

AUDIT OF NBFC

- Q.1** Keshav Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans. The company was having net owned funds of ₹ 1,50,00,000 (one crore fifty lakhs) and was not having registration certificate from RBI and applied for it on 30th March 2024. The company appointed Mr. Kabra as its statutory auditors for the year 2023-24. Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO, 2020? *[MTP-March 19, Oct. 21]*

OR

As per CARO, 2020 the auditor is required to report “whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.” Mention the Audit procedures and reporting for the same. *[Jan. 21- Old Syllabus (5 Marks)]*

Ans.: **Audit Procedure for reporting under CARO, 2021 w.r.t. registration u/s 45-IA of RBI Act, 1934:**

Clause (xvi) of Paragraph 3 of CARO, 2020 requires the company auditor to report: “Whether the company is required to be registered under Section 45-IA of the RBI Act, 1934 and if so, whether the registration has been obtained”.

Auditor is required to examine whether company is engaged in the business which attract the requirements of the registration. Registration is required where the financing activity Is a principal business of the company. RBI restrict companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration.

Audit Procedure and Reporting

- (i) Examine the transactions of the company with relation to the activities covered under the RBI Act and directions to determine whether the company is engaged in financial activity.
- (ii) Auditor should examine the financial statements to ascertain whether company’s financial assets constitute more than 50% of the total assets and income from financial assets constitute more than 50% of the gross income.
- (iii) Ascertain whether the net owned funds of the company exceed such amount so as to require the company to get itself registered as NBFC with RBI.
- (iv) Ascertain whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.
- (v) Auditor’s Report under CARO, 2020 shall incorporate the following:
 - Whether the registration is required under section 45-IA of the RBI Act, 1934.
 - If so, whether it has obtained the registration.
 - If the registration not obtained, reasons thereof.

In the instant case Keshav Finance Ltd. is a NBFC and was in business of accepting public

deposits and giving loans since 2015. Company was having net owned funds of ₹ 1,50,00,000/-(one crore fifty lakhs) which is less in comparison to the prescribed limit for existing companies i.e. ₹ 2 Crores and was also not having registration certificate from RBI (though applied for it on 30th March 2024).

Auditor is required to report on the same as per Clause (xvi) of Paragraph 3 of CARO 2020.

Q.2 Write a short note on the following: Categorisation of NBFCs carrying out specific activity.
[RTP - May 23]

Ans.: Categorisation of NBFCs carrying out specific activity:

As the regulatory structure envisages scale based as well as activity-based regulation, the following prescriptions shall apply in respect of the NBFCs

- NBFC-P2P, NBFC-AA, NOFHC and NBFCs without public funds and customer interface will always remain in the Base Layer of the regulatory structure.
- NBFC-D, CIC, IFC and HFC will be included in Middle Layer or the Upper Layer (and not in the Base layer), as the case may be. SPD and IDF-NBFC will always remain in the Middle Layer.
- The remaining NBFCs, viz., Investment and Credit Companies (NBFC-ICC), Micro Finance Institution (NBFC-MFI), NBFC-Factors and Mortgage Guarantee Companies (NBFC-MGC) could lie in any of the layers of the regulatory structure depending on the parameters of the scale based regulatory framework.
- Government owned NBFCs shall be placed in the Base Layer or Middle Layer, as the case may be. They will not be placed in the Upper Layer till further notice.

Q.3 What are the specific matters to be included in Auditor's Report in an audit of NBFC not accepting public deposits.

OR

Dinesh Bank Pvt. Ltd. is a Non-Deposit Taking Non-Systemically Important NBFC registered with Reserve of India. The Statutory Auditor of the company is required to give a report to the Board of Directors. What shall be the content of the Auditor's Report to the Board.

Ans.: Matters to be included in Auditor's Report in case of NBFC:

In addition to the Report made by the auditor u/s 143 of the Companies Act, 2013, the auditor shall also make a separate report to the Board of Directors of the Company on the matters as specified in paragraph 3 of the NBFCs Auditor's Report (Reserve Bank) Directions, 2016:

Matters to be reported in case of all NBFC – Para 3

1. Whether the company has obtained a Certificate of Registration (CoR) from the Bank. (Conducting Non-Banking Financial Activity without a valid CoR is an offence under the RBI Act, 1934)
2. In 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 Principal Business Criteria (Financial asset/income pattern) as on March 31 of the applicable year.
3. Whether the NBFC is meeting the required net owned fund requirement as laid down in Directions issued by RBI.

Matters to be reported in case of NBFC not accepting public deposits – Para 3

- (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;
- (iv) In respect of Systemically Important Non-deposit taking NBFCs:
 - Whether the capital adequacy ratio as disclosed in the return submitted to the Bank, has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;
 - Whether the company has furnished to the Bank the annual statement of capital funds, risk assets/exposures and risk asset ratio within the stipulated period.
- (v) Whether the NBFC has been correctly classified as NBFC Micro Finance Institutions (MFI).

Q.4 Bhumik & Associates are going to start the audit of NBFCs. They have not performed much work for the NBFCs in the past years. You are required to explain the requirements related to registration and regulation of NBFCs which an auditor needs to keep in his mind while planning the audit of NBFC which would help this firm.

Ans.: Registration and regulation of NBFC:

- Sec. 45-1A of RBI (Amendment) Act, 1997 provides that no NBFC is allowed to commence or carry on the business of a NBFC without:

1. obtaining a certificate of registration issued by the RBI.
2. having the net owned fund (NOF) of ₹ 25 lakh or such other amount, not exceeding ₹ 100 crore, as the Bank may, by notification in the Official Gazette, specify.

NOTE

For all companies currently applying for registration as a NBFC, minimum NOF requirement is ₹ 10 Crores (earlier it was ₹ 2 crores). All existing companies should meet NOF of ₹ 10 Crores in a phased manner by 31st March 2027.

- A company incorporated under the Companies Act and desirous of commencing business of nonbanking financial institution can apply to RBI in prescribed form along with necessary documents for registration. RBI issues CoR after satisfying itself that the conditions as enumerated in Section 45-1A of the RBI Act, 1934 are satisfied.
- However, to obviate dual regulation, certain categories of NBFC which are regulated by other regulators are exempted from requirement of registration with the RBI, for example: companies registered with SEBI or IRDA.
- The RBI has issued directions to NBFC on acceptance of public deposits, prudential norms, risk exposure norms & other measures to monitor financial solvency and reporting by NBFC.
- RBI also issued directions to auditors to report to the RBI, BOD and shareholders, any noncompliance with the RBI Act and regulations made by the RBI.

Q.5 CA Aashish is conducting the statutory audit of HCL Ltd., a non-banking financial company. It has branches in various parts of India. The company with a focus on housing finance, has outstanding nonconvertible debentures worth ₹ 150 Crores. The company reportedly missed interest payments of INR ₹ 15 Crores on its debts because of inadequate liquidity. As a result, HCL Ltd. faced a series of downgrades by rating agencies on its debts over the past two months. Rating was cut to D from A4 implying that the company was in default or expected to be in default soon. What aspects CA Aashish should look into in relation to the activity of mobilization of public deposits (particularly in relation to downgrading of credit facilities) by RHL Ltd?

[Nov. 20 (5 Marks), MTP-March 22, April 23]

Ans.: Auditor's procedure in relation to mobilization of public deposits in case of NBFC:

- (i) The ceiling on quantum of public deposits has been linked to its credit rating as given by an approved credit rating agency. In the event of a upgrading/downgrading of credit rating, the auditor should bear in mind that the NBFC will have to increase/reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame and should ensure that the NBFC has informed about the same to the RBI in writing.
- (ii) In the event of downgrading of credit rating below the minimum specified investment grade, a non-banking financial company, being an investment and credit company or

a factor, shall regularise the excess deposit as provided hereunder:

- with immediate effect, stop accepting fresh public deposits and renewing existing deposits;
- all existing deposits shall run off to maturity;
- report the position within 15 working days, to the concerned Regional Office of the RBI where the NBFC is registered; and
- no matured public deposit shall be renewed without the express and voluntary consent of the depositor.

Q.6 Arjun Pvt. Ltd. is primarily into the business of selling computer parts. However, the company is fulfilling the Principal Business Criteria as at the balance sheet date i.e. Financial Assets are more than 50% of total assets and Financial Income is more than 50% of Gross Income. What shall be the obligation of the Statutory Auditor in such a scenario?

OR

Murlidhar and Associates, a firm of Chartered Accountants, was appointed as auditor of an NBFC. The audit work has been completed. The audit team which was involved in the fieldwork came across various observations during the course of audit of this NBFC and have also an limited understanding about the exceptions which are required to be reported in the audit report. They would like to understand in detail regarding the obligations on the part of an auditor in respect of exceptions in his report so that they can conclude their work. Please explain.

[MTP-May 20, Nov. 21, Sep. 22]

OR

Rahul and Associates, a firm of chartered accountants, is appointed as auditor of NBFC. During the audit, audit team comes across various observations/exceptions and Mr. Jeel, a junior member of audit team, due to his limited understanding about exceptions which are required to be reported in the audit report, would like to understand in detail, the obligations on the part of an auditor in respect of exceptions in the audit report so that he can conclude his work. Discuss.

[July 21 (5 Marks)]

Ans.: Obligations of Statutory Auditor of NBFC:

- A company will be treated as NBFC when a company's financial assets constitute more than 50% of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50% of the gross income. In the given case, Krishna Pvt. Ltd. Is fulfilling the Principal Business Criteria i.e. Financial Assets are more than 50% of total assets and Financial Income is more than 50% of Gross Income.
- In such a scenario, the statutory auditor has an obligation to submit exception report to the RBI. As per Para 5 of NBFC Auditor's Report (Reserve Bank) Directions, 2008 provides that where, in the case of a NBFC, the statement regarding any of the items

referred to in para 3, is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:

1. the provisions of Chapter III-B of Reserve Bank of India Act, 1934; or
 2. the NBFC Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or
 3. NBFC-Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and NBFC-Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016
- it shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the Bank under whose jurisdiction the registered office of the company is located.

NOTE

Duty of the Auditor to submit exception report shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions and such report shall not contain any statement with respect to compliance of any of those provisions.

Q.7 Define NBFC. Also give a brief description about types of NBFCs covering any five NBFCs.

Ans.: Meaning of NBFC:

Sec. 45-1(f) of the RBI (Amendment) Act, 1997 defines a NBFC as:

- a financial institution which is a company;
- a non-banking institution which is a company with principal business of receiving of deposits or lending in any manner;
- such other non-banking institution or class of such institutions, as the RBI, with the previous approval of the C.G. may specify by notification in the Official Gazette.

Types of NBFC:

1. Investment and Credit Company (ICC).
2. Infrastructure Finance Company
3. Systemically Important Core Investment Company.
4. Infrastructure debt Fund-NBFC.
5. NBFC-Micro Finance Institution.
6. Non-Banking Financial Company – Factors (NBFC-Factors).
7. Non-Operative Financial Holding Company (NOFHC).

Q.8 Manish Ltd. is a company registered under the Companies Act, 2013. The company is engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authorities. For the year ended 31st March, 2024 following are some extracts from the financial

statements:

(1)	Paid-up share capital	₹ 40.53 Cr.
(2)	Non-Current Assets – Loans & Advances	₹ 75.50 Cr.
(3)	Current Assets – Loans & Advances	₹ 294.33 Cr.
(4)	Total assets of the company	₹ 618.55 Cr.
(5)	Intangible assets	₹ 6.35 Cr.
(6)	Profit of the Year	₹ 8.15 Cr.
(7)	Income from interest and dividends	₹ 62.31 Cr.
(8)	Gross Income	₹ 111.23 Cr.

Directors intend to apply for registration as Non-Banking Financial Company (NBFC) under Section 45-1A of the Reserve Bank of India (Amendment) Act, 1997. Advise.

[RTP-Nov. 22]

Ans.: Registration of NBFC:

- Sec. 45-1A of RBI (Amendment) Act, 1997 provides that no NBFC is allowed to commence or carry on the business of a NBFC without
 1. obtaining a certificate of registration issued by the RBI; and
 2. having the net owned fund of ₹ 25 lakh or such other amount, not exceeding ₹ 100 crores, as the Bank may, by notification in the Official Gazette, specify.

NOTE

For all companies currently applying for registration as a NBFC, minimum NOF requirement is ₹ 10 Crores (earlier it was ₹ 2 crores). All existing companies should meet NOF of ₹ 10 Crores in a phased manner by 31st March 2027.

- The registration is required where the financing activity is a principal business of the company.
- Financial activity will be considered as principal business if the company's financial assets constitute more than 50% of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50% of the gross income.

- Financial Assets of Manish Ltd. are:

Non-Current Assets – Loans & Advances	₹ 75.50 Cr.
Add: Current Assets – Loans & Advances	₹ 294.33 Cr.
Total Financial Assets	₹ 369.83 Cr.

- Total Assets (netted off by intangible assets) of Manish Ltd. are:

Total assets of the company	₹ 618.55 Cr.
Less: Intangible assets	₹ 6.35 Cr.

Total Assets (netted off by intangible assets) ₹ 612.20 Cr.

- In view of above, financial assets of Manish Ltd. constitute more than 50% of the total assets (netted off by intangible assets).
- Income from financial assets ₹ 62.31 Cr.
Gross Income ₹ 111.23 Cr.
Income from financial assets constitute more than 50% of the gross income.
- From the above, it is clear that Manish Ltd.'s financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets constitutes more than 50 per cent of the gross income.

Conclusion: As the net owned funds of the company exceeds ₹ 10 Crores and financial activity is the principal business of the company (based on 50:50 test), company is required to register as NBFC.

Q.9 “Len and Den Platform” is a P2P online platform owned by Future Technologies Pvt. Ltd. which is registered with RBI as NBFC. Peer to Peer Platform (P2P) means an intermediary providing the services of loan facilitation via online medium or otherwise to the participants. Participants have to enter into an arrangement with NBFC-P2P to lend on its platform or avail loan facilitation services provided by it. It provides only as a medium connecting lenders and borrowers. It also carries out the credit assessment and risk profiling of the participants on the platform. It also provides services relating to loan documentation and loan recovery. The company falls outside purview of upper layer. Where does such NBFC fit into in accordance with scale-based regulations? Suggest few audit procedures for above NBFC-P2P.

Ans.: **Classification of NBFC and Audit procedures:**

NBFC-P2P falls in base layer in accordance with scale-based regulations of RBI.

Audit procedures:

1. Obtain an understanding of business conducted by NBFC-P2P. Verify verified that company undertakes only permissible activities like providing online marketplace to participants for lending and borrowing. It should not be engaged in business of lending funds on its own.
2. Verify certificate of registration obtained from RBI.
3. Verify adherence to lending and borrowing guidelines prescribed by RBI.
4. Ensure compliance with reporting requirements of RBI.
5. Verify Board approved policy setting out eligibility criteria for participants i.e. lenders and borrowers.
6. Verify Board approved policy for pricing of services.
7. Verify Board approved policy for grievance redressal and complaints.
8. Verify the appropriateness of arrangements entered into among participants & NBFC-P2P.

Q.10 Mr. Girish has been appointed as an auditor of PAL Ltd., a NBFC company registered with RBI. Mr. Girish is concerned about whether the format of financial statements prepared by PAL Ltd. is as per notification issued by the Ministry of Corporate Affairs (MCA) dated October 11, 2018. The notification prescribed the format in Division III under Schedule III of the Companies Act, 2013 applicable to NBFCs complying with Ind-AS. Mr. G wants to know the differences in the presentation requirements between Division II and Division III of Schedule III of the Companies Act, 2013. Help Mr. Girish. *[Nov. 19 (5 Marks), MTP-April 21]*

OR

Rishab & Co. are the statutory auditors of Legal Finance Ltd, an NBFC engaged in the business of accepting public deposits and giving loans. Auditors are concerned that the format of the financial statements should be prepared as per the notification issued by the Ministry of Corporate Affairs dated 11th Oct, 2018. While auditing there was a difference of opinion between CA Rohit and CA Bimal regarding the disclosure of “Other Income” in the financial statements. CA Rohit believes that there is no difference in the presentation requirements between Division II and Division III of Schedule III of the Companies Act, 2013. Is the contention of CA R correct?

[May 23 (5 Marks)]

Ans.: Differences between Division II and Division III:

The presentation requirements under Division III for NBFCs are similar to Division II (Non-NBFC) to a large extent except for the following:

- NBFCs have been allowed to present the items of the balance sheet in order of their liquidity which is not allowed to companies required to follow Division II. Additionally, NBFCs are required to classify items of the balance sheet into financial and non-financial whereas other companies are required to classify the items into current and non-current.
- An NBFC is required to separately disclose by way of a note any item of ‘other income’ or ‘other expenditure’ which exceeds 1% of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1% of the revenue from operations or ₹ 10 lakhs, whichever is higher.
- NBFCs are required to separately disclose under ‘receivables’, the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member.
- NBFCs are also required to disclose items comprising ‘revenue from operations’ and ‘other comprehensive income’ on the face of the Statement of profit and loss instead of showing those only as part of the notes.
- Separate disclosure of trade receivable which have significant increase in credit risk & credit impaired.
- The conditions or restrictions for distribution attached to statutory reserves have to be separately disclose in the notes as stipulated by the relevant statute.

Q.11 Shubham and Associates, a firm of Chartered Accountants, are the auditors of NBFC (Investment and Credit Company). Some of the team members of the audit team who audited this NBFC have left the firm and the new team members are in discussion with the previous team members who are still continuing with the firm regarding the verification procedures to be performed. In this context, please explain what verification procedures should be performed in relation to audit of NBFC – Investment and Credit Company (NBFC-ICC). *[MTP – Oct. 19, RTP-Nov. 19]*

Ans.: Audit of NBFC – Investment and Credit Companies:

(A) Points related in Investments:

- **Physical Verification:** Auditor should physically verify the securities held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.
- **Income recognition:** Verify that dividend income wherever declared by a company, has been duly received and accounted for. NBFC Prudential Norms directions require dividend income on shares of companies and units of mutual funds to be recognised on cash basis.
- **Authorisation:** Verify the Board Minutes for purchase and sale of investments.
- **Classification:** Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.
- **Valuation:** 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.
- **Compliance of AS 13:** An auditor will have to ascertain whether the requirements of AS 13 “Accounting for Investments” or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.
- **External Confirmations:** In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC. Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.

(B) Point related to Credit:

- **Sanctioning:** Auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.

- **Security:** Auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.
- **Loan against own shares:** Verify whether the NBFC has not advanced any loans against the security of its own shares.
- **Compliance of prudential norms:** 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.
- **Appraisal and follow up System:** Auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.
- **Classification:** Check the classification of loans and advances (including bills purchased and discounted) made by a NBFC into Standard Assets, Sub-Standard Assets, Doubtful Assets and Loss Assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.

Q.12 Tarun Ltd. is a company registered under the Companies Act, 2013. The company is engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authorities. For the year ended 31st March, 2024, following are some extracts from the financial statements:

(1)	Paid-up share capital	₹ 40.53 Cr.
(2)	Non-Current Assets – Loans & Advances	₹ 55.90 Cr.
(3)	Current Assets – Loans & Advances	₹ 344.47 Cr.
(4)	Total assets of the company	₹ 530 Cr.
(5)	Intangible assets	₹ 3 Cr.
(6)	Profit of the Year	₹ 7.25 Cr.
(7)	Income from interest and dividends	₹ 52 Cr.
(8)	Gross Income	₹ 102.57 Cr.

Directors intend to apply for registration as Non-Banking Financial Company (NBFC) under Section 45-IA of the RBI (Amendment) Act, 1997. Advise. [Dec. 21 (4 Marks)]

Ans.: Registration of NBFC:

- Sec. 45-1A of RBI (Amendment) Act, 1997 provides that no NBFC is allowed to

commence or carry on the business of a NBFC without

1. obtaining a certificate of registration issued by the RBI; and
2. having the net owned fund of ₹ 25 lakh or such other amount, not exceeding ₹ 100 crores, as the Bank may, by notification in the Official Gazette, specify.

NOTE

For all companies currently applying for registration as a NBFC, minimum NOF requirement is ₹ 10 Crores (earlier it was ₹ 2 crores). All existing companies should meet NOF of ₹ 10 Crores in a phased manner by 31st March 2027.

- The registration Is required where the financing activity is a principal business of the company.
- Financial activity will be considered as principal business if the company’s financial assets constitute more than 50% of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50% of the gross income.
- In the given case, net owned funds exceed ₹ 10 Crores and financial activity is the principal business of the company as the financial assets constitute more than 50% of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50% of the gross income.

Conclusion: As the net owned funds of the company exceeds 2 Crores and financial activity is the principal business of the company (based on 50:50 test), company is required to register as NBFC.

Q.13 You are auditor of a deposit taking NBFC (NBFC-D). The NBFC is identified by RBI in its upper layer and its financial statements are required to prepared in accordance with requirements of Ind AS. The following is extract of statement of profit and loss for year ending 31st March, 2024 in accordance with Division III of Schedule III of Companies Act, 2013. Previous year figures are ignored.

Particulars	Note No.	Figures for year ended 31 st March, 2024 (in ₹ Crores)
Revenue from Operations		
Interest income	15	9500
Dividend income		-
Rental Income		150
Fees and commission income	16	100
Net gain on fair value changes	17	150
Net gain on derecognition of financial instruments under amortised category		
(a) Total revenue from operations		9900
(b) Other Income	18	100
(c) Total Income		10000

On going through details of head “other expenditure” in expenses side of statement of profit and loss, it is noticed that there is an expenditure relating to manpower outsourcing cost amounting to ₹ 99.50 crores included under “other expenditure”. Does it meet the requirements of Division III of Schedule III of Companies Act, 2013?

Ans.: Compliance of Requirements of Schedule III:

An NBFC is preparing financial statements in accordance with requirements of Division III of Schedule III of Companies Act, 2013 has to separately disclose by way of note any item of “other expenditure” exceeding 1% of total income.

In the given case, expenditure of ₹ 99.50 crore, i.e. it does not exceed 1% of total income.

Conclusion: Requirements of Division III of Schedule III of Companies Act, 2013 has been complied with.

Q.14 CG & Co. is the statutory auditor of Unicorn NBFC Ltd. While planning the audit procedures to be done during the audit of entity, there was a difference of opinion between Mr. Pranav and his partner Mr. Arihant. Mr. Arihant is of the opinion that evaluation of Internal control system and verification of registration with RBI should not be the part of audit procedure, as it is the part of internal audits only. Is the contention of Mr. Arihant correct? Also state what broad areas should mandatorily become part of the audit procedure of CG & Co. for conducting the audit of Unicorn NBFC Ltd.?
[Dec. 21 (4 Marks), MTP-April 22, Oct. 22]

Ans.: Audit procedure in case of NBFC:

(A) 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 its business vests with the management. A sound internal control system would enable an organisation to plug loopholes in its workings, particularly in the detection of frauds and would also aid in timely decision. Making. An auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures. An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.
- In particular, 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 effective monitoring and follow up. The absence of a periodical review system could result in non-detection of sticky advances at their very inception which may ultimately result in the NBFC having an alarmingly high level of NPAs.

(B) Verification of registration with RBI:

- Sec. 45-1A of the RBI Act, 1934, has made it incumbent on the part of all NBFCs to comply with registration requirements and have minimum net owned funds (NOF) of ₹ 2 crore for commencing/carrying on its business.
- 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.
- An auditor should, therefore, verify whether the dual conditions relating to registration with the RBI and maintenance of minimum net owned funds have been duly complied with by the concerned NBFC.

Q.15 Om Pvt. Ltd. is a company engaged in trading activities, it also has made investments in shares of other Companies and advanced loans to group companies amounting to more than 50% of its total assets. However, trading income constitutes majority of its total income. Whether the Company is an NBFC?

Ans.: Classification of company as NBFC:

- In order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business.
- The company will be treated as NBFC when a company's financial assets constitute more than 50% of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50% of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by Reserve Bank of India.

Conclusion: Om Pvt. Ltd. is fulfilling the criteria on the asset side, but however is not fulfilling the criteria on the income side, the company cannot be classified as a deemed NBFC.

Q.16 You are the auditor of Ravi Ltd., a NBFC registered with RBI. How would you proceed to ensure the compliance of "Prudential Norms Directions" by Ravi Ltd.?

[Nov. 18 (4 Marks)]

Ans.: Compliance of Prudential Norms by NBFC

- **Prudential Norms:** 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 & doubtful debts;
 5. Capital adequacy norm;
 6. Prohibition of granting loans against its own shares;
 7. Prohibition on loans & investments for failure to repay public deposits &

8. Norms for concentration of credit etc.

- **Policy for demand Loans:** The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.
- **Classification of Advances:** 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 3. The directions.
- **Income from NPA:** Auditor should ensure that unrealised income from non-performing assets has not been taken to profit and Loss Account. 4.
- **Recovery in NPA Accounts:** 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.

Q.17 Hariram Housing Finance Limited is in the business of housing finance activities having asset size of ₹ 800 crores. Its principal business is of providing finances for housing mainly to individuals. It is not identified by RBI in upper layer. Under scale-based regulations introduced by RBI, what should be appropriate classification for such a company?

Is there any specific reporting requirement under CARO, 2020 for statutory auditor of a company engaged in housing finance activities?

Ans.: Classification of NBFC:

Under scale-based regulations, NBFCs undertaking housing finance activities constitute “middle layer”. The asset size is not relevant in such a case. All housing finance companies not identified in upper layer would constitute middle layer due to nature of such activities undertaken by them.

Reporting Requirements under CARO, 2020:

There is specific reporting requirement under CARO, 2020 under clause 3 (xvi)(b) which requires auditor to report whether the company has conducted any non-Banking financial or housing finance activities without a valid Certificate of Registration (CoR) from the RBI as per the RBI Act, 1934.

Q.18 Write short note on: Classification of Frauds by NBFC. [RTP-May 19, Nov. 20]

Ans.: Classification of Frauds by NBFC:

In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of the Indian Penal Code:

1. Misappropriation and criminal breach of trust.
2. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
3. Unauthorised credit facilities extended for reward or for illegal gratification.
4. Negligence and cash shortages. Reporting as fraud is required only if the intention to

cheat/ defraud is suspected/proved. However, if fraudulent intention is not suspected/proved, at the time of detection, cases of negligence and cash shortage will be treated as fraud and reported, if:

- Cash shortages are more than ₹ 10,000 and
 - Cash shortages are more than ₹ 5000 and detected by management/ auditor/inspecting officer and not reported on the occurrence by the persons handling cash.
5. Cheating and forgery.
 6. Irregularities in foreign exchange transactions. Reporting as fraud is required only if the intention to cheat/defraud is suspected/ proved.
 7. Any other type of fraud not coming under the specific heads as above.

Q.19 What is a Core Investment Company (CIC) under the Reserve Bank of India regulations? What are the specific reporting requirements to be considered by an auditor in respect of CIC under CARO 2020? [Nov. 22 (5 Marks)]

Ans.: Meaning of Core Investment Company:

A non-banking financial company carrying on the business of acquisition of shares and securities and which satisfies the following conditions as on the date of the last audited balance sheet:

- it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies;
- its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies and units of Infrastructure Investment Trust only as sponsor constitute not less than 60% of its net assets as mentioned in clause (i) above;
- it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
- it does not carry on any other financial activity.

Reporting Requirements in respect of CIC under CARO, 2020:

Clause (xvi) of Para 3 of CARO, 2020 requires the auditor to report the following:

- whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria;
- whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICS which are part of the Group.