14

Audit of Non-Banking Financial Companies

Question 1

Write a short note on Classification of frauds by NBFC. *(4 Marks, May, 2014)*

Answer

Classification of Frauds by NBFC: In order to have uniformity in reporting, frauds have been classified as under-

(i) Misappropriation and criminal breach of trust.

(ii) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

(iii) Unauthorised credit facilities extended for reward or for illegal gratification.

(iv) Negligence and cash shortages.

(v) Cheating and forgery.

(vi) Irregularities in foreign exchange transactions.

(vii) 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 (iv) and (vi) 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:

(i) cases of cash shortages more than ₹ 10,000/- (including at ATMs) and

(ii) 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.

Question 2

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?

(6 Marks, November, 2012)

Or

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. *(4 Marks, November, 2008)*

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/doubtfull/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 Statement of Profit and Loss.

(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 3

Write a short note on Special points that may be covered in the audit of equipment leasing finance company. *(4 Marks, May, 2010)*

Or

What are the special points in the audit of a Non-Banking Equipment Leasing Finance Company? *(8 Marks, May, 2007)*

Answer

Special Points in the Audit of Non Banking Equipment Leasing Finance (NBELF) 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 4

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

(8 Marks, June, 2009)

Answer

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

(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

List the matters to be included in the 'Auditor's report' in the case of Non Banking Financial Companies (NBFCs) accepting or holding public deposits. (8 Marks, November, 2007)

Answer

Matters to be included in the Auditors' 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.

(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 NBFCs as defined in paragraph 2(1)(xix) of the Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007 -

(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.

Question 6

Write a short note on Categories of Non-banking Finance Companies (NBFCs).

(4 Marks, November, 2005)

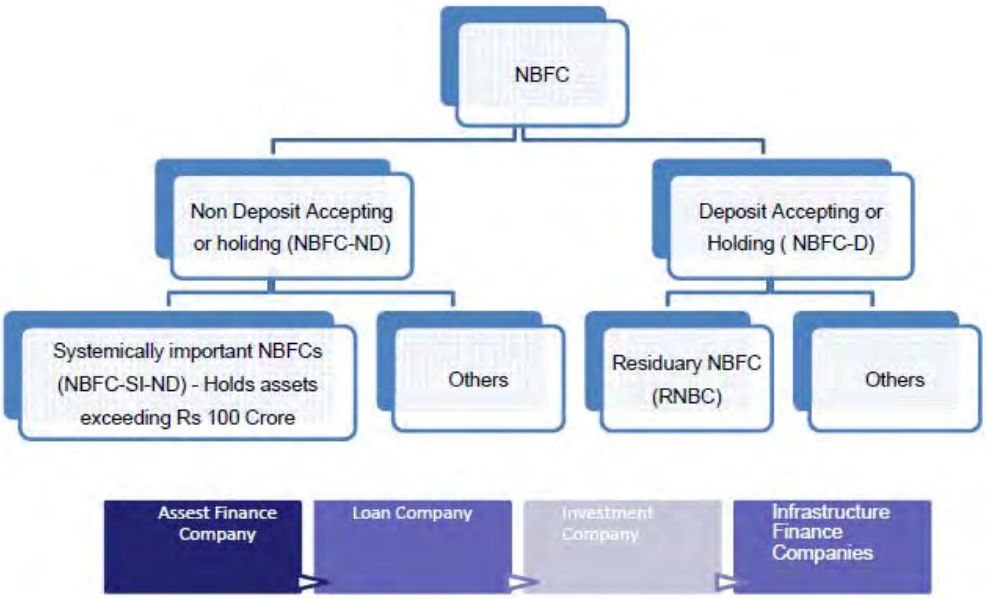
Answer

Categories of 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-

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 {now section 8 of the Companies Act, 2013}) 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 {now section 8 of the Companies Act, 2013}) 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.