- (x) Whether the company has furnished to the Bank within the stipulated period the return on deposits as specified in the NBS 1 to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998;
- (xi) Whether the company has furnished to the Bank within the stipulated period the half-yearly return on prudential norms as specified in the Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;
- (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, 1998.

**(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: -

- (i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits.
- (ii) Whether the company has accepted any public deposits during the relevant period/year;
- (iii) 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 (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007.
- (iv) In respect of Systemically Important Non-deposit taking NBFs as defined in paragraph 2(1)(xix) of the Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007

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- (a) whether the capital adequacy ratio as disclosed in the return submitted to the Bank in form NBS- 7, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;
- (b) whether the company has furnished to the Bank the annual statement of capital funds, risk assets/exposures and risk asset ratio (NBS-7) within the stipulated period.

### **(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, the auditor shall include a statement on the following matters, namely:

- § Where a Company has obtained a specific advice from the Bank that it is not required to hold CoR from the Bank whether the company is complying with the conditions stipulated as advised by the Bank.

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

Where, in the auditor's report, the statement regarding any of the items referred to in paragraph 3 above is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred to in paragraph 3 above, his report shall indicate such fact together with reasons therefore.

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

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

- (a) the provisions of Chapter III B of Reserve Bank of India Act, 1934 (Act 2 of 1934); or
- (b) the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998; or
- (c) Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007; or
- (d) Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

it shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the Bank under whose jurisdiction the registered office of the company is located as per Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-



paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

#### **14.5 Classification of Frauds by NBFC (RBI Circular March, 2008)**

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

- (a) Misappropriation and criminal breach of trust.
- (b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- (c) Unauthorised credit facilities extended for reward or for illegal gratification.
- (d) Negligence and cash shortages.
- (e) Cheating and forgery.
- (f) Irregularities in foreign exchange transactions.
- (g) Any other type of fraud not coming under the specific heads as above.

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

- (a) cases of cash shortages more than ₹ 10,000/- and
- (b) cases of cash shortages more than ₹ 5000/- if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

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