

Seminar on Non-Banking Financial Companies Audit and Taxation  
by  
WIRC of ICAI

**Auditing of NBFCs**

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*CA Vipul K Choksi*

## OUTLINE

- Financial Reporting Framework
- Key Considerations
- Audit Areas
- Audit Areas – Prudential Norms
- Reporting Obligations
- Practical Issues

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## Financial Reporting Framework

- **Reserve Bank of India Directives**
  - Recognition and measurement of loans
  - establishment of loan loss provisions
  - credit risk disclosure in financial statements
  - sound loan accounting and disclosure practices
- **Accounting Standards and disclosures**
  - Accounting Standards notified by the Central Government
  - Guidance Note and technical guide issued by ICAI

**In so far as they are not inconsistent with RBI directions**

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## Key Considerations

- **Understanding the entity and its environment**

*(SA 315 – “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment”)*

- ❖ accepting public deposit
- ❖ not accepting / holding public deposit
- ❖ Core investment companies

**Objective**

- *Understand the business issues and the associated risks*
- *Understanding the entity and its internal control environment*
- *to identify the issues that may require special attention in the audit*
- *to develop an audit scope that may add value to the entity by focusing on areas more meaningful to the management*

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## Key Considerations

### ■ Risk assessment procedures

- ❖ Inquiries with the Management, operating personnel, those charged with governance.
  - Nature and extent of management override of controls
  - Controls over preparation and generation of financial information and reporting
- ❖ Analytical review to identify any unusual trends and gaining insight into revenue stream etc.
- ❖ Inspection of documents like Minutes of meetings (Appraisal/Credit committee, Investment committee, ALM committee etc), MIS Reports, Procedural Manual etc.
- ❖ Performing *walk through* tests (i.e. verification of controls for a sample of transactions of each type), identification of any procedural inadequacies vis-à-vis the documented controls in the key business cycles like sanctioning, monitoring, recovery etc.
- ❖ Understanding of industry and economic environment and its exposure to various industrial segments

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## Key Considerations

### ■ Other Related Auditing Standards

- ❖ SA 240 – "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements"
- ❖ SA 250 – "Consideration of Laws and Regulations in an Audit of Financial Statements"
- ❖ SA 402 – "Audit Considerations Relating to an Entity Using a Service Organization"
- ❖ SA 500 – "Audit Evidence"
- ❖ SA 505 – "External Confirmations"
- ❖ SA 620 – "Using the Work of an Auditor's Expert"

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## Audit Areas

### ■ Credit – Loans

#### Selection criteria for exposure file review

- ❖ New Sanctions and accounts with an outstanding balance equal to or greater than a specified amount
- ❖ Accounts on a "Watch List" with an outstanding balance in excess of a specified amount
- ❖ Accounts where the amount outstanding is in excess of the authorized credit line/limit
- ❖ Accounts with entities operating in industries or countries that the auditor's own general economic knowledge indicates could be at risk
- ❖ Problem accounts (including NPAs) identified by the NBFC's regulatory authorities and problem accounts selected in the prior year
- ❖ Accounts with a provision in excess of a specified amount
- ❖ Accounts where principal or interest of more than a specified amount is in arrears for more than a specified period

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## Audit Areas

### ■ Credit – Loans

#### Key Considerations

- ❖ Know Your Client/Customer (KYC) procedures performed
- ❖ Credit approval process including authorisation
- ❖ Loan documentation obtained from the existing/prospective borrower, test check the documents for borrower's financial position/ credit worthiness
- ❖ Internal credit rating assigned to borrower
- ❖ Credit monitoring by credit committee
- ❖ Scope and extent of work performed by internal audit department  
(SA 610: 'Using the work of Internal Auditors')
- ❖ Collateral coverage (if any)
- ❖ The auditor is also required to verify whether there has been any window dressing, i.e., sanction of new loans to repay an existing doubtful loan. This method may be resorted to by the NBFC to cover up bad loan
- ❖ Concentration of credit exposure – [single and group exposure limits]

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## Audit Areas

### ■ Credit – Loans

#### Verification Procedure

- ❖ Understanding of method for appraising the value of exposure, securities, collateral and for identifying potential and definite losses
- ❖ Verification of procedures/rules prescribed for sanctioning the credit
- ❖ Competency of senior management and credit department personnel
- ❖ Obtaining credit report or have independent investigation on borrowers
- ❖ Review of lending policies and consider whether the policies are reviewed and updated periodically to ensure they are relevant with changing market conditions
- ❖ Tests for documentation exceptions, policy exceptions, noncompliance with internal procedures, and violations of laws and regulations
- ❖ Examination of concentration of credit including concentration of classified credits
- ❖ Review of credit monitoring system including its schedule, exposure review plan, contents, current, information on emerging trend in portfolio and lending areas

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## Audit Areas

### ■ Treasury Operations – Investments

#### Key Considerations

- ❖ To consider the investment policy describing the nature of treasury operations to be undertaken by the company as well as setting out the limits / authorisation for such operations
- ❖ Understanding of the scale, volume, complexity and risk of treasury activities
- ❖ In IT environment the auditor should test whether key processing controls and procedures are operating effectively before assessing the level of inherent and control risks as low
- ❖ Concentration of exposure

#### Specific Audit Risk

- ❖ Newly traded instruments are ordinarily subject to careful review
- ❖ Smooth flow of the new transactions through the controls system should be ensured in the relevant IT systems
- ❖ Seek the assistance of IT experts to supply appropriate skills and knowledge in the testing of systems and relevant account balances as considering the volume of date

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## Audit Areas

### ■ Treasury Operations – Investments

#### Specific Audit Risk

- ❖ Verify the purpose of transaction i.e. speculative or hedging should be identified at the inception stage so as to apply the correct accounting treatment
- ❖ To ensure the presentation and disclosures of transaction entered into by the NBFCs in accordance with the relevant accounting requirements
- ❖ Test all portfolio valuations as of the date of the financial statements and obtain the understanding of the entity's process of determining fair value of the instruments
- ❖ check the controls, security procedures for valuation models, significant assumptions used in determining fair value, as well as the process used to develop and apply management's assumptions, including whether management used available market information in order to develop the assumptions and controls over the consistency, timeliness, completeness and reliability of data used in valuation models
- ❖ Establishing the ownership of instruments held in bearer form

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## Audit Areas

### ■ Treasury Operations – Investments

#### Verification Process

- ❖ The appropriateness of the exchange rates, interest rates or other underlying market rates used at the period end date to calculate unrealized gains and losses
- ❖ The appropriateness of the valuation models and assumptions used to determine the fair value of financial instruments outstanding as at the year end
- ❖ The appropriateness of the accounting policies used particularly around income recognition and the distinction between hedged and trading instruments
- ❖ All significant gains and losses from sales and revaluations have been reported in accordance with the financial reporting framework
- ❖ Consider the RBI prudential norms guidelines with regard to accounting for investments
- ❖ To verify inter-class transfer made on adhoc basis and relevant approval of the Board

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## Audit Areas – Prudential Norms

### ■ Asset Classification and Provisioning Requirements

Assets	Explanation	Period	Provision on Loan Balance	Provision on Security
Standard Assets	"Standard asset" means the asset in respect of which, no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business	It is regular asset and does not form part of NPA	0.25% of All standard assets	-
NPA	An asset, in respect of which, interest/installment/reimbursement has remained overdue for a period of six months or more;	6 months	-	-

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## Audit Areas – Prudential Norms

### ■ Asset Classification and Provisioning Requirements

Assets	Explanation	Period	Provision on Loan Balance	Provision on Security
Sub standard assets	Asset classified as NPA for a period not exceeding 18 months; Asset where terms of agreement regarding interest/principal were renegotiated or rescheduled or restructured after commencement of operations, until the expiry of one year of satisfactory performance under the renegotiated or rescheduled or restructured terms:	Non-performing assets for a period of 18 months or Renegotiated loans up to one year of satisfactory performance of new terms.	10% of the outstanding amount	No specific provisions regarding Security

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## Audit Areas – Prudential Norms

### ■ Asset Classification and Provisioning Requirements

Assets	Explanation	Period	Provision on Loan Balance	Provision on Security
Doubtful Assets	"Doubtful asset" means: (a) a term loan, or (b) a lease asset, or (c) a hire purchase asset, or (d) any other asset, which remains a sub-standard asset for a period exceeding 18 months	Remains sub standard asset for period of 18 months and above	100% over realizable value of Securities	To the extent of loan which is covered by value of Realizable securities, the following provisioning is required based on the period the asset (the underlying loan) has been considered doubtful Up to - one year - 20% One - three year - 30% More than three years - 50%

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## Audit Areas – Prudential Norms

### ■ Asset Classification and Provisioning Requirements

Assets	Explanation	Period	Provision on Loan Balance	Provision on Security
Loss Assets	As Identified by Company, Auditor or RBI (Period is not specified) or Potential threat of Non Recoverability due to erosion in the value of securities or non-availability of security or any fraudulent act or omission on the part of the borrower.	Period not specified	100% Write off in the books	-

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## Reporting obligations

### ■ Reserve Bank of India Act, 1934

- ❖ Certificate/Report required to be issued for Registration from RBI under Section 45-IA of the Reserve Bank of India Act, 1934
  - ❖ Statement of the capital funds, risk assets/exposures and risk asset ratio
  - ❖ Certifying that the Company is not carrying on any Non Banking Financial Company activity for the period
  - ❖ Certifying that the Company is not holding / shall not accept Public Deposit for the period [date] to [Date]
  - ❖ Statement of Computation of Net Owned Funds
  - ❖ Statement of foreign direct investment
  - ❖ Certifying whether the Company has engaged in any capital market activity for the period [Date] to [Date]
- ❖ S 45 MA(1) – Auditor to inquire whether NBFC has submitted to the RBI, the requisite information, statements or particulars regarding deposits accepted by it.

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## Reporting obligations

### ■ NBFCs Auditor's Report (Reserve Bank) Directions

- ❖ Separate report to the Board of Directors on specific matters
  - ❖ Whether the NBFC has obtained a Certificate of Registration in terms of NBFC directives
  - ❖ Whether the Board of Directors has passed a resolution for non-acceptance of any public deposits;
  - ❖ Whether the Company has accepted any public deposit during the year/period;
  - ❖ Whether the Company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts etc.
- ❖ Obligation of auditor to submit Exception Report to RBI in respect of unfavorable or qualified statements
- Auditor's Additional Report for Systemically Important Non Deposit taking NBFCs

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## Reporting obligations

- **Other Reporting Obligations**

- ❖ [Auditors' Report on NBS 1 Quarterly Return](#)
- ❖ [Auditors' Certificate on Monthly Return](#)
- ❖ [Auditors' Certificate on Statement of Assets and Income Pattern](#)

- **Companies Act, 1956**

- ❖ Auditors' reporting under section 227 (2) and 227 (4A) [CARO] of the Companies Act, 1956
- ❖ [Independent Auditor's Report \(As per SA 700 \(Revised\)\)](#)

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## Practical Issues

- **Company doing investing activities of its surplus – Reporting requirements**
- **Company whose application for Registration rejected by RBI – Reporting requirements**
- **Classification of current / non-current and operating cycle in case of NBFCs under Schedule VI (Revised)**
- **Classification of interest receivable as Trade Receivables in case of NBFCs under Schedule VI (Revised)**

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**THANK YOU  
FOR  
YOUR ATTENTION**