

Audit of Non Banking Financial Companies

Question 1

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

Answer

Section 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

- (i) A financial institution which is a company;
- (ii) A non banking institution which is a company with principal business of receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
- (iii) Such other non-banking institution or class of such institutions, as the Reserve Bank with the previous approval of the Central Government may specify by notification in the Official Gazette.

For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a –“Loan company, Investment company, Hire purchase finance company, Equipment leasing company and Mutual benefit financial company”.

Question 2

What are the different types of NBFCs registered with RBI?

Answer

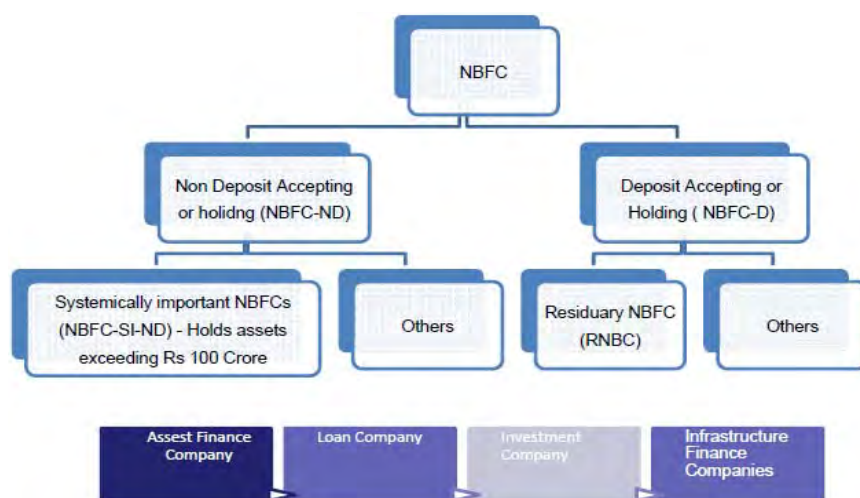
Non-Banking Financial Company - In terms of the Section 45-I(f) read with Section 45-I (c) of the RBI Act, 1934, as amended in 1997, NBFC is one whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance 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:

14.2 Advanced Auditing and Professional Ethics

Currently, NBFCs registered with RBI are being classified as:

- Asset Finance Company (AFC) - The main activity of an AFC is financing of physical assets supporting productive / economic activity. These may be in the areas such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments and general purpose industrial machines.
- Investment Company (IC) which mainly deal in acquisition of shares and securities of other companies. A core investment company would be a company which acquires shares and securities of Group companies.
- Loan Company (LC): Loan companies primarily provide finance (whether by making loans or advances or otherwise for any activity), other than its own activity.
- Infrastructure Finance Companies: This category of NBFCs deploys a minimum of three-fourths of their total assets in infrastructure loans. The net owned funds of this category of NBFCs are more than ₹ 300 crores and they should have a minimum credit rating of 'A' or equivalent and the Capital to Risk-Weighted Assets Ratio (CRAR) is 15% (with a minimum Tier I Capital of 10%).
- Core Investment Company (CIC): These are NBFCs which carry on the business of acquisition of shares and securities in group companies and satisfies four conditions stated in the regulatory framework for Core Investment Companies issued by RBI.
- Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC) - Infrastructure Debt Funds (IDFs) are funds set up to facilitate the flow of long-term debt into infrastructure projects. The IDF will be set up either as a trust or as a company. A trust based IDF would normally be a Mutual Fund (MF) while a company based IDF would normally be a NBFC.
- Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI) - An NBFC-MFI is defined as a non-deposit taking NBFC (other than a company licensed under Section 25 of the Indian Companies Act, 1956) that fulfils certain conditions.

The above type of companies may be further classified into those accepting deposits or those not accepting deposits.



Core Investment Companies, Infrastructure Debt Fund NBFC and NBFC – Micro Finance Institution (other than Companies Act, 1956 - Section 25 companies) are non deposit holding Companies.

Others

Housing Finance Companies : National Housing Board set up by the Government of India is the Apex authority regulating the housing finance companies. The Housing Finance Companies (NHB) Directions, 2010 deals with matters relating to acceptance of deposits by housing finance companies, prudential norms for income recognition, accounting standards, asset classification, provision for bad and doubtful assets, capital adequacy and concentration of credit/ investments to be observed by the housing finance companies and matters to be included in the auditors report by the auditors of such housing finance companies and matters ancillary and incidental thereto and amended the said directions from time to time.

Question 3

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

Answer

Compliance of Prudential Norms by NBFC

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

14.4 Advanced Auditing and Professional Ethics

- (ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.
- (iii) The auditor should verify the classification of advances and loans as standard/substandard/doubtful/loss and that proper provision has been made in accordance with the directions.
- (iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to profit and Loss Account.
- (v) The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.

Question 4

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

Answer

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

Hire Purchase Finance Company

- (i) Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance. The system of appraisal is basically concerned with obtaining information regarding the credit worthiness of the hirer, his experience in the field, assets owned, his past track record and future projections of his income.
- (ii) Verify that the payment for acquiring an asset should be made directly to the supplier/dealer and that the original invoice has been drawn out in the name of the NBFC.
- (iii) In the case of high value hire purchase items relating to machinery/equipment, an auditor should ascertain whether the valuation reports and installation reports are called for. In case of some high value items, he should also physically verify the asset in possession of the hirers, particularly in a situation where he has any doubts as regards the genuineness of the transaction.
- (iv) If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favour of the hire purchase company.
- (v) The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hirers have not sold the assets or otherwise encumbered them.
- (vi) Check whether hire purchase instalments are being received regularly as and when they fall due. Check whether adequate provision has been made for overdue hire purchase instalments as required by the NBFC Prudential Norms directions.

- (vii) Examine the method of accounting followed by the hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract. Ascertain that there is no change in the method of accounting as compared to the immediately preceding previous year.
- (viii) Verify that the assets given on hire purchase have been adequately insured against.
- (ix) In case the goods are repossessed by the hire purchase finance company on account of non-repayment of hire purchase instalments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

Question 5

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

Answer

Audit of equipment leasing finance company

The auditor should:

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

Question 6

As an auditor of a Non Banking Financial Company registered with the Reserve Bank of India (RBI), what are the prudential norms of RBI, whose compliance is to be verified?

Answer

Compliance of Prudential Norms by NBFC:

- (i) *The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting*

loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.

- (ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.*
- (iii) The auditor should verify the classification of advances and loans as standard / sub-standard / doubtful / loss and that proper provision has been made in accordance with the directions.*
- (iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to profit and Loss Account.*
- (v) The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.*