

AUDIT OF NON BANKING FINANCIAL COMPANIES

Question 1

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

Answer

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (Residuary non-banking company).

Question 2

What are the different types of NBFCs registered with RBI?

Answer

NBFCs registered with RBI are classified as

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

AFC 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. 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.

Advanced Auditing and Professional Ethics

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).
- (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.

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

Question 3

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

Answer

Compliance of Prudential Norms by NBFC

- (i) The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.
- (ii) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.
- (iii) The auditor should verify the classification of advances and loans as standard/substandard/doubtful/loss and that proper provision has been made in accordance with the directions.
- (iv) Auditor should ensure that unrealised income from non-performing assets has not been taken to 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.