

14. Audit of Non-Banking Financial companies

Important Point of this chapter

1.

Introduction

The NBFC institution which is known as: “Loan Company, Investment Company, Hire Purchase finance company, Equipment leasing Company, and mutual benefit financial company”

According to RBI Act, 1997, no NBFC is allowed to commence or carry on the business of a NBFC institution without obtaining a certificate of registration issued by the RBI.

However some other institution which is registered under or regulated by other regulators is expected from getting license. Such company is as follows:

- a. Venture capital fund
- b. Merchant banking companies
- c. Stock broking companies registered with SEBI,
- d. Insurance company holding a valid certificate of registration issued by IRDA.
- e. Nidhi Companies as notified
- f. Chit companies as notified
- g. Housing finance companies managed by National Housing Bank.

Types of NBFS

1. Non-Banking Financial Companies
2. Investment Company
3. Loan Company
4. Infrastructure Finance Company
5. Core Investment Company
6. Infrastructure debt fund – Non – Banking financial Company
7. Non Banking financial Company
8. Housing Finance Companies
9. Mortgage guarantee company

Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC)

Infrastructure Debt Funds, to facilitate the flow of the long term debt into infrastructure projects. IDF-NBFC would raise resources through issue of either rupee or Dollar denominated bonds of minimum 5 year maturity. The investor would be primarily domestic and off-shore institutional investors, especially insurance and pension funds which would have long term resources. IFD-NBFC would be regulated by the Reserve Bank.

Non Banking Financial Company – Micro Finance institution (NBFC-MFI)

The reserve bank of India having considered it necessary in the public interest and being satisfied that for the purpose of enabling the bank to regulate the credit system to the advantage of the country, gave the direction for the NBFC-MFI direction, 2011

This company may be defined as NBFC-MFI if it fulfils the following condition:

- I. Minimum net owned funds of Rs. 5 crore. (for North region of country it Rs. 2 crore)
- II. Not less than 85% of its net assets are in the nature of ‘qualifying assets’.

- For the purpose of ii above, “net assets” means as total assets other than cash and bank balances and money market instruments
- “Qualifying Assets” shall mean a loan which satisfies the following criteria.
 - a. Loan distributed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. 60,000 or urban and semi-urban household income not exceeding Rs. 1,20,000;
 - b. Loan amount does not exceed Rs. 35,000 in the first cycle and Rs. 50,000 in subsequent year;
 - c. Total indebtedness amount of the borrower does not exceed Rs. 50,000;
 - d. Tenure of the loan not be less than 24 months for loan amount in excess of Rs. 15,000 with prepayment without penalty;
 - e. Loan to be extended without collateral;
 - f. Aggregate amount of loans, given for income generation, is not less than 75% of the total loans given by the MFIs.
 - g. Loan is repayable on weekly, fortnightly or monthly installments at the choices of the borrower.
- III. Further the income an NBFC-MFI derives from the remaining 15% of assets shall be in accordance with the regulations specified in that behalf.
- IV. An NBFC which does not qualify as an NBFC-MFI shall not extend loans to micro finance sector, which in aggregate exceed 10% of its total assets.

Audit Procedures

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 AOA of the company, so as to acquaint oneself through the type of business that the proposed to engage itself in.
- An auditor may also scan through the minutes of the Board/committee meeting and hold discussions with the top level management to ascertain the corporate business plan/strategy which would give him a clear picture as to principal objects of the company.

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 business vests with the management.
- 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 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

- 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.
- Every NBFC holding public deposit is required to invest a specified percentage. 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 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

- If 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 of mobilization 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.
 - 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.
 - 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.
 - iv. Verify the deposit register maintained by a NBFC and test check the particulars that have been entered therein 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 AGM.
 - vii. Check whether the NBFC has filed its annual return as specified in the first schedule before the 30th June with the reference to its position as on the 31st March of each year.

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

- 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, prohibiting on granting of loans by a NBFC against its own shares, prohibition on loans and investments for failure to repay public deposit and norms for concentration of credit/investment.
- Auditors should ensure that the BOD of every NBFC granting/intending to grant call/demand loans shall frame a policy for the company and shall implement too.
- Auditor should verify that advances and other credit facilities have been properly classified as standard/sub standard/doubtful/loss and that provision has been made in accordance with directions.
- In respect of NPA, an auditor should check whether the unrealized income in respect of such assets has not been taken to the P&L on accrual basis.
- 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. If the same is not treated as NPA in the current year, the auditor should specially examine such accounts to ascertain whether the account has become regular and the same can be treated as performing as per the directions.

Audit Check List

a. Investment Companies

- Physically verify all the shares and securities held by a NBFC.
- 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. Verify that the credit facilities extended and investments made by the concerned NBFC are in accordance with the prescribed ceiling.
- Verify whether the NBFC has not advanced any loans against the security of its own shares.
- NBFC prudential Norm's directions require dividend income on shares of companies and units of mutual funds to be recognized 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 AGM and it 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.
- Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.
- Verify the board minutes for purchase and sale of investment.

- 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.
- Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year.
- Check whether investment in unquoted debentures/bonds have been treated as investment but as term loans or other credit facilities for the purpose of income recognition and asset classification.
- An auditor will have to ascertain whether the requirements of AS-13 “accounting for Investments” have been duly complied with by the NBFC.
- In respect of shares/securities held through a depository, obtain a conformation from the depository regarding the shares/securities held by it on behalf of the NBFC.
- In the case of securities lent/borrowed under the securities landing scheme of SEBI, verify the agreement entered into with the approved intermediary.
- 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.
- Verify charges received or paid in respect of securities lend/borrowed.
- Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.

b. Loan Company

- An auditor should examine whether each loan or advance have been properly sanctioned.
- An auditor should verify the security obtained and the agreements entered into. If any, with the concerned parties in respect of the advances given.
- Obtain balance confirmation from the concerned parties.
- As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC.
- 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.
- Check whether the NBFC has not advanced any loans against the security of its own shares.
- An auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances.
- Check the classification of loans and advances made by a NBFC into standard assets, Sub standard assets, doubtful assets and loss assets and the adequacy provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.
- 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. Assets Finance Company

1. Hire Purchase finance company.

- Ascertain whether the NBFC has an adequate appraisal system for extending hire purchase finance.
- 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.

- In the case of high value hire purchase items relating to machinery, an auditor should ascertain whether the valuation reports and installation reports are correct for.
- If the hire purchase finance is against vehicles, check whether the registration certificate contains an endorsement in favor of the hire purchase company.
- The auditor should verify whether the NBFC has a system in place for verifying the hire purchase assets periodically to ensure that the hires have not sold the assets or otherwise encumbered them.
- Check whether hire purchase installments are being received regularly as and when they fall due.
- Examine the method of accounting followed by hire purchase finance company for appropriation of finance charges over the period of the hire purchase contract.
- Verify that the assets given on hire purchase have been adequately insured against.
- In case of goods are repossessed by the hire purchase finance company on account of non-payment of hire purchase installments, verify that the repossessed goods have been valued on a realistic basis by the hire purchase finance company.

2. Equipment Leasing Finance Company.

- Ascertain whether the NBFC has an adequate appraisal system for extending equipment leasing finance.
- The auditor should verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification.
- Ascertain whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the lease assets is being carried out by the lessees.
- Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.
- An auditor should verify whether the AS issued by the ICAI in respect of “Accounting for lease” has been compulsorily followed.

Classification of Frauds by NBFC

- In order to have uniformity in reporting, frauds have been classified as under based mainly on the provision of IPC.
 - 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. Unauthorized 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.
- 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.