

Chapter 14B - "Audit of NBFC"

i) Classification of a Company as NBFC: A company shall be classified as NBFC, if financial activity is the principal business of the company.

Financial activity will be considered as principal business, if:



(a) Financial Assets $> 50\%$ of total assets (netted off by Intangibles)

AND

(b) Income from financial assets $> 50\%$ of Gross Income.

Examples:

Co.	Total Assets	Intangibles	financial Assets	Gross Income	Income from F.A.	NBFC
A Ltd.	100 Cr.	10 Cr.	40 Cr. ($< 50\%$)	30 Cr.	20 Cr. ($> 50\%$)	NO
B "	100 Cr.	20 Cr.	50 Cr. ($> 50\%$)	30 Cr.	10 Cr. ($< 50\%$)	NO
C "	100 Cr.	30 Cr.	40 Cr. ($> 50\%$)	30 Cr.	15 Cr. ($= 50\%$)	NO
✓ D "	100 Cr.	-	60 Cr. ($> 50\%$)	30 Cr.	20 Cr. ($> 50\%$)	YES
E "	100 Cr.	10 Cr.	45 Cr. ($= 50\%$)	30 Cr.	20 Cr. ($> 50\%$)	NO
✓ F "	100 Cr.	10 Cr.	46 Cr. ($> 50\%$)	30 Cr.	20 Cr. ($> 50\%$)	YES

ii) Registration and Regulation of NBFC:

No NBFC is allowed to commence the business of NBFC without:

(a) Obtaining a Certificate of Registration issued by RBI.

AND

(b) having Net Owned Funds of ₹ 10 Crore. (Earlier it was ₹ 2 crore)

- * CoR is required only if financing activity is the Principal business.
However, in case of NBFC regulated by other regulators, there is no need to get registration with RBI (Purpose is to obviate dual regulation)
For Ex: Housing Finance Companies (Regd. with NHB)
Merchant Banking Companies (" " SEBI)
Venture Capital Fund Companies (" " SEBI)
Insurance Companies (" " IRDAI)

** All Existing Companies should meet NoF of ₹ 10 crore in phased manner by 31.03.2027.

NoF shall remain ₹ 2 crore for NBFC - P2P Lending

NBFC - AA

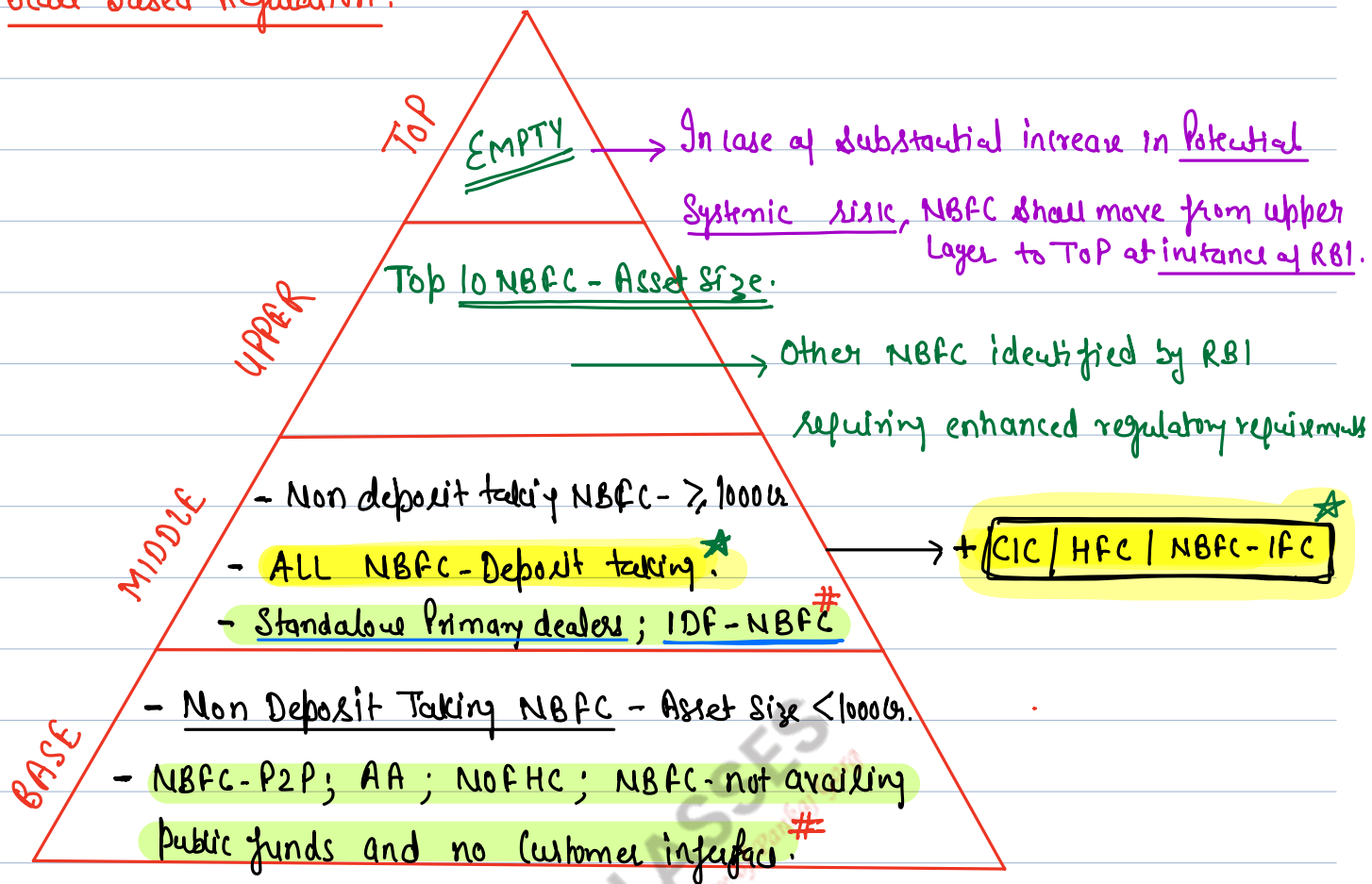
NBFC with no public funds and no customer interface.

(iii) Types of NBFC: NBFC may be classified as :

- Investment and Credit Companies (ICC)
- Infrastructure Finance Companies (IFC)
- ✓ Systemically Important^{*} Core Investment Companies (SI-CIC)
- Infrastructure debt fund - NBFC (IDF)
- NBFC - Micro Finance Institutions (NBFC-MFI)
- NBFC - Factors
- Non operative Financial Holding Company (NOFHC)

* S.I. - Asset size \geq 500 Cr.

Scale Based Regulation:



* NBFC deposit taking companies - may be included in upper layers.

* CIC/HFC/NBFC-IFC - may be included in upper layers.

Fixed

Imp:

Categorisation of NBFC carrying out specific Activity:

(i) P2P, AA, NOFHC, NBFC - not availing public funds and no customer interface

Always remain in base layer.

(ii) NBFC - deposit; CIC; HFC, NBFC - CIC SPD; IDF - NBFC

Middle or upper layer

Always remain in Middle layer.

(iii) NBFC - ICC; MFI; Factors; Mortgage Guarantee Co. (MGC)

Any layer - depending upon Parameters.

(iv) Govt. Owned NBFC

- Base or Middle layer

(iv) Prudential Norms:

(a) Capital Requirements: Capital Ratio $\geq 15\%$

NBFC (other than MFI, IDF) - Tier I Capital $\geq 10\%$

NBFC (Gold loans) - Tier I Capital $\geq 12\%$

(b) Income Recognition: NPA - Realisation Basis

Other than NPA - Accrual Basis

First time NPA - Income recognised but not

realised need to be reversed.

P2P - Peer to Peer

AA - Accounts Aggregator

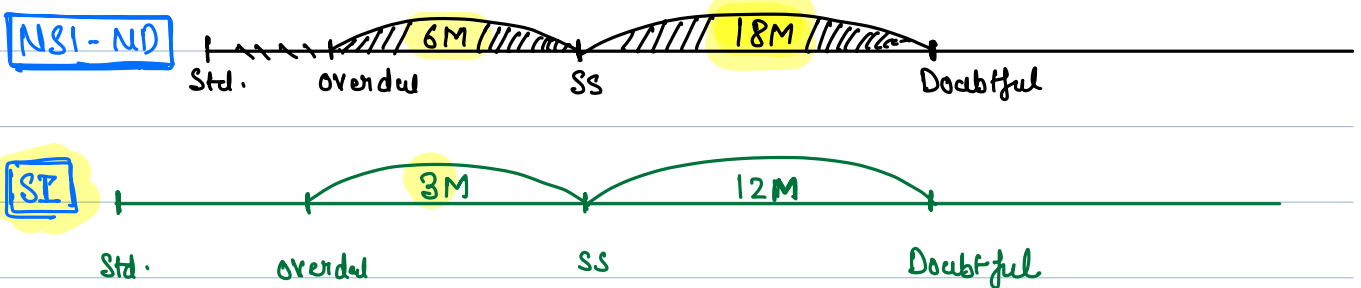
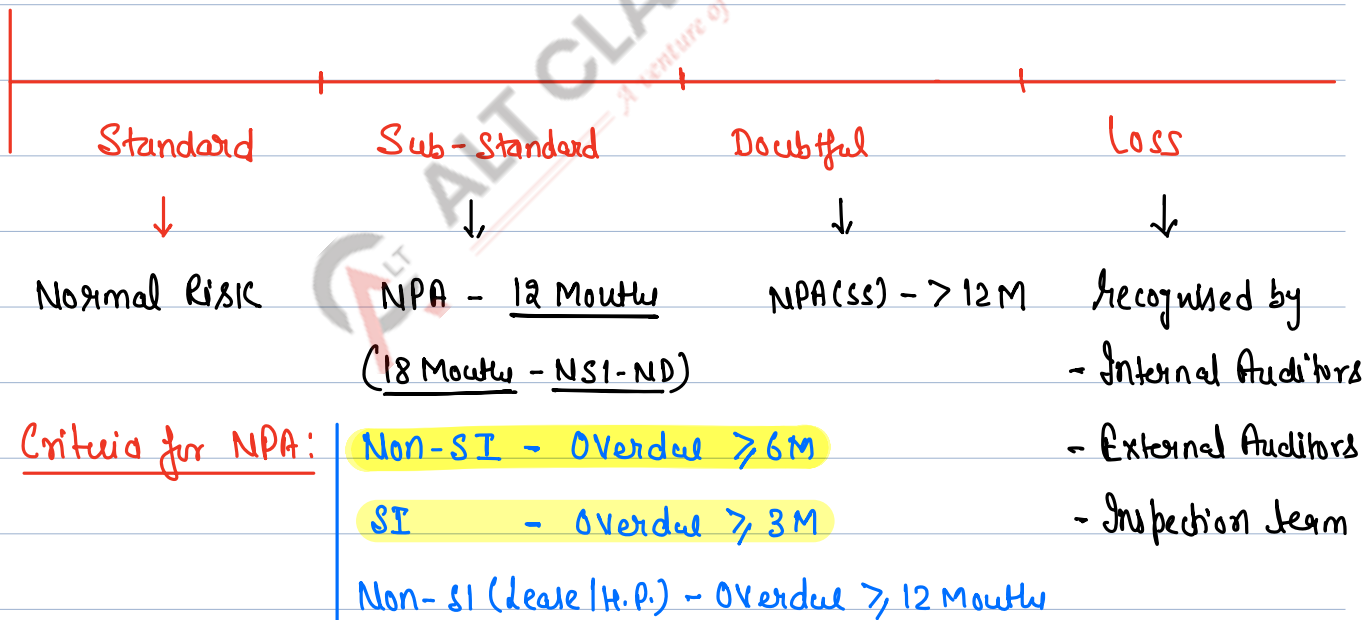
NOFHC - Non-operative

financial holding co.

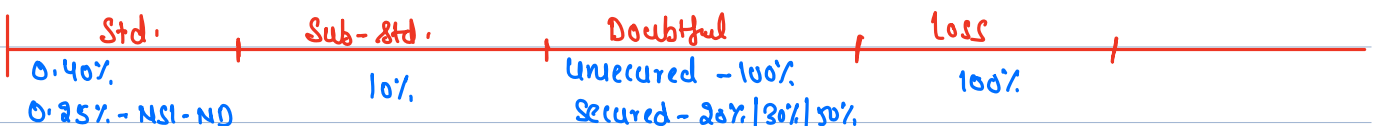
SPD - Standalone Primary

dealer.

(c) Asset classification:



(d) Provisioning:



(V) Audit Procedure:

(A) Ascertain business of Company: Study - MoA/AoA/Business Policies of the Co./Minutes of Meetings.

(B) Evaluation of I.C. System: To ensure Existence, adequacy and effectiveness.
Put more focus on effectiveness of system of Recovery and Periodical Review of Accounts.

(C) Registration with RBI: Obtain a copy of regn. certificate issued by RBI.
If not yet issued - Obtain a copy of application.

✓(d) Compliance of Public deposit directions:

- 1) Credit Rating:
- Obtain a copy of credit rating and check whether deposits are in limits.
 - In case of change in credit rating, examine whether NBFC increase/decrease deposits as per revised credit rating and inform the same to RBI in writing.
 - In case of downgrading of credit rating below minimum specified investment grade, NBFC shall regularise excess deposits in following manner:
 - (a) Stop accepting fresh deposits and renewing existing deposits.
 - (b) All existing deposits shall run off to maturity.
 - (c) Report the position within 15 working days to concerned Regional office of RBI.

(2) Check Interest and brokerage calculations (to ensure that not paid in excess).

(3) Written applications to be obtained before accepting or renewing deposits.

(4) Verify deposit register and test check the particulars entered therein.

(5) Ensure repayments of deposits on due dates.

(6) Check whether Board Resolution has been passed, if NBFC not accepting deposits.

(7) Check whether Annual Returns filed within prescribed time.

(E) Compliance of Prudential Norms:

(1) Ensure compliance of Prudential norms relating to:

- (a) Income Recognition (b) Capital Requirements (c) Asset Classification
(d) Provisioning Norms (e) Prohibition for granting loan against own shares
(f) Prohibition for loan/ advances in case of failure to repay deposits.

(2) Ensure that Board frame a policy for demand loans.

(3) Verify classification of advances as Standard / Sub-standard / Doubtful / loss and proper provision has been made in accordance with RBI Direction.

(4) Ensure that Unrealised income has not been credit to P&L A/c, in case of NPAs.

(5) Check recovery in NPA accounts whether any payment have been received or not.

(vi) Classification of Frauds: (Monitoring of Fraud in NBFC (Reserve Bank) Direction)

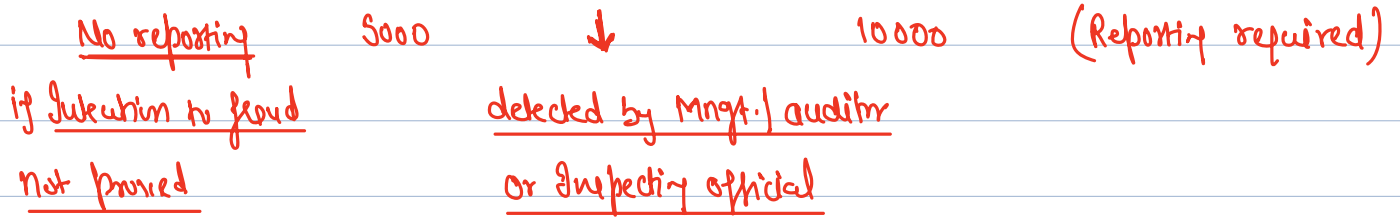
✓ (A) Negligence and Cash Shortage

✓ (B) Irregularities in foreign exchange transaction

→ Reported as fraud only when intention to fraud is suspected or proved.

Example:

<u>Amt. of fraud</u>	<u>Reported/Identified by</u>	<u>Intention:</u>	<u>Remarks:</u>	<u>Exception: Cash Shortage > 10000</u> ↓ Cash Shortage > 5000 and detected by <u>Mngt./ auditor/ Inspecting Official</u>
4000	Cashier	Not Exist	No reporting.	
6000	Mngt.	- Not certain -	Reporting ✓	
12000	Cashier	Not Exist	" ✓	
8000	Cashier	- Not certain -	No reporting	



- (c) Misappropriation and Criminal breach of trust
- (d) Fraudulent Encashment through forged instruments etc.
- (e) Unauthorised Credit facilities extended for reward
- (f) Cheating and forgery
- (h) Any other fraud, not covered above.

(vii) Audit Check List:

Self-study (H.W.)