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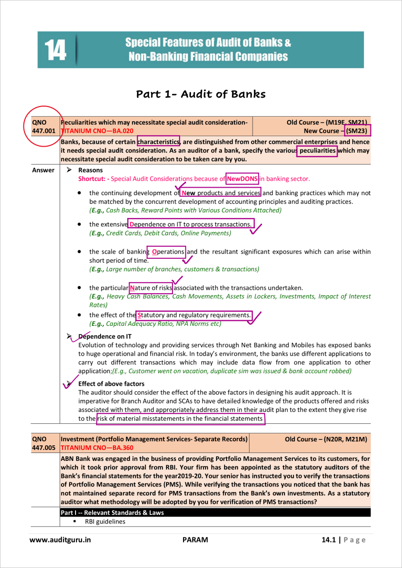


14 Special Features of Audit of Banks & Non-Banking Financial Companies

Part 1- Audit of Banks

QNO 447.001	Peculiarities which may necessitate special audit consideration- TITANIUM CNO—BA.020	Old Course – (M19E, SM21) New Course – (SM23)
	Banks, because of certain characteristics, are distinguished from other commercial enterprises and hence it needs special audit consideration. As an auditor of a bank, specify the various peculiarities which may necessitate special audit consideration to be taken care by you.	

Answer

- **Reasons**

  Shortcut: - Special Audit Considerations because of **NewDONS** in banking sector.

  - the continuing development of **New** products and services and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices.
    *(**E.g.,** Cash Backs, Reward Points with Various Conditions Attached)*
  - the extensive **D**ependence on IT to process transactions.
    *(**E.g.,** Credit Cards, Debit Cards, Online Payments)*
  - the scale of banking **O**perations and the resultant significant exposures which can arise within short period of time.
    *(**E.g.,** Large number of branches, customers & transactions)*
  - the particular **N**ature of risks associated with the transactions undertaken.
    *(**E.g.,** Heavy Cash Balances, Cash Movements, Assets in Lockers, Investments, Impact of Interest Rates)*
  - the effect of the **S**tatutory and regulatory requirements.
    *(**E.g.,** Capital Adequacy Ratio, NPA Norms etc)*

- **Dependence on IT**

  Evolution of technology and providing services through Net Banking and Mobiles has exposed banks to huge operational and financial risk. In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application;*(E.g., Customer went on vacation, duplicate sim was issued & bank account robbed)*

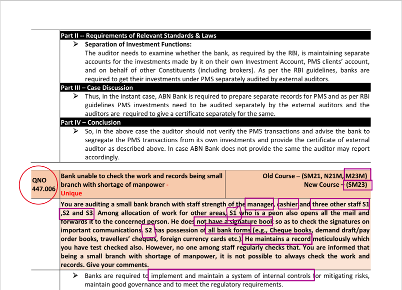
- **Effect of above factors**

  The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for Branch Auditor and SCAs to have detailed knowledge of the products offered and risks associated with them, and appropriately address them in their audit plan to the extent they give rise to the risk of material misstatements in the financial statements

QNO 447.005	Investment (Portfolio Management Services- Separate Records) TITANIUM CNO—BA.360	Old Course – (N20R, M21M)
	ABN Bank was engaged in the business of providing Portfolio Management Services to its customers, for which it took prior approval from RBI. Your firm has been appointed as the statutory auditors of the Bank's financial statements for the year2019-20. Your senior has instructed you to verify the transactions of Portfolio Management Services (PMS). While verifying the transactions you noticed that the bank has not maintained separate record for PMS transactions from the Bank's own investments. As a statutory auditor what methodology will be adopted by you for verification of PMS transactions?	

Part I -- Relevant Standards & Laws

- RBI guidelines



Part II -- Requirements of Relevant Standards & Laws

- **Separation of Investment Functions:**

  The auditor needs to examine whether the bank, as required by the RBI, is maintaining separate accounts for the investments made by it on their own Investment Account, PMS clients' account, and on behalf of other Constituents (including brokers). As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors.

Part III – Case Discussion

- Thus, in the instant case, ABN Bank is required to prepare separate records for PMS and as per RBI guidelines PMS investments need to be audited separately by the external auditors and the auditors are required to give a certificate separately for the same.

Part IV – Conclusion

- So, in the above case the auditor should not verify the PMS transactions and advise the bank to segregate the PMS transactions from its own investments and provide the certificate of external auditor as described above. In case ABN Bank does not provide the same the auditor may report accordingly.

QNO 447.006	Bank unable to check the work and records being small branch with shortage of manpower - Unique	Old Course – (SM21, N21M, M23M) New Course – (SM23)
	You are auditing a small bank branch with staff strength of the manager, cashier and three other staff S1 ,S2 and S3. Among allocation of work for other areas, S1 who is a peon also opens all the mail and forwards it to the concerned person. He does not have a signature book so as to check the signatures on important communications. S2 has possession of all bank forms (e.g., Cheque books, demand draft/pay order books, travellers' cheques, foreign currency cards etc.). He maintains a record meticulously which you have test checked also. However, no one among staff regularly checks that. You are informed that being a small branch with shortage of manpower, it is not possible to always check the work and records. Give your comments.	

- Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements.

- Given below are examples of internal controls that are violated in the given situation:
  - In the instant case, S1 who is a peon opens all the mail and forwards it to the concerned person.
    - Further, he does not have a signature book so as to check the signatures on important communications are not in accordance with implementation and maintenance of general internal control. As the mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book.
    - All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery.
  - In the given case, S2 has possession of all bank forms (e.g. cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He maintains a record meticulously which were also verified on test check basis.
- Further, contention of bank that being a small branch with shortage of manpower they are not able to check the work and records on regular basis, is not tenable as such lapses in internal control pose risk of fraud.
- The auditor should report the same in his report accordingly.

S1

S2

QNO 447.050	NPA(Cash Credit Branch wise Sub Limits) TITANIUM CNO-- BA.400	Old Course – (M23R)

BOT Limited is enjoying cash credit facility sanctioned from Nariman Point, Mumbai branch of KNB Bank for 250 crore. However, for practical considerations, various sub-limits have been fixed for the borrower company for operation at Solapur, Pune and Nashik branches of the same bank.

The manager of the Solapur branch notices that there are no credit transactions in sub - limit account being operated at the Solapur branch for more than 90 days as on 31st March,2022.

Discuss the approach of CA. Muni, statutory branch auditor of Nariman Point branch, Mumbai of KNB Bank, in the matter of asset classification of the above borrower account. Also discuss considerations for classifying said account at the Solapur branch.

Answer Sometimes, a customer is sanctioned a cash credit limit at one branch but is authorised to utilise such overall limit at several other branches also, for each of which a sub-limit is fixed.

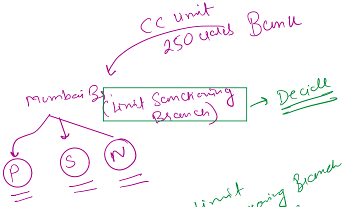
In such a case, the determination of status of the account as NPA or otherwise should be determined at the limit-sanctioning branch with reference to the overall sanctioned limit/drawing power and not by each of the other branches where a sub-limit has been fixed.

The auditor of the limit-sanctioning branch should examine whether it receives particulars of all transactions in the account at sub-limit branches and whether status of the account has been determined considering the total position of operation of the account at all

concerned branches. The standalone matter of no credit transactions for more than 90 days as on 31st March,2022 at Solapur branch is irrelevant.

Hence, keeping in view above, CA. Muni should consider asset classification considering the total position of operation of the account at all concerned branches.

Regarding sub-limit at branches, the classification adopted by the limit-sanctioning branch should be followed. Hence, the Solapur branch has to follow asset classification made by the limit-sanctioning branch.



✓— CC Limit

✓— Limit Sanctioning Branch & other Branches

✓— Case

✓— Conclusion

QNO 449.010	NPA (Classification of Assets Pressure by Bank Manager) TITANIUM CNO—BA.400	Old Course – (N18M)

M/s. S Ltd. is a MSME unit. The company does multiple banking. The company is availing cash credit limit from U Bank of Rs. 25 crores. The limit availed remained less than Rs. 5.00 crores during all the days of F.Y. 2017-18. The company has not done any credit in cash credit account during the year as it is operating current account in newly opened another bank branch adjoining to company premises. The company is having sufficient security of stocks and debtors and DP of Rs.25.00 crores remain all over the year. The company is availing term loans from other bank branches. Now the Bank Manager is insisting to route the sale proceeds through U Bank, otherwise cash credit limit and term loan accounts with other banks will be treated as Non-Performing Accounts. Now company seeks your opinion.

Answer

Part I -- Relevant Laws

- Classification of Account as NPA in case of Multiple Banking

Part II -- Requirements of Relevant Laws

- If the account remains overdue for more than 90 days, the account becomes Non-Performing Assets. The account will also be called as overdue, if there are not sufficient credits in the cash credit account which even could not serve the interest charged.

Part III – Case Discussion

- In this case, there are no credits in accounts, it means interest has not been served in the account. Thus, accounts become overdue after 90 days for non-credit of amounts which could even serve the interest amount. Thus, cash credits will become as NPA if no credits/sale proceeds are deposited in that account.

Part IV – Conclusion

- However, in multiple banking system, each bank is independent for classification of account as NPA. If SBI declares the account as NPA due to non-serving of interest amount, other bank will be free and will not classify the term loan accounts as NPA, if they are regular.

QNO 449.050	NPA (credit limit renewal) TITANIUM CNO—BA.400	Old Course – (SM21) New Course – (SM23)

ABC Bank had sanctioned credit limits of Rs.100 lakh to M/s Volkart Ltd on 1st September 2018. The renewal of limits was due on 1st September 2019. While doing the statutory branch audit for the year ended 31st March 2020, you find that the renewal has not been done even though 180 days are over. The bank says that the renewal process has been initiated on time and most of the documents are received. The account is operated regularly and is in order; balance is maintained within drawing power. It also shows a letter from Volkart stating that due to a sudden death of their auditor, a new auditor had to be appointed. Procedure for appointment took some time and the new auditor was doing the audit all over again. The limit was not renewed till 31/3/2020. However, the audited financials are received on

10th April 2020 and the renewal letter was issued immediately. Your assistant is insisting that the account must be classified as NPA since the limit was not renewed as on 31/3/2020. What is your opinion?

- As per Guidelines of Reserve Bank of India the account should be classified as NPA if renewal is not done in 180 days.
- However, in the present case, operations in the account are excellent.
- The bank has shown a letter from that company that due to certain reasons the audited financial statements are delayed. Further, the limit has been renewed before signing the audit report.
- Thus, even if the sanction was issued after the balance sheet date, it relates to the position as on the balance sheet date.
- Therefore, it is an adjusting event under AS 4, Contingencies and Events Occurring After the Balance Sheet Date. It is also a matter of substance over form.
- The auditor would consider classifying the account as a standard asset.

✓— Renewal Criteria

✓— Case

✓— Position as on B/S Date is classified

✓— Conclusion Ls Standard Asset

449.080	NPA (regularization before balance sheet date)- TITANIUM CNO—BA.400	Old Course – (N20E)

In the course of statutory Branch audit of KS Bank Ltd, you observe that some borrower accounts have been regularized before Balance sheet date by payment of overdue amount. Narrate the audit procedures to be carried out with special focus on the Classification of advances and Provisioning for Non-Performing assets of the Branch.

The Audit procedures that need to be carried out with special focus on classification of advances and provisioning for NPAs of KS Bank Ltd, in which the auditor has observed that some borrower accounts have been regularized before balance sheet date by payment of overdue amount shall be carried out as under :

(i) As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA.

(ii) Where subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not.

(iii) Where the account indicates inherent weakness based in the data available, the account shall be deemed as a NPA.

Classification and Provision

- **a.** Examine whether the classification made by the branch is appropriate. Particularly, examine the classification of advances where there are threats to recovery.
- **b.** Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.
- **c.** It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date.
- **d.** The date of NPA is significant to determine the classification and hence specific care be taken in this regard.
- **e.** NPA should be recognized only based on concept of Past Due/ Overdue concept, and not based on the Balance Sheet date.

QNO 451.000	(Consortium)NPA TITANIUM CNO—BA.400	Old Course – (N11R, N12M, M13R, PM17, N17R, M18M, SM21,) New Course – (SM23)

Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. The bank is a consortium member of Cash Credit Facilities of Rs 50 crores to X Ltd Bank's own share is Rs 10 crores only. During the last two quarters against a debit of Rs 1.75 crores towards interest the credits in X Ltd's account are to the tune of Rs 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing. Advise your views

on the issue which were brought to your notice by your Audit Manager.

OR

The bank is a consortium member of Cash Credit Facilities of Rs 50 crores to X Ltd. Bank's own share is Rs 10 crores only. During the last two quarters against a debit of Rs 1.75 crores towards interest the credits in X Ltd.'s account are to the tune of Rs 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing.

Answer

Part I -- Relevant Laws

- As per Classification Norms Related to NPAs

Part II -- Requirements of Relevant Laws

- Sometimes, **several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors.**

Part III – Case Discussion

- The bank is a consortium member of cash credit facilities of Rs 50 crores to X Ltd. Bank's own share is Rs 10 crores only. During the last two quarters against a debit of Rs 1.75 crores towards interest, the credits in X Ltd.'s account are to the tune of Rs 1.25 crores only.

Part IV – Conclusion

- Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

✓ Consortium Finance
✓ Role of lead Branch
✓ NPA criteria (Individual Bank)

Author's Note

- **The conclusion part of the answer says, "Interest Should be reversed". The reason why interest should be reversed here and the logic behind it.**
    - In case of consortium every bank has to see at its own status of recovery, so as to determine whether loan is NPA or not. Even if lead bank is getting money that is not going to affect our status. Our status depends on our recovery and not what is happening with the lead bank or other banks. Here in consortium every bank has to see their own recovery for the purpose of NPA. If bank not getting money it is a NPA and if it is NPA then interest should be reversed.

QNO 454.500	NPA (Multiple Cases) TITANIUM CNO—BA.400	Old Course – (N21R)

Gupta & Co. has been appointed as a statutory auditor of TCB Bank Ltd., a private sector bank, registered with RBI. Mr. Kaival Gupta, the engagement partner, while performing the audit as per the checklist, noted down the following points, which would be part of the audit queries, as tabulated below:

Sr. No.	Queries
1	Interest on State Government Guaranteed advance has been taken to income even though such advance has remained overdue for more than 90 days.
2	There is an account for which an ad hoc limit has not been reviewed for 180 days from the date of such ad hoc sanction and such account has been treated as a performing asset in the books.
3	One of the NPAs was sold for a value higher than the net book value. Profit was not recognized but the excess provision in respect of the same has been reversed.
4	In case of one of the accounts, an additional temporary limit has been sanctioned for 25% of the existing limit and for 120 days tenure.
5	On verification of outstanding forward exchange contracts, the 'net position' in respect of one of the foreign currencies was not squared and was uncovered by a substantial amount.

You are required to provide the reasons due to which such queries would have been raised by Mr. Kaival Gupta and describe the actions that may be taken by the person responsible on behalf of TCB Bank Ltd. for solving such queries.

Answer

Sr. No.	Reason for such Query	Action that may be taken in response to the query
1	A State Government Guaranteed advance has to be treated as NPA even if it remains overdue for more than 90 days and in case of NPA, for the purpose of income recognition, interest on such advance should not be taken to income unless interest is realized.	Interest income recognized on such advance would be reversed and would be taken to income only when it is realized.
2	Accounts for which an ad hoc limit has not been reviewed for 180 days from the date of such ad hoc sanction, should be considered as NPA.	It's treatment in the books would be changed from performing asset to a non-performing asset from the date when such change in the treatment was required
3	In case of sale of NPA, where the sale is for a value higher than the NBV, the auditor is required to ensure that no profit is recognized, and the excess provision has not been reversed but retained to meet the shortfall/ loss that may arise because of the sale of other nonperforming financial assets.	The entry for reversal of the excess provision would be cancelled in the books and such excess provision would be retained to meet the shortfall/ loss that may arise because of the sale of other non-performing financial assets.
4	Additional temporary limit may be sanctioned, for a maximum of 20% of the existing limit and 90 days maximum tenure.	The terms of additional temporary limit in case of such account would be revised to 20% of the existing limit and for 90 days maximum tenure.
5	Net position in respect of each of the foreign currencies should be generally squared and should not be uncovered by a substantial amount.	The net "position" of the branch in relation to each foreign currency should be squared off and get covered by a substantial amount.

QNO 454.550 **Deficiencies in "credit appraisal"** **New Course – (SM23)**

TITANIUM CNO -- Unique

CA. Harshit is conducting statutory audit of branch of a public sector bank. On examining 20 large advances of the branch, he finds that in 5 examined cases, loan applications have been filled up scantily with important details left out. In these cases, it is also noticed that cash credit limits to the borrowers were enhanced during the year but there are no records pertaining to assessment of enhanced working capital requirements in respective borrower files. The branch is unable to show such assessments/workings in system either.

However, all the five accounts are operating satisfactorily. These accounts have been classified as standard assets by branch. Would above information prompt auditor to suggest change in asset classification of above accounts? What does depicted situation reflect?

- NPA Norms
- Credit Appraisal
- Case Discussion ↗ Std Asset
- Conclusion → LFAR

Answer An account becomes NPA when it ceases to generate income for bank. In the given situation, all the examined five accounts are operating satisfactorily. There is no reason for suggesting changes in their classification.

The matter of scantily filling up loan applications and lack for record for assessment of enhanced working capital requirements shows that internal control over advances in branch is not proper. The above said situation shows deficiencies in "credit appraisal" at branch level. Such deficiencies need to be highlighted by auditor in LFAR.

QNO 454.600 **Audit Procedures to check Compliance of Audit norms in different situations.** **Old Course – (N21M)** **New Course – (SM23**

TITANIUM CNO—BA.400

M/s Aadi & Co., Chartered Accountants, have been allotted the branch audit of a nationalized bank for the year ended 31st March 2021. You are part of audit team and have been instructed by your partner to verify the following areas:

(i) Fulfilment of the criteria prescribed for NPA norms for government guaranteed advance.

(ii) Fulfilment of the criteria prescribed for NPA norms for the advances given for agricultural purposes.

(iii) Drawing power calculation from stock statements in respect of working capital accounts.

(iv) Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of ad hoc sanction. What may be your areas of concern as regards matters specified above?

Answer

Area of Focus	**Suggested Audit Procedures**
Government Guaranteed Advances ✓	• If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked. This exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days. • In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR
Agricultural Advances ✓	• Ensure that NPA norms have been applied in accordance with the crop season determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops – short term/ long term - raised by an agriculturist, the NPA norms would also be made applicable to agricultural term loans availed of by them. Also ensure that these norms are made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector. • In respect of agricultural loans, other than those Specified in the circular, ensure that identification of NPAs has been done on the same basis as non agricultural advances
Drawing Power Calculation ✓	• Ensure that the drawing power is calculated as per the extant guidelines (i.e. the Credit Policy of the Bank) formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power. • The stock audit should be carried out by the bank for all accounts having funded exposure of more than stipulated limit. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power. The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be ensured that mobilization advance being received by the contractors is reduced while calculating drawing power.
Limits not reviewed ✓	Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of ad hoc sanction, should be considered as NPA. Auditors should also ensure that the ad hoc/short reviews are not done on repetitive basis. In such cases, auditor can consider the classification of account based on other parameters and functioning of the account.

QNO 454.700 **NPA Case -- Deficiency in Documents** **Old Course – (N22R)**

TITANIUM CNO—BA.400

CA Prachi was conducting statutory audit of branch of a nationalized bank for the year 2021-22. While reviewing operations and documents/papers of a borrower enjoying overdraft credit facilities of ₹ 50 crore (availed against security of stocks and book debts), following observations were jotted down by her: -

(i) The balance in overdraft credit facility as on 31st March,2022 was ₹ 55.65 crore. The balance in account exceeded sanctioned limit during the whole month of March 2022. → Not NPA

(ii) As per terms of sanction letter, stock/book debt statements were required to be submitted monthly. Latest available stock/book debt statement for the month of February, 2022 showed drawing power of ₹ 48.50 crore only. However, stock/book debt statements of previous months showed adequate drawing power. → Not NPA

(iii) Stock audit of borrower was also conducted during the year by one of empanelled stock auditors of the bank. Stock audit report dated 31st December,2021 placed on the record showed adequate drawing power in the account. However, it has commented adversely on the declining turnover of borrower in year 2021 -22(till the date of stock audit report) as compared to proportionate turnover in preceding year. → TO

(iv) The renewal of overdraft facilities was due on 20th October,2021. The account was short renewed by competent authority for a period of 3 months pending submission of complete papers. → Renewal

However, borrower has not submitted complete renewal papers till 31st March,2022. There is a request letter from borrower on record stating that valuation report of a property located at a faraway location was taking time. The branch has classified the account as 'Standard Asset'. Considering above, CA Prachi is in dilemma relating to proper classification of above advance. Guide her.

Answer

The borrower was enjoying overdraft credit facilities of ₹ 50 crore against security of stocks and debts. Further, though latest available stock statement for the month of February, 2022 showed inadequate drawing power, there was adequate drawing power available throughout the year. Stock audit report dated 31.12.2021 also reflected adequate drawing power. Hence, it shows that borrower had adequate drawing power during the year.
Further, comment on declining sales is of general informative value to management for making credit decisions.

The fact of over drawings in account during the month of March, 2022 and inadequate drawing power in a month are in nature of temporary deficiencies and do not require account to be classified as NPA in accordance with asset classification and provisioning norms of RBI.

RBI instructions lay down that ordinarily credit limits need to be reviewed not later than three months from the due date. As per Guidance note on Audit of Banks, in case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is underway and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the credit limits have not been reviewed/ renewed within 180 days from the due date will be treated as NPA.

It would be pertinent to note that the counting of 180 days would be required to be done from the date of original due date for renewal and not from the date of expiry of short reviews / technical reviews. In the instant case, the original date of renewal was 20th October, 2021 and period of 180 days has still not expired as on balance sheet date.

✓

Keeping in view all above factors, CA Prachi should accept classification of account as 'Standard Asset' made by branch.

QNO 455.000	**Sale of NPA** **TITANIUM CNO—BA.400**	**Old Course – (M15E M18E, N20E, SM21, N22M)** **New Course – (SM23)**

CA K have been doing audit of branch of LUD Bank Ltd. The principal business of the branch is lending advances to large corporates. Since last one year, many large accounts have become Non-Performing Asset (NPA) as per guidelines. The Management of the Bank decided to sell one of the NPA account and consequently one NPA namely DEF Ltd. amounting to Rs. 10.00 Crores was sold to Asset Reconstruction Company. What audit points CA K should keep in mind while doing audit of this transaction?

OR

During the bank audit AB & Co. a new Chartered Accountant firm, observed the sale/purchase of NPAs. Please help them by narrating the aspects, relating to sale/purchase of NPAs, to be considered.

OR

In the course of audit of Skip Bank Ltd., you found that the Bank had sold certain of its non-performing assets. Draft the points of audit check that are very relevant to this area of checking.

Answer

- In case of a sale/ purchase of NPAs by the bank, the auditor should examine the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

  - **Sale**
    In case of sale of an NPA, the auditor should also ensure that:
    - only such NPA has been sold which has remained NPA in the books of the bank for **at least 2 years.**
    - the NPA has been sold at **cash basis only.**
    - the assets have been sold/ purchased **"without recourse"** only.
    - subsequent to the sale of the NPA, the bank **does not assume any legal, operational or any other type of risk** relating to the sold NPAs.
    - on the sale of the NPA, the same has been **removed from the books** of the account.
    - the **short fall in the net book value** has been charged to the profit and loss account.
    - where the **sale is for a value higher than the NBV,** no profit is recognised, and the excess provision has not been reversed but retained to meet the shortfall/ loss on account of sale of other non-performing financial assets.
  - **Purchase**
    Similarly, in case of purchase of NPAs, the auditor should verify that:
    - the bank has not purchased an NPA which it had **originally sold.**
    - the NPA purchased has been subjected to the **provisioning requirements** appropriate to the classification status in the books of the purchasing bank.
    - any **recovery** in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.
    - for the purpose of capital adequacy, banks have assigned **100% risk weights** to the NPAs purchased from other banks.

QNO 458.010	**(Income, CASE) Advances** **TITANIUM CNO—Unique**	**Old Course – (M13E, SM17, PM17, M18M, M19M, N19R, M20R, SM21, M21M, M23M)**

In course of audit of Good Samaritan Bank as at 31st March 15 you observed the following:
In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government?

Answer

Part I -- Relevant Laws

- Classification of Government Guaranteed Advances

Part II -- Requirements of Relevant Laws

- If a government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.

Part III – Case Discussion

- In the above case, Since the bank has not revoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed. The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days .

Part IV – Conclusion

- In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

QNO 458.020	Investment (Income, Mutual Fund) TITANIUM CNO—UNIQUE	Old Course--(N11R, N12M, N16R, SM17, PM17, N18R, N18M, SM21) New Course – (SM23)

Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. State your views on the following issues which were brought to your notice by your Audit Manager:

The bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year.

Answer

Part I -- Relevant Laws

- RBI Circulars

Part II -- Requirements of Relevant Laws

- **Interest on bonds and debentures** ✓
  Banks may book income from Government Securities and bonds and debentures of corporate bodies on accrual basis, where interest rates on these instruments are pre-determined and provided interest is serviced regularly and is not in arrears.
- **Interest Income Guaranteed by Government** ✓
  Banks may book income on accrual basis on securities of corporate bodies/ public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.
- **Dividend income on shares** ✓
  Banks may book income from dividend on shares of corporate bodies on accrual basis provided dividend on the shares has been declared by the corporate body in its Annual General Meeting and the owner's right to receive payment is established
- **Dividend income on mutual funds** ✓
  Banks may book income from units of mutual funds on cash basis

Part III – Case Discussion

- The bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year.

Part IV – Conclusion

- Treatment given by bank is inappropriate, such dividend on mutual fund units

QNO 462.000	(Audit)Advances TITANIUM CNO—BA.380	Old Course – (N8E, M11R, N12R, N14R, M16R, N16R, PM17, M18E, M19R, SM21, N23M,) New Course – (SM23)

As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances. ✓

OR

ABC Chartered Accountants have been appointed as concurrent auditors for the branches of Effective Bank Ltd. for the year 2019-20. You are part of the audit team for Agra branch of the bank and have been instructed by your senior to verify the advances ✓ **of the audit period. You are required to guide your assistant about the areas to be taken care while doing verification during the concurrent audit.**

Answer

- ***Audit of Advances of a Bank:***

The items to be covered in the current audit of advances of a bank are as follows-

- Ensure that loans and advances are sanctioned properly.
- Verify whether the sanctions are in accordance with the delegated authority.
- Check whether letters of credit issued by the branch are within the delegated power and ensure that they are genuine trade transactions.
- Verify the instances of exceeding delegate powers have been promptly reported.
- Verify the frequency and geniuses of such exercise of authority beyond to delegated powers of the concerned officials.
- Ensure that securities and documents have been received and properly charged/registered.
- Ensure that post disbursement supervision and follow up is proper
- Verify whether there is any misuse of loans and advances and whether there are instances indicative of diversion of funds.
- Verify the classifications of advances are as per RBI directions.
- Ensure proper follow up of overdue bills of exchange.
- Verify whether the submission of claims to DICGC and ECGC is in time.
- Check bank guarantees issued are properly worked and recorded.

Authors Note
Question w.r.t Audit of Advances, ICS over advances and LFAR report over advances have similar points
So we have created a combined common answer and have arranged it in a logical sequence .
However original text has also been kept. Students can also read that if they want.
For common answer see after QNO 466.000

QNO 465.000	Advances (ICS) TITANIUM CNO—UNIQUE	Old Course – (M18R)

Advances generally constitute the major part of the assets of the bank. There are substantial number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

As an expert in bank audit, you are required to briefly discuss the area of focus and suggested audit procedures regarding evaluation of internal controls over advances, substantive audit procedures and recoverability of advances

Answer

- The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- Sufficient margin should be kept against securities taken to cover any decline in the value thereof and to comply with Reserve Bank directives. Such margins should be determined by the proper authorities of the bank as a general policy or after detailed scrutiny for specific accounts.
- All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank.
- All accounts should be kept within both the drawing power and the sanctioned limit as per prescribed norms. Additional temporary limit may be sanctioned, for a maximum of 20% of existing limit and 90 days maximum tenure.
- All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.

- The operation (in each advance account) should be reviewed at least once every year.

QNO 470.020 **Audit Procedure for revenue leakages** — TITANIUM CNO -- Unique — **Old Course – (N23M)**

CA X is conducting concurrent audit of a branch of MNB Bank (a nationalised bank) in industrial hub of Pune. It is a CBS branch, and its advances are to the tune of about ₹ 500 crores. The branch has borrowers / customers with cash credit, term loans, and export credit facilities, including pre - shipment and post shipment credits. Some customers in the branch are importers who regularly get letters of credit issued to foreign suppliers. During tenure of Mr. X as concurrent auditor, fresh credit facilities under aforesaid segments are being sanctioned every month to new customers. The branch is also considering requests of its existing customers for enhancements / fresh requirements in line with established norms. As a result of the above, the staff of the advances department in the branch is always on its toes. The previous regular inspection of the branch (not pertaining to CA X's tenure) had pointed out huge revenue leakage in advances of the branch, raising alarm bells in the Zonal Office and Inspection Department. Keeping in view the above situation, CA X is taking steps to ensure that there is no revenue leakage in advances of the branch and recoveries are made on the spot in case such leakages are detected. Discuss any five areas in this regard where concurrent auditor's audit procedures should be focused.

Answer **The major areas to plug revenue leakage where concurrent auditor should focus audit procedures include: -**

REPLI

✓ Interest Income.

(i) Verifying rates of interest as per terms of sanction in sanction letter vis-à-vis those fed in CBS as well as the calculation of interest through product rate sheets generated by CBS to satisfy that interest has been charged on all the performing accounts and interest rates charged are in accordance with the bank's internal regulations, directives of the RBI and agreements with the respective borrowers.

✓ Renewal charges

(ii) Verification of renewal charges in respect of existing customers enjoying cash credit and export credit facilities. Similarly, for fresh borrowers, proposal processing charges, including upfront fees for term loan, needs to be verified in accordance with Bank's circulars to ensure that all charges are debited at time of release of facilities to new customers. These charges also need to be levied proportionately in respect of customers whose credit facilities have been enhanced.

✓ Penal charges

(iii) Verification of penal charges for non-submission of stock statements on due dates in case borrowers availing cash credit and export credit facilities consisting of pre-shipment credit facilities.

✓ LOC

(iv) Verification of commission /charges in case of letter of credit has been issued to importers in accordance with the Bank's circulars.

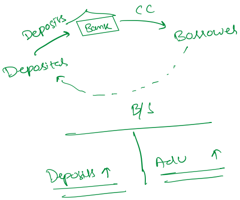
✓ EB

(v) As the branch has also granted export credit facilities in the nature of post -shipment credit facilities, verification of commission/charges on export bills purchased is required.

QNO 470.200 **Deposits-Window dressing** — TITANIUM CNO—BA.500 — **Old Course- (N22M)**

You are part of engagement team conducting statutory audit of a branch of nationalized bank. During the course of audit, it has come to your notice that there are large number of cash credit accounts in the branch. Many of the cash credit accounts are only partially utilized during substantial part of year. However, in the month of March, the accounts are fully utilized. On further scrutiny, it is observed that these account holders have made fixed deposits from these utilized amounts at the end of year. These deposits have been liquidated in first week of April of next financial year. Comment upon how this situation would be dealt by you as a statutory branch auditor?

Answer In the given case, many of the cash credit accounts in the branch of a nationalized bank are only partially utilized during substantial part of year. However, in the month of March, the accounts are fully utilized. On further scrutiny, it is observed that these account holders have made fixed deposits from these utilized amounts at the end of year. These deposits have been liquidated in first week of April of next financial year.



This is an example of **window dressing**. The branch is resorting to window dressing by artificially boosting its advances and deposits. Utilization of advances and placing of fixed deposits at end of year in branch and again liquidation of deposits early next year indicate that branch is resorting to window dressing to inflate its advances as well as deposits artificially.

The auditor has to verify whether the unavailed portion of the credit facilities (overdraft, cash credit) are used to boost the loans and deposits which might tantamount to window dressing.

The relevant regulatory guidelines also prohibit such type of practices and these might involve penal action in terms of Banking Regulation Act, 1949.

The same needs to be suitably reported in audit report and commented in LFAR also. In appropriate cases, making a suitable qualification in the main audit report has also to be considered

QNO 473.000 **Credit Card (ICS)** — TITANIUM CNO—BA.260 — **Old Course – (M04E, N09E, M15R, PM17, N19E, N20M, SM21, M22R, N22E)** **New Course – (SM23)**

How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank?

OR

You have been appointed as an auditor of LCO Bank, a nationalized bank. LCO Bank also deals in providing credit card facilities to its account holders. The bank is aware of the fact that there should be strict control over storage and issue of cards. As an auditor of the bank, how will you evaluate the Internal Control System with respect to Credit Card operations maintained byte LCO Bank?

Answer

➢ **Credit Card Operations**

- **Storage**
  There should be strict control over storage and issue of cards.
- **Screening Before Issue**
  There should be effective screening of applications with reasonably good credit assessments.
- **Available Card Limit**
  There should be at system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.
- **Settlement Confirmation**
  There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.
- **Reimbursement**
  Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.
- **Charge to Customer**
  All the reimbursement (gross of commission) should be immediately charged to the customer's account.
- **Statements**
  There should be a system to ensure that statements are sent regularly and promptly to the customer.
- **Monitoring**
  There should be a system to monitor and follow-up customers‟ payments.
  - There should be a system of periodic review of credit card holders‟ accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.
  - Items overdue beyond a reasonable period should be identified and attended to

carefully. Credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.

Authors Note
Points are rearranged for ease of understanding and memorising

QNO 475.000	SLR TITANIUM CNO—BA.300	Old Course – (PM17, M17R, SM17, N17M, M18M, SM21,) New Course – (SM23)

You have been appointed as a statutory central auditor of APNA Bank, a Nationalized bank. What special points would be borne in mind while conducting the audit of compliance with "Statutory Liquidity Ratio' (SLR) requirements?

Answer

- *Statutory Liquidity Ratio (SLR) Requirements –*

  The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements **of 12 odd dates in different months of a financial year not being Fridays. The resultant report is to be sent to the top management of the bank and to the Reserve Bank. The report of the statutory auditors in relation to compliance with SLR requirements has to cover two aspects:**
  - **correctness of the compilation of DTL (Demand and Time Liabilities) position; and**
  - **maintenance of liquid assets.**
- *Audit approach and procedure:*
  - Obtain an understanding of the relevant circumstances of the RBI, particularly regarding **composition of items of DTL.**
  - Require the **branch auditors to send their weekly trial balance** as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances **relevant to the dates selected by him.** The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates.
  - Review the relevant **returns received from un-audited branches** to identify any obvious errors or omissions or inconsistencies.
  - Examine, **on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches.** The auditor should examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.
  - While examining the computation of DTL, specifically examine that the following items have been **excluded from liabilities-**

    RIL-Mobile
    - Part amounts of **R**ecoveries from the borrowers in respect of debts considered bad and doubtful of recovery. *(Recovery of Bad Debts is not a liability)*
    - Amounts received in **I**ndian currency against import bills and held in sundry deposits pending receipts of final rates. *(Such money is not returnable hence not liability)*
    - Un-adjusted deposits/balances lying in **L**ink branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches. *(Link branch of bank deals with RBI and other Banks, if money is received by such branches but not yet used or adjusted)*
    - **M**argins held and kept in sundry deposits for funded facilities. *(Money deposited in bank before giving loan)*
    - Similarly, specifically examine that the following items have been **included in liabilities –**
      - **Net credit balance in branch adjustment accounts** including these relating to foreign branches.
      - **Interest on deposit as at the end of the half year** reversed in the beginning of the next half-year.

      - Borrowings from abroad by banks in India needs to be considered as 'liabilities to other' and thus, needs to be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'
      - The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.
  - Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches.
  - It may be noted that, even though interest accrues on a daily basis, it is recorded in the books only at periodic intervals. Thus, examine whether such interest accrued but not accounted for in books is included in the computation of DTL.
  - The auditor at the central level should apply the audit procedures listed above to the overall consolidation prepared for the bank as a whole. Where such procedure is followed, the central auditor should adequately describe the same in his report.
  - Test check the relevant records maintained by the bank in respect of **investments to verify the amount of approved securities held by the bank on the dates selected by him Examine whether the valuation of approved securities has been done by the bank is in accordance with the guidelines prescribed by the RBI.**
    - While reporting on compliance with SLR requirements, the auditor should specify the **number of unaudited branches** and state that he has relied on the returns received from the unaudited branches in forming his opinion.

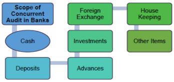
QNO 478.010	Concurrent Audit(Scope)- TITANIUM CNO—~~BA.680~~ BA.760	Old Course – (N06E, M09R, SM17, PM17, SM21) New Course – (SM23)

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines

Answer

- *Scope of Concurrent Audit*
  - The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Banks Inspector and Audit Department in consultation with the Banks Audit Committee of the Board of Directors (ACB).
  - In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving small amounts.
  - While the detailed scope of the concurrent audit may be determined and approved by the ACB.

  Further, **the guidelines issued by the RBI cover**all the key areas of activities of the branch which is under concurrent audit. Most banks have prepared an Audit Manual for this purpose. Broadly stated, the following areas are covered by these guidelines:



QNO 479.000 | **Verification of Balances (Foreign Country)** | **Old Course – (PM17, N17R, M20M)**

UNIQUE

NAYASA Bank appointed your firm of Chartered Accountants as a branch auditor for the financial year 2016-17. Being head-in-charge of the assignment, while planning, you distributed the work among your team members and assigned Mr. Hary for verification of Balances in account of the bank situated in foreign country. However, Mr. Hary, being fresh to the bank audits, needs your guidance. Kindly guide.

OR

As an auditor of a nationalised bank, how would you verify the following?
Balances in account of a bank situated in a foreign country.

OR

M/s CAS & Associates have been appointed as one of the statutory central auditors of FDMH Bank., for the Financial Year 2019-20. During the course of the audit, the auditor found that the bank has a balance with a Zurich based bank. The auditor understands that such balance is a matter of important consideration in the audit of the bank. Being head-in-charge of the assignment, while planning, you distributed the work among your team members and assigned Mr. Ansh for verification of Balances in account of the bank situated in foreign country. However, Mr. Ansh, being fresh to the bank audits, needs your guidance. Kindly guide.

Answer

➢ **Balances in Account of a Bank situated in a Foreign Country:** The following procedure may be followed while verifying balances in account of a bank situated in a foreign country-

- Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.
- Review the reconciliation statements and pay particular attention to the following.
    - Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.
    - Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.
    - Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
- Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window dressing.
- Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.
- Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with relevant Accounting Standard**.**

QNO 479.010 | **Foreign Exchange Transaction-** | **Old Course – (N18E, N19E SM21, N21E)**
TITANIUM CNO—AOB.620 | **New Course – (SM23)**

You are the Concurrent Auditor of a Branch of Nationalized Bank which deals in foreign exchange transactions. Give focus areas of your checking in this respect.

OR

You have been appointed as Concurrent Auditor of a nationalized bank branch. The main business at the branch is dealing in foreign exchange. Suggest the main areas of coverage with regard to foreign exchange transactions of the said branch under concurrent audit

Answer

➢ **Focus Areas in case of Foreign Exchange Transactions:**

- Check foreign bills negotiated under letters of credit.
- Check FCNR and other non-resident accounts whether the debits and credits are permissible under rules.
- Check whether inward/outward remittance have been properly accounted for.

- Examine extension and cancellation of forward contracts for purchase and sale of foreign currency. Ensure that they are duly authorized and necessary charges have been recovered.
- Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank.
- Ensure that the overbought/oversold position maintained in different currencies is reasonable considering the foreign exchange operations.
- Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations.
- Ensure verification/reconciliation of Nostro and Vostro account transactions/ balances

QNO 483.050 | **Verification of bills payable** | **Old Course – (N19M)**

TITANIUM CNO—BA.540

INDO Bank appointed your firm of Chartered Accountants as a branch auditor for the financial year 2018-19. Being head-in-charge of the assignment, while planning, you distributed the work among your team members and assigned Mr. Pary for verification of bills payable. However, Mr. Pary, being fresh to the bank audits, needs your guidance. Kindly guide.

Answer

Bills Payable: Evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following-

- Drafts, mail transfers, traveller's cheques, etc. should be made out **in standard printed forms.**
- **Unused forms** relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer.
- The bank should have a **reliable private code** known only to the responsible officers of its branches, coding and decoding of the telegrams should be done only by such officers.
- All the **telegraphic transfers and demand drafts** issued by a branch should be immediately confirmed by advices to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch.
- The **signatures on a demand draft** should be checked by an officer with the specimen signature book.

Examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding debits in respect of drafts or other similar instruments paid without advice should be ascertained.

Correspondence with other branches after the year-end *(e.g., responding advices received from other branches, advices received from other branches in respect of drafts issued by the branch and paid by the other branches without advice)*should be examined specially in so far as large value items outstanding on the balance sheet date are concerned.

Author's Note

ICAI has taken answer of this question directly from module. Question is only about Bills payable but unfortunately answer is a mixed bag covering bills payable, DD, and telegraphic transfer.

QNO 485.000 | **Contingent Liability-** | **Old Course – (PM17, M17R, N19R, SM21)**
TITANIUM CNO—~~BA.560~~ BA·620 | **New Course – (SM23)**

While auditing APNA Bank, you observed that a lump sum amount has been disclosed as contingent liability collectively. You are, therefore, requested by the management to guide them about the disclosure requirement of Contingent Liabilities for Banks. Kindly guide.

Answer

➢ **Contingent Liabilities**

- ① Guarantees given on behalf of constituents
    - In India
    - Outside India
- ② Acceptances, endorsements and other obligations
- ③ Liability on account of outstanding forward exchange contracts.

- 4 Liability for partly paid investments
- 5 Claims against the bank not acknowledged as debts
- 6 Other items for which the bank is contingently liable

➢ **Bills for Collection**

QNO 485.005	**Management Representation For Contingent Liability** **TITANIUM CNO—UNIQUE**	**Old Course – (M22E)**

Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank for the financial year 2021-22. During the course of audit your audit team observed that a lump sum amount has been disclosed as Contingent Liability collectively though the components are correctly identified. In respect of contingent liabilities, the auditor is primarily, concerned with seeking reasonable assurance that all the contingent liabilities are identified and properly valued and the audit firm intends to obtain a representation from the 'management. Highlight the points/checklists that are to be covered in the management representation.

Answer

Contingent Liabilities: In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. The auditor should obtain representation from management that: -

(i) all off-balance sheet transactions have been accounted in the books of accounts as and when such transaction has taken place;

(ii) all off balance sheet transactions have been entered into after following due procedure laid down;

(iii) all off balance sheet transactions are supported by the underlying documents;

(iv) all year end contingent liabilities have been disclosed;

(v) the disclosed contingent liabilities do not include any crystallised liabilities which are of the nature of loss/ expense and which, therefore, require creation of a provision/adjustment in the financial statements;

(vi) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including consideration of the possibility of any reimbursement;

(vii) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulation Act, 1949 has arisen on account of such guarantee; and

(viii) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote include the management's justification for reaching such a decision in respect of those contingent liabilities.

Note: Students may be given due credit for any other relevant point quoted.

QNO 488.500	**Bank Audit Report -- Submission, Requirement of Company's Act, Applicability of CARO** **UNIQUE**	**Old Course – (M21E)**

M/s GH & Associates have been appointed as Central Statutory Auditors of BNH Bank, a nationalized bank, headquartered in New Delhi for the F.Y 2020-2021. Bank functions in automated environment using "FLC Software". While preparing audit report, one of the partners highlighted that some matters covered by Companies Act. 2013 and the requirements of Companies (Auditor's Report) Order, 2020 reporting. You are required to answer the following: -

(i) To which authority auditors should submit their audit report?

(ii) List the matters covered under Companies Act. 2013 and

(iii) Reporting under Companies (Auditor's Report), Order, 2020.

Answer

(i) Authority to whom Auditors to submit their Audit Report -

In the case of a nationalised bank, the auditor is required to make a report to the Central Government.

So, GH & Associates, Central Statutory Auditors of BNB Bank- a nationalized bank, would be required to submit their report to Central Govt.

(ii)The auditor of a banking company is also required to state in the report the matters covered by Section 143 of the Companies Act, 2013.

1. **Report on adequacy and operating effectiveness of Internal Controls** over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
2. **Report on whether any serious irregularity was noticed in the working** of the bank which requires immediate attention (in accordance with sec 143(12) of the Companies Act, 2013.)
3. **As per reporting requirements cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014** the auditor's report shall also include their views and comments on the following matters, namely:

a) Whether the bank has disclosed the impact, if any, of the pending litigations on its financial position in its financial statements.

b) Whether the bank has made provision, as required under the law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts.

c) Whether there has been any delay in transferring amounts, required to be transferred to the Investor Education and Protection Fund by the bank.

(iii) Reporting requirements relating to the Companies (Auditor's Report) Order, 2020 are not applicable to a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949.

QNO 488.600	**Areas of credit appraisals and credit monitoring** **TITANIUM CNO -- Unique**	**old Course – (N23R)**

CA. Sundaram is an engagement partner conducting a statutory audit of a nationalised bank. The bank operates on the CBS platform, and the identification of NPAs is system based in accordance with RBI guidelines on asset classification. He wants to be assured of satisfactory operation of internal control in this respect. He wants to be sure that there exists an internal control system in the bank which not only prevents and reduces the risk of loan assets becoming non-performing at the initial stages but also sends out timely signals to the bank subsequently. He is putting considerable importance on effective credit appraisals due to their role in preventing NPA slippages. While carrying out a walk-through of internal control over advances of banks especially in areas of "credit appraisals" and "credit monitoring", identify ✓ any four specific controls which you may be looking for.

Answer

The following controls may be considered by auditor in areas of credit appraisals and credit monitoring for ensuring that internal control over advances is effective and the system is capable of not only preventing and reducing the risk of NPAs at the sanction stage itself but also sending out timely signals to the bank subsequently.

✓ STRE

(i) Use of third-party data sources ✓ in the bank for comprehensive due diligence at the sanction stage itself to mitigate risk on account of misrepresentation and fraud.

(ii) Classification of accounts as special mentioned accounts (SMA) ✓ for early recognition of signs of incipient stress resulting in default in timely servicing of debt obligations. It can enable banks to initiate timely remedial actions to prevent potential slippages into NPAs.

(iii) Institution of comprehensive, automated Early Warning Systems (EWS) ✓ in banks with EWS triggers to detect stress and reduce slippage into NPAs.

(iv) Reporting of repayment behaviour ✓ of borrowers in their loan accounts to credit information companies and inclusion of this information in the credit appraisal and decision-making process for further sanctioning of loans to borrowers.

QNO 488.700 **Gross NPA and Net NPA- Case**
TITANIUM CNO -- Unique
Old Course – (N23R)

PQS & Associates are one of the joint auditors of KNO Bank for the year 2022-23. While auditing KNO Bank, they are analysing industry data relating to NPAs in select public sector banks as part of risk assessment procedures: -

Name of Bank	Gross NPAs (in ₹ crore)	Net NPAs (in ₹ crore)	Ratio of Net NPAs to Net advances
BBI Bank	55,000	13,000	1.72%
DAB Bank	45,000	10,000	2.34%
CNI Bank	55,000	18,000	2.65%
KNO Bank	28,000	6,500	3.97%
BRB Bank	35,000	8,800	2.27%

In the above context, what do you understand by "Gross NPAs" and "Net NPAs" as on reporting date in the context of financial statements of a Bank? As an auditor of KNO Bank, what inference would you draw by comparing the "Ratio of net NPAs to net advances" with other public sector banks?

Answer Gross NPAs represent opening balances of NPAs as increased by fresh NPAs during the year and reduced by upgradations, recoveries and write-offs during the year. Net NPAs are arrived at after deducting amounts on account of the total provision held against NPAs/ balance in the interest suspense account to park accrued interest on NPAs and certain other adjustments.

The Net NPAs to Net advances ratio is higher in the case of KNO Bank as compared to other public sector banks. It shows that there is a risk that the bank could not have made the required provisions in accordance with RBI guidelines. A higher net NPAs to Net advances ratio indicates the probability and risk of under-provisioning. Keeping in view the above, audit procedures have to be tailored towards the examination and verification of this crucial area.

QNO 489.100 **Stock Audit issues**
TITANIUM CNO -- Unique
New Course – (SM23)

CA. Seema is appointed as stock auditor of Bhawani Rice Mills Pvt. Ltd. availing credit facilities from R.K. Puram Branch, Near Tamil Educational Society, New Delhi.

The borrower is enjoying cash credit limit of ₹ 12 crore from branch against security of paid stocks and debtors up to 90 days against margin of 25%. She proceeds to visit premises of Bhawani Rice Mills Pvt. Ltd. located on outskirts of Delhi. She verifies books of accounts and stock records of the company and also test checks quantity of paddy and rice of 20000 quintals and 8000 bags lying in premises of the company. Drawing power of ₹ 12.05 crore is computed in stock audit report and report stands submitted to bank.

After about a week, regular internal inspector appointed by Inspection department of bank also happened to visit premises of the borrower and found that rice contained in about 5000 bags included in stocks having approx. value of ₹ 1.50 crore was fungus ridden. The company was holding this stock for last 15 months.

How do you view the above situation? Discuss

- Stock Audit
- Case Discuss
- Conclusion → Diligence
→ Effect
→ Loss

Answer **Professional Work Not Diligent:**

The above situation reflects that professional work of stock audit was not performed diligently by stock auditor. It is one of the important responsibilities of stock auditor to verify condition of stocks. The auditor's role is not limited to verify physical quantities only.

Responsibility to Verify Stocks:

In given case, she should have got opened rice bags on test check basis. In the process, she could have come to know about fungus ridden condition of rice. Value of such rice should have been excluded while arriving at value of stocks for purpose of computation of drawing power.

Failure in Diligent Performance:

It shows that she has failed to perform her work diligently and drawing power calculated in the report submitted to bank is not proper.

Part 2- NBFC

QNO 513.500 **Identification of Company as NBFC**
TITANIUM CNO—NBFC.020
Old Course –(SM21)

Satyam 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?

- Nature of Transactions
- 50-50 Rule
- Case Discussion
- Conclusion

- ➢ 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 per cent of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50 per cent 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.
- ➢ In the given case, though Satyam 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.

QNO 513.800 **Identification of Company as NBFC**
TITANIUM CNO—NBFC.020
Old Course –(SM21)

Krishna 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?

✓ - Nature of Transaction
✓ - 50-50 Rule
✓ - Discuss case
✓ - Conclusion
✓ - Obligation
· COR
· Net own Funds (2 crore)
✓ - Exception Report
✓ - CARO

- ➢ 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.
- ➢ The company which fulfils both these criteria shall qualify as an NBFC and hence is required to obtain Certificate of Registration (CoR) with Reserve Bank of India. In such a scenario, the statutory auditor has an obligation to submit exception report to the RBI on the following matters :
  - Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016, is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:
    - the provisions of Chapter III B of RBI Act (Act 2 of 1934); or
    - Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or
    - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - 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 unfavorable 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 RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.
  - The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

No need to Remember

QNO 513.900 **Identification of Company as NBFC -- Case Study** **Old Course –(N21E,N22R)**
TITANIUM CNO—NBFC.020

ABC 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 2021 following are some extracts from the financial statements:

(i) Paid-up share capital ₹ 40.53 Cr.
(ii) Non-Current Assets - Loans & Advances ₹ 55.90 Cr.
(iii) Current Assets - Loans and advances ₹ 344.47 Cr.
(iv) Total assets of the company ₹ 530 Cr.
(v) Intangible assets ₹ 3 Cr.
(vi) Profit for the Year ₹ 7.25 Cr.
(vii) Income from interest and dividends ₹ 52 Cr.
(viii) Gross income ₹ 102.57 Cr.

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

Answer 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
(i) Financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and
(ii) Income from financial assets constitute more than 50 per cent 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 RBI.

In the given case of ABC Ltd, its Financial Assets are = 55.90 + 344.47= 400.37 Cr

Total Assets (netted off by intangible assets) = 527 Cr

Income from financial assets = 52 Cr

Gross Income = 102.57 Cr

From the above, it is clear that ABC 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. Hence, ABC Ltd. fulfills both these criteria to qualify as an NBFC.

Thus ABC Ltd. can apply for registration under Section 45-IA of Reserve Bank of India (Amendment) Act, 1997 in prescribed form along with the necessary documents.

QNO 514.000 **Types of NBFC-** **Old Course – (N05E, M11R, M13R, PM17, SM21)**
TITANIUM CNO—NBFC.080

What are the different types of NBFCs registered with RBI?

Answer

Part I -- Relevant Standards & Laws

- Section 45-I(f) read with Section 45-I (c)of the RBI Act, 1934, as amended in 1997

Part II -- Requirements of Relevant Standards & Laws

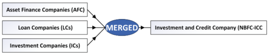
➢ ***NBFC Business***

A Non-Banking Financial Company (NBFC) is a company: -

- Registered under the Companies Act, 2013,
- It may receive deposits under any scheme or arrangement in one lump sum or in instalments.
- Its principal business is lending, investments in various types of shares /stocks /bonds /debentures / securities, leasing, hire-purchase, insurance business, chit business etc.

➢ ***Recent Amendment***

To provide NBFCs with greater operational flexibility


Asset Finance Companies (AFC)
Loan Companies (LCs)
Investment Companies (ICs)
MERGED
Investment and Credit Company (NBFC-ICC

➢ ***Classification***

Currently, NBFCs registered with RBI are being classified as:
IFFI inaugurated by **CM** sponsored by NBFCs

- Investment and Credit Company (ICC)
- Non-Operative Financial Holding Company - (NOFHC)
- Non-Banking Financial Company - Factors (NBFC-Factors)
- Infrastructure Finance Company (IFC) (Only 9 such companies in India, L&T Infrastructure Finance Company Ltd)&Infrastructure Debt Fund- Non- Banking Financial Company (IDF-NBFC) (Only 4 such companies in India, L&T Infra Debt Fund Ltd)
- Core Investment Company (CIC) &Systemically Important Core Investment Company (CIC-ND-SI)(For financing of a particular business group, TATA Capital Limited)
- Non-Banking Financial Company - Microfinance Institution (NBFC-MFI). (Bandhan Financial Services Limited)

QNO 514.300 **New Activity Based Classification** **Old Course – (M23R)**
TITANIUM CNO—NBFC.120

Categorisation of NBFCs carrying out specific activity.

Answer **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

i. NBFC-P2P, NBFC-AA, NOFHC and NBFCs without public funds and customer interface will always remain in the Base Layer of the regulatory structure.
ii. 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.
iii. 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.
iv. 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

514.400 missing

QNO 514.450 **Housing Finance Activities** **New Course – (SM23)**
TITANIUM CNO -- NBFC.120

Sugam 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?

middle layer

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

Answer The said company is not identified in upper layer by RBI. Under scale based regulations introduced by RBI, 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.

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 Reserve Bank of India as per the Reserve Bank of India Act, 1934.

QNO 514.500	**Registration and Regulation of NBFCs** **TITANIUM CNO—NBFC.040**	**Old Course – (SM21)** **New Course – (SM23)**

Shubham & 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.

- **An auditor should know following points regarding registration and regulation of NBFCs:**

①Who?

Under Section 45–IA of the RBI Act, 1934, no NBFC shall commence or carry on the business of a non-banking financial institution without

  - obtaining a certificate of registration issued by the RBI; and
  - having a net owned fund (NOF) of ` 25 lakhs (₹ Two crore since April 1999) not exceeding two hundred lakhs rupees, as the RBI may, by notification in the Official Gazette, specify.

(The RBI (Amendment) Act (1997) provided an entry point norm of ` 25 lakh as the minimum NOF which was revised upwards to ` 2 crore for new NBFCs seeking grant of certificate of registration (CoR) on or after 21 April 1999).

③ Process

A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to the RBI in prescribed form along with necessary documents for registration. The RBI issues CoR after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

② Who are not?

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock Broking Companies registered with SEBI, Insurance Company holding a valid CoR issued by IRDA, Nidhi Companies as notified under Section 406 of the Companies Act, 2013, Chit Companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

④ RBI Regulations

The RBI has issued directions to NBFCs on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.

Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders.

QNO 514.600	**Regulation of NBFCs – Case** **TITANIUM CNO -- NBFC.040**	**Old Course – (N23M)**

Super Non-Bank Limited, a "Systemically Important Non-Deposit Taking Non-Banking Financial Company", was operating appropriately till the start of COVID-19 Pandemic. Due to unforeseen conditions during the Pandemic and after that, the operating revenue of the NBFC started decreasing. Following were the position of Net Owned Funds of the company during the last 4 financial years:

Financial Year	Net Owned Funds
FY19-20	₹ 15 Crore ✓
FY20-21	₹ 6 Crore ✓
FY21-22	₹ 4 Crore ✓
FY22-23	₹ 1.5 Crore ✓

Super Non-Bank Limited appointed Mr Shyam as their statutory auditor for the FY 22-23. Mr Shyam identified that the Net Owned Funds of the company have been less than ₹ 2 Crore since June 2022

Kindly guide Mr Shyam with respect to his reporting requirements as per relevant NBFC provisions.

Answer

NOF Requirement

In exercise of the powers conferred under clause (b) of sub-section (1) of section 45–IA of the RBI Act and all the powers enabling it in that behalf, the Bank hereby specifies two hundred lakh rupees as the Net Owned Fund (NOF) required for a non-banking financial company to commence or carry on the business of non-banking financial institution, except wherever otherwise a specific requirement as to NOF is prescribed by the Bank.

It will be incumbent upon such NBFCs, the NOF of which currently falls below ₹ 200 lakh, to submit a statutory auditor's certificate certifying compliance with the prescribed levels by the end of the period as given above.

Auditor Responsibility Certificate

NBFCs failing to achieve the prescribed level within the stipulated period shall not be eligible to hold the CoR as NBFCs. Every non-banking financial company shall submit a certificate from its Statutory Auditor that it is engaged in the business of a non-banking financial institution requiring it to hold a Certificate of Registration under Section 45-IA of the RBI Act and is eligible to hold it. A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31 may be submitted to the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the non-banking financial company is registered, within one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year. The format of the Statutory Auditor's Certificate (SAC) to be submitted by NBFCs has been issued vide DNBS. PPD.02/66.15.001/2016-17 Master Direction- Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016.

Hence, in the current case, it is the responsibility of the Statutory Auditor, i.e., Mr. Shyam, to report where NOF has fallen below ₹ 200 Lakhs

QNO 515.000	**Compliance with Prudential Norms** **TITANIUM CNO—NBFC.200**	**Old Course – (N08E, N12E, N13R, M15R, M16R, PM17, M18M, N18E)**

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.

Answer

Compliance of Prudential Norms by NBFC:

- ***Verification by Auditor***

  The auditor has to verify the compliance of prudential norms relating to

  - At the time of giving advances / investment
    - Prohibition on loans and investments for failure to repay public deposits and
    - Prohibition of granting loans against its own shares;
    - Norms for concentration of credit etc.

  In case of Investment Company, 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 borrowers. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. Verify that the credit facilities extended, and investments made by the concerned NBFC are in accordance with the prescribed ceiling.

  - The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.

  - After the giving advances / investment
    - Income recognition (Advances);
      Auditor should ensure that unrealized income from non-performing assets

has not been taken to Statement of Profit and Loss.

- Income from investments;

  NBFC prudential norms directions require dividend income on shares of companies and units of mutual funds to be recognized on cash basis.
- Asset classification
  - The auditor should verify the classification of advances and loans as standard/ substandard/doubtful/loss and that proper provision has been made in accordance with the directions.
  - 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.
- Provision for bad and doubtful debts;
- Capital adequacy norm;
- Investment 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.

Author's Note

You may see difference in the answer given in PARAM with PM answer. Use our answer. We select best and recent answer whenever there are different answers.

QNO 515.300	**NBFC-General Audit Procedures** **TITANIUM CNO—NBFC.200**	**Old Course – (M22M,N22M)**

"OM & Co. is the statutory auditor of OTAPS NBFC Ltd. While planning the audit procedures to be done during the audit of entity, there was a difference of opinion between Mr. O and his partner Mr. M. Mr. O 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 interna l audit only. Briefly state what broad areas should mandatorily become part of the audit procedure of OM & Co. for conducting the audit of OTAPS NBFC Ltd.? Also comment whether contention of Mr. O is correct?"

Answer Following are broad areas that should be mandatorily part of the audit procedure for conducting the audit of NBFC:

② **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 Articles of Association of the company, so as to acquaint oneself with the type of business that the company is engaged into. The task of ascertaining the principal business activity of any NBFC is of paramount importance since the very classification of a company as a NBFC and its further classification would all depend upon its principal business activity. Based on the classification of a company, it will be required to comply with the provisions relating to limits on acceptance of public deposits as contained in the NBFC Public Deposit Directions.

③ **2.** Evaluation of Internal Control System - 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.

④ **3.** Registration with the RBI - Section 45-IA 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. 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. 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. 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.** The auditors must ascertain whether the company properly classified as per the requirements of various regulations. In case, 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.

⑤ **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, prohibition on granting of loans by a NBFC against its own shares, prohibition on loans and investments for failure to repay public deposits and norms for concentration of credit/investments.

In the given situation, OM & Co., is the statutory auditor of OTAPS NBFC Ltd. While planning the audit procedures to be done during the audit of entity, there was difference of opinion between O and his partner M regarding evaluation of internal control and verification of registration with RBI. As discussed above NBFCs are not entitled to commence business without first obtaining a registration certificate from the RBI. 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. Further, 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. Accordingly, contention of Mr. O regarding evaluation of internal control system and verification of registration with RBI should not be part of the audit procedure as it is part of internal audits only, is not correct.

QNO 515.600	**Audit of Deposit Mobilisation in NBFC** **UNIQUE**	**Old Course – (N20E, M22M, M23M)**

CA Nadar is conducting the statutory audit of RHL Ltd., a non-banking financial company. It has branches in various parts of India. The company with a focus on housing finance, has outstanding non convertible debentures worth 150 Crores. The company reportedly missed interest payments of INR 15 Crores on its debts because of inadequate liquidity. As a result, RHL 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 Nadar should look into in relation to the activity of mobilization of public deposits (particularly in relation to downgrading of credit facilities) by RHL Ltd?

Answer **CA Nadar has to ascertain whether the company has complied with the following aspects in relation to the activity of mobilization of public deposits:-**

Credit Ration & Deposit

- 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 inwriting.

Action

- 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; and
  - report the position within 15 working days, to the concerned Regional Office of the RBI where the NBFC is registered.
  - No matured public deposit shall be renewed without the express and voluntary consent of the depositor.

QNO 517.000	Investment Co (Audit)- TITANIUM CNO—NBFC.240	Old Course – (M08R, N15E, SM17, N18R, M19M)

You are appointed as the auditor of a NBFC which an Investment company is registered with RBI. What shall be the special points to be covered for the audit of NBFC in case of Investment companies?

Answer

INVESTMENT COMPANIES: -

(Buying & Selling)

- Verify the **Board Minutes for purchase and sale of investments**. 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.**
- Test **check bills/contract notes** received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

(Conditions while Purchasing)

- 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 borrowers. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. Verify that the credit facilities extended, and investments made by the concerned NBFC are in accordance with the prescribed ceiling.
- Obtain a list of subsidiary/group companies from the management and verify the **investments made in subsidiary/group companies** during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.
- Check whether **investments in unquoted debentures/bonds** have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.

(Income)

- 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 thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon.)

(Verification / Confirmation / Valuation)

- **Physically verify** all the shares and 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.
- 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.
- 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.
- An auditor will have to ascertain whether the **requirements of AS 13 "Accounting for Investments"** (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

(Securities Lending / Borrowing)

- 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 they earned.

QNO 518.000	Hire Purchase Co (Audit)- TITANIUM CNO—NBFC.280	Old Course – (M09E, N13R, SM17, PM17, M17R)

You are appointed as the auditor of a Hire-Purchase Finance Company. Enumerate the verification procedures in relation to audit of such Non-Banking Financial Company.

Answer

HIRE PURCHASE FINANCE COMPANY

(Internal Control System)

- 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.

(Acquisition of Asset)

- 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.

(Registration Certificate)

- If the hire purchase finance is against vehicles, check **whether the registration certificate contains an endorsement** in favour of the hire purchase company.

(Insurance)

- Verify that the assets given on hire purchase have been **adequately insured** against.

(Installation & Valuation Report)

- 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.

(Instalments)

- 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.

(Method of Accounting)

- 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.

(Verification)

- 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.

QNO 519.000	Equipment Leasing Co (Audit)- TITANIUM CNO—NBFC.300	Old Course – (M07E, M10E,N10R, N15R, M16M, PM17)

Write a short note on the special points that may be covered in the audit of equipment leasing finance company.

Answer

EQUIPMENT LEASING FINANCE COMPANY

(Internal Control System)

- Ascertain whether the NBFC has an adequate appraisal system for extending equipment leasing finance.

(Agreement)

- Verify the lease agreement entered into with the lessee in respect of the equipment given on lease.

(Insurance)

- Ascertain whether the NBFC has an adequate system for monitoring whether the assets have been adequately insured against and regular maintenance of the leased assets is being carried out by the lessee.

(Installation & Valuation Report)

- The auditor should verify whether there is an adequate system in place for ensuring installation of assets and their periodical physical verification. In respect of some major transactions, an auditor should 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.

(Accounting)

- An auditor should verify whether the AS issued by the Institute of Chartered Accountants of India in respect of "Accounting for Lease" has been compulsorily followed.

QNO 520.050	NBFC-Investment & Credit Company- TITANIUM CNO—NBFC.240	Old Course – (N19R, N19M, SM21) New Course – (SM23)

Shivam & Co LLP 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).

Answer

Investment Business Related Points

Buying & Selling

- Verify the **Board Minutes for purchase and sale of investments**. 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.**
- Test **check bills/contract notes** received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

Conditions while Purchasing

- Obtain a list of subsidiary/group companies from the management and verify the **investments made in subsidiary/group companies** during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.
- Check whether **investments in unquoted debentures/bonds** have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.

Dividend & Interest

- Verify that **dividend income wherever declared** by a company, has been **duly received by an NBFC** and **interest wherever due** [**except in case of NPAs**] **has been duly accounted for**.
- NBFC **Prudential Norms directions** require **dividend income on shares of companies and units of mutual funds to be recognised 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 Annual General Meeting** and its right to receive 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**.

Verification / Confirmation / Valuation

- **Physically verify** all the shares and 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.
- 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.
- 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.

- An auditor will have to ascertain whether the **requirements of AS 13 "Accounting for Investments"** (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

Securities Lending / Borrowing

- 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 they earned.
- 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 thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon.)

Loan Company Related Points

(Own Shares)

- Check whether the NBFC has not advanced any loans against the security of its **own share.**

(Internal Control System)

- An 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.

(Sanction & Conditions Attached)

- An 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.
- 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.

(Security & Agreement)

- An 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.

(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

(Confirmation)

- Obtain **balance confirmations** from the concerned parties. *(2 Special Lending)*

(Bill Discounting)

- As regards bill discounting, verify that **proper records/documents** have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.

Author's Note:-
In this answer the points are simply combination of QNO 517.000 and 520.000.

QNO 522.000	Report to BOD- TITANIUM CNO—NBFC.320	Old Course – (N07E, M16E, PM17, M17E, SM21)

List the matters to be included in the 'Auditor's report' in the case of Non-Banking Financial Companies (NBFCs).

OR

What are the specific matters to be included in auditor's report in an audit of Non -Banking Financial Company (NBFC) not accepting public deposits?

OR

Karma Pvt Ltd is a Non-Deposit Taking Non-Systemically Important NBFC registered with Reserve Bank 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.

Answer

- *Matters to be Included*

  Material to be included in the Auditor's report to the Board of Directors: The auditor's report on the accounts of a non-banking financial company shall include a statement on the following matters, namely.

All NBFCs

- In the case of all Non-Banking Financial Companies

  (COR)
  - Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the Bank is an offence under chapter V of the RBI Act, 1934. Therefore, if the company is engaged in the business of non-banking financial institution as defined in section 45-I (a) of the RBI Act and meeting the Principal Business Criteria (Financial asset/income pattern) as laid down vide the Bank's press release dated April 08, 1999, and directions issued by DNBR, auditor shall examine whether the company has obtained a Certificate of Registration (CoR) from the Bank.

  (Principal Business Test)
  - 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.

  (Net Owned Fund)
  - **3.** Whether the non-banking financial company is meeting the required net owned fund requirement as laid down in Master Direction Non-Banking Financial Company Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Master Direction Non-Banking Financial Company Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

    Systematically Important if Asset Size above 500 Crore
    Non-Systematically Important & Non-Deposit taking NBFC (ND-NBFC)
    Systematically Important & Not Deposit taking NBFC (SI-ND-NBFC)
    Systematically Important & Deposit taking NBFC (SI-D-NBFC)

  (Certificate from Statutory Auditor)
  - Note: Every non-banking financial company shall submit a **Certificate from its Statutory Auditor** that it is engaged in the business of non-banking financial institution requiring it to hold a Certificate of Registration under Section 45-A of the RBI Act and is eligible to hold it. A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31st may be submitted to the Regional Office of the Department of Non-Banking Supervision under whose jurisdiction the non-banking financial company is registered, **within one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year.** The format of Statutory Auditor's Certificate (SAC) to be submitted by NBFCs has been issued by RBI.

NBFCs holding Deposits

- In the case of a non-banking financial companies accepting/holding public deposits Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely-

  (Regularization of Deposits)
  - 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, 2016 are regularized in the manner provided in the said Directions;

  (Rating)

  - In respect of non-banking financial companies 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, 2016 is in force; and

  (MIGR)
  - Whether the non-banking financial company is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency as per the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

  (Limit as per Credit Rating Agency)
  - 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;

  (Deposits within the limit?)
  - **5.** Whether the public deposits accepted by the company together with other borrowings indicated below viz.
    - from public by issue of **unsecured non-convertible debentures/bonds;**
    - from its **shareholders (if it is a public limited company);** and
    - which are not excluded from the definition of 'public deposit' in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016, 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, 2016;

  (Computation of CAR)
  - Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial Company-Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;

  (Liquidity Norms)
  - 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 +6communicated to the office concerned of the Bank in terms of NBS 3; Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

  (Default of Interest)
  - 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;

  (Compliance with Prudential Norms)
  - 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 Bank in terms of the Master Direction Non-Banking Financial Company Systemically Important No deposit taking Company and Deposit taking Company (Reserve Bank) Directions,2016;

  (Return of Deposit)
  - Whether the company has furnished to the Bank within the stipulated period the return on deposits as specified in the NBS 1 to – Non- Banking Financial Company Returns (Reserve Bank) Directions, 2016;

  (Quarterly Report)
  - Whether the company has furnished to the Bank within the stipulated period the quarterly return on prudential norms as specified in the Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(Violation of Public Deposit Direction)

- Whether the company has violated any restriction on acceptance of public deposit as provided in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(New Branches)

- 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,2016.

NBFCs Not Accepting Deposits

- **(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: -

  (Board Resolution)

  - Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits;

  (Acceptance of Deposit)

  - Whether the company has accepted any public deposits during the relevant period/year;

  (Classification)

  - whether the non-banking financial company has been correctly classified as NBFC Micro Finance Institutions (MFI) as defined in the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

  (Systematically Important NBFC)

  - In respect of Systemically Important Non-deposit taking NBFCs as defined in Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016:
    - 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;
    - 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.

  (Prudential Norms)

  - 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 Company – No Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;

NBFC not required COR

- **(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 where a company has obtained a specific advice from the Bank that it is not required to hold CoR from the Bank, the auditor shall include a statement that the company is complying with the conditions stipulated as advised by the Bank.

  Reasons

  - Reasons to be stated for unfavourable or qualified statements Where, in the auditor's report, the statement regarding any of the items referred to in paragraph 3 above is unfavourable or qualified, the auditor's report shall also

state the reasons for such unfavourable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred to in paragraph 3 above, his report shall indicate such fact together with reasons therefor.

Exception Report

- **2.** Obligation of auditor to submit an exception report to the Bank
  - **(I)** Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:
    - the provisions of Chapter III B of RBI Act (Act 2 of 1934); or
    - Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or
    - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - 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 Nonbanking Supervision of the Bank under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

- The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions

QNO 523.000	**Exception Report** TITANIUM CNO—NBFC.320	**Old Course – (N16E, M20M, SM21, M21E, N21M,N22M)** **New Course – (SM23)**

What are the obligations of auditor to submit Exception Report to RBI in case of nonbanking financial companies?

OR

Kammo & Co LLP, 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 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. Briefly explain.

Answer **Exception Report**

Obligation of auditor to submit an exception report to the Bank.

- Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:
  - the provisions of Chapter III B of RBI Act (Act 2 of 1934); or
  - Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or
  - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - 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 Nonbanking Supervision of the Bank under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

- The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions

QNO 524.000	**Frauds-** **TITANIUM CNO—NBFC.220**	**Old Course – (M14E, M16M, N16R, N16M, PM17, N17R, N17M, N17E, N17M, M19R, N18M,N20R)**

Under what heads can the frauds committed by Non-Banking Financial Companies (NBFCs) be classified?

OR

Classification of frauds by NBFC.

Answer

- *Classification of Frauds by NBFC (RBI Circular July 2015)*

  In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of the Indian Penal Code:
  - Misappropriation and criminal **breach of trust.**
  - Negligence and cash **shortages.**
  - **Fraudulent encashment** through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
  - **Unauthorized credit facilities** extended for reward or for illegal gratification.
  - **Cheating and forgery.**
  - Irregularities in **foreign exchange** transactions.
  - **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 (b) and (f) 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:

  (a) cases of cash shortages more than Rs 10,000/- and

  (b) cases of cash shortages more than Rs 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.

QNO 525.000	**NBFC -Applicability & differences in the presentation requirements between Division II & Division III of Schedule III** **TITANIUM CNO—NBFC.380**	**Old Course – (N19E, M20R, SM21, M21M,M23E)** **New Course –(SM23)**

Mr. G has been appointed an auditor of LMP Ltd, T a NBFC company registered with RBI Mr. G is concerned about whether the format of financial statements prepared by LMP Ltd. is as per notification issued by the Ministry of Corporate Affaire (MCA) dated October 11, 2018 The notification prescribed the format in Envision III under Schedule Ill 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. G.

Answer

- *Applicability of Indian Accounting Standards (IND- AS) on NBFCS*
  - *Accounting periods beginning 1 April 2018:*

    Listed and unlisted NBFCs having a net worth of Rs 500 crore or more and holding, subsidiary, joint venture or associate companies of such NBFCs;

  - *Accounting periods beginning 1 April 2019:*
    - **All other listed NBFCs, unlisted NBFCs having a net worth of Rs 250 crore or more**

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but less than Rs 500 crore and holding, subsidiary, joint venture or associate companies of such NBFCs.
    - The **net worth** shall be calculated in accordance with the standalone financial statements of the NBFCs as on **31st March 2016** or the first audited financial statements for accounting period which ends after that date.
    - **Format for preparation of financial statements by NBFCs under Ind- AS –**

      The Ministry of Corporate Affairs (MCA) vide notification dated October 11, 2018 introduced **Division III under Schedule III of the Companies Act, 2013, wherein a format for preparation of financial statements by NBFCs complying with Ind-AS has been prescribed.**

- *Differences Between Division Ii (Ind- AS- Other Than NBFCS) And Division Iii (Ind- AS- NBFCS) of Schedule III*

  The presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent except for the following:
  - *Classification & Order in Balance Sheet*

    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.
  - *Material Items Disclosure*

    An NBFC is required to separately disclose by way of a note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1 per cent of the revenue from operations or Rs10 lakhs, whichever is higher.
  - *Separate Disclosures*
    - 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.
    - 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.
  - *Common Point*

    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 as part of the notes

QNO 525.100	**Material Item Disclosure** **TITANIUM CNO -- NBFC.380**	**New Course – (SM23)**

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, 2023 in accordance with Division III of Schedule III of Companies Act, 2013. Previous year figures are ignored.

Particulars	Note No.	Figures for year ended 31st March, 2023 (in ₹ Crores)
Revenue from Operations		
(i) Interest income	**15**	**9500**
(ii) Dividend income		**-**
(iii) Rental Income		**150**
(iv)(Fees and commission income	**16**	**100**
(v) Net gain on fair value changes	**17**	**150**
(vi)Net gain on derecognition of financial instruments under amortised category		
(I) Total revenue from operations		**9900**

(II) Other Income	**18**	**100**
(III) 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?

Answer 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.

The said expenditure of ₹ 99.50 crore does not exceed 1% of total income. Hence, it meets requirements of Division III of Schedule III of Companies Act, 2013.

QNO 525.500	NBFC CARO Reporting TITANIUM CNO -- Unique	New Course – (SM23)

Abhimanyu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. 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 2023. The company appointed Mr. Kabra as its statutory auditors for the year 2022-23. Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO 2020?

Answer As per Clause (xvi) of Paragraph 3 of CARO 2020, the auditor is required to report that "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."

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

Audit Procedures and Reporting:

(i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.

(ii) The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.

(iii) Whether the company has net owned funds as required for the registration as NBFC.

(iv) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.

(v) The auditor should report incorporating the following:-

   (1) Whether the registration is required under section 45-IA of the RBI Act, 1934.
   (2) If so, whether it has obtained the registration.
   (3) If the registration not obtained, reasons thereof.

In the instant case Abhimanyu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ₹ 1,50,00,000/-(one crore fifty lakhs) which is less in comparison to the prescribed limit i.e. 2 crore rupees and was also not having registration certificate from RBI (though applied for it on 30th March 2021). The auditor is required to report on the same as per Clause (xvi) of Paragraph 3 of CARO 2020.

QNO 525.520	CIC CARO Reporting TITANIUM CNO -- Unique	Old Course – (N22E)

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?

Answer **Core Investment Companies:** As per RBI Master Direction – Core Investment Companies (Reserve Bank) Directions, 2016, (Reference may be made to aforesaid Master Direction), these directions shall apply to every Core Investment Company (CIC), that is to say, a nonbanking 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:-

(i) 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;

(ii) 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;

Provided; that the exposure of such CICs towards InvITs shall be limited to their holdings as sponsors and shall not, at any point in time, exceed the minimum holding of units and tenor prescribed in this regard by SEBI (Infrastructure Investment Trusts) Regulations, 2014, as amended from time to time.

(iii) 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;

(iv) it does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the Reserve Bank of India Act, 1934 except

a. investment in

(i) bank deposits,
(ii) money market instruments, including money market mutual funds and liquid mutual funds
(iii) government securities, and
(iv) bonds or debentures issued by group companies,

b. granting of loans to group companies and

c. Issuing guarantees on behalf of group companies.

As per CARO 2020, the auditor is required to report that –

(i) 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; [Paragraph 3(xvi) (c)]

(ii) 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; [Paragraph 3(xvi) (d)]