Demystifying loans and advances – Responsibilities on auditors

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Loans and advances provided by a company are some of the most important and heavily regulated areas of today. Failure to comply with any can cause major headaches down the line and potentially lead to financial penalties, depending on what was addressed by law. Some of the regulations were always present ab initio and some have been evolved with time. One may find some regulation to be statutory fictions. Nevertheless, taking time to understand and manage regulatory compliance should be high on your checklist.

Someone who is or has been a part of the auditing process in India, whether as an audit practitioner or as an auditee responsible for providing various information to the auditor, must have read the regulatory provisions under Section 143 and 186 of the Companies Act, 2013; deemed non-banking financial companies (NBFCs); core investment companies (CIC); investment companies and reporting responsibilities under Companies (Auditor's Report) Order, 2020. One common factor driving these regulations is the loans and advances provided by the company.

For banking companies granting of loans and advances is a normal course of the business. For other companies making investments, granting loans and advances is also something not new. However, enormous regulations and the depth with which they deal have undoubtedly put these transactions as highly regulated areas. In this context, this article aims to provide a comprehensive view of the above-mentioned regulations.

Section 143 of the Companies Act, 2013

Most of the auditor's work in forming the opinion consists of obtaining and evaluating audit evidence. While there are a number of ways to obtain audit evidence, *Inquiry* is used extensively throughout the audit in addition to other audit procedures. Section 143 of the Companies Act, 2013 (CA, 2013), a predominant legal provision for Indian auditors, *"specifically"* requires an auditor to inquire into the following matters related to loans and advances:

a) *whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;*

b) whether loans and advances made by the company have been shown as deposits.

In case a company has provided secured loans to another person, the auditor's duty is to make sure that the security is properly made and not prejudicial to the company's interests. For example, where a company has granted secured loans to another company the auditor may, for the purpose of checking proper security, verify whether the charge has been created by the borrower. Such verification can be made easily at the company master data of the borrower available free of cost at the MCA website. Another example is that Section 186(7) of CA, 2013 requires a company to charge interest on loan higher than the prevailing yield of one, three, five or ten year Government Security closest to the tenor of the loan. In case the lender company has charged a lower interest, the auditor may conclude that the terms of the loans are prejudicial to the interest of the company. It is to be noted that the section nowhere restricts the companies to provide unsecured loans to any person but provisions contained in section 185 and 186 of CA, 2013 must be pursued in such cases.

Section 186 of the CA, 2013

If Section 143 is a predominant legal provision for the auditors, Section 186 can be considered as a predominant section for loans and investments made by the companies. The section covers issues such as how much loans and investments can be made, what interest needs to be charged, disclosures in the financial statements and exemptions available. Chart 1 depicts the specified limit for loans and investments:

As a general rule, a company cannot give any loan to any person, guarantee or provide security in connection with loan and acquire securities of any other body corporate exceeding 60% of its paid-up share capital, free reserves and securities premium, or 100% of its free reserves and securities premium, whichever is more. In case, the aggregate of the above along with further loans, investments, guarantees, and securities proposed to be made exceed the specified limits, special resolution is mandatorily required to be passed by the company.

It is to be noted that loans, securities, and guarantees provided to employees and transactions between a company and its wholly owned subsidiary or joint venture company are exempted from this provision and therefore not subject to specified limits supra. Similarly, investments made by an investment company are outside the scope of this section.

Investment Company

The CA, 2013 defines investment companies as ***"a company whose principal business is the acquisition of shares, debentures or other securities".*** Further, a legal fiction has been created wherein a company will be deemed to be principally engaged in the business of acquisition of shares, debentures or other securities, if its assets in the form of investment in shares, debentures or other securities constitute not less than fifty per cent of its total assets, ***"or"*** if its income derived from investment business constitutes not less than fifty per cent as a proportion of its gross income.

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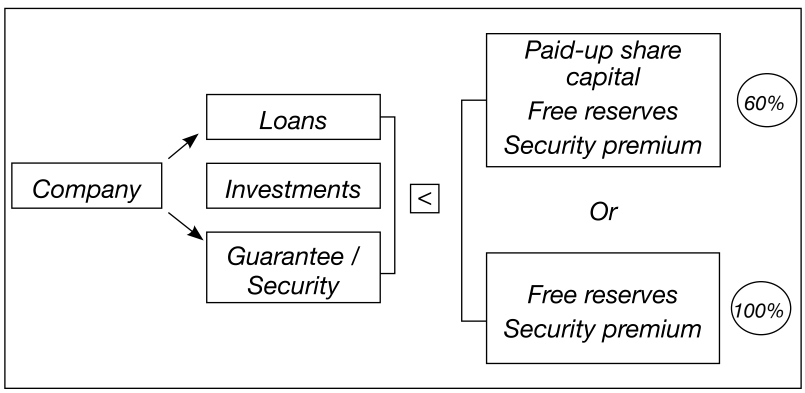
Investment companies are no different from other companies as there is no additional or specific regulations that deal with such companies except the fact that investments made by investment company are outside the scope of section 186 of CA, 2013 which allows them the liberty to invest freely without any ceiling.

Chart 1



Further, the company is also required to disclose the following in its financial statements:

Descriptions	As at March 31, 20XX	As at March 31, 20XX
Loans given *Purpose of utilisation:*		
Investments made		
Guarantee given *Purpose of utilisation:*		
Security provided *Purpose of utilisation:*		

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Deemed Non-banking Financial Company (NBFCs)

NBFCs are now deeply interconnected with the entities in the financial sectors and one of the most regulated form of entities in India. The sector itself has evolved considerably in terms of size, operations and technology. RBI defines NBFC as *"a company registered under the Companies Act, 1956 (or 2013) engaged in the business of loans and advances, acquisition of shares/stocks/ bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property."*

Further to avoid any ambiguity in the definition, another legal fiction has been created wherein assets and income of that company have to be evaluated. A company whose 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 will be deemed to be NBFC. This test is popularly known as the 50-50 test and is applied to determine whether a company is into financial business or not. This legal fiction is similar to what has been created in the definition of investment company with the only difference being the usage of the word 'or' and 'and' under both definition. To be classified as NBFC, a company needs to satisfy both the conditions of having financial assets and income from such financial assets whereas satisfaction of any one condition would make a company, an investment company. In simple words,

"All NBFCs are investment companies but all investment companies may not be NBFCs."

Companies will be required to be registered with the RBI as NBFC and have to maintain a net owned fund of minimum Rs. 2 crores. The RBI has not defined financial assets anywhere; however, such assets may include loans granted, investments in shares, debentures and other similar securities and income from financial assets which may, inter-alia, include dividend and interest income.

Companies, often, overlook the 50:50 test for the reasons best known to them. In case where a company is an NBFC by virtue of the above principle and has not registered itself with the RBI, as usual the auditors have been entrusted with certain responsibilities, that include:

- submitting an exception report to the RBI;
- submitting an additional report to the Board of the company; and
- comment the same in clause 3( ) of CARO, 2020 if applicable.

Core-investment companies (CICs)

India, in spite of broadening its economy, remains dependent on family group businesses, some public and many private. The desire for control by such businesses has led to the formation of investment companies by many family groups wherein investments in group companies are made through one or two companies whose principal business is to particularly invest in group companies only e.g. Bajaj Holdings and Investment Limited and TATA Investment Corporation Limited. Legal fiction created under NBFC have resulted in classifying these entities as NBFCs. While there is no harm in doing so, legal compliances for NBFCs were otiose for small entities. Therefore, a need was felt to classify such companies

Reporting requirements under para 3(iii)

Sr. No.	Clause	Coverage	Brief reporting requirement
1	3(iii)(a)(A)	All items except "I"	Aggregate amount during the year and balance outstanding on balance sheet date to subsidiaries, associates and joint ventures.
2	3(iii)(a)(B)	All items except "I"	Aggregate amount during the year and balance outstanding on balance sheet date to other than subsidiaries, associates and joint ventures.
3	3(iii)(b)	All items	Terms and conditions are not prejudicial in the interest of the company.
4	3(iii)(c)	Only "L" and "AL"	Schedule of repayment of principal and payment of interest.
5	3(iii)(d)	Only "L" and "AL"	If any amount is overdue, state amount overdue for more than ninety days, and steps taken to recover such amount.
6	3(iii)(e)	Only "L" and "AL"	If any amount fallen due, has been renewed / extended or fresh loan has been granted to settle overdue amount.
7	3(iii)(f)	Only "L" and "AL"	Loans and advances in the nature of loans repayable on demand or without any schedule of repayment.

as a separate class of NBFCs with fewer regulations as their exposure was mainly restricted to their respective groups and the fact that these companies would be taking limited risks by investing majorly in group companies. That is where CICs were evolved. CIC has been defined as a company carrying on business of acquisition of shares and securities and which satisfies the following condition:

(i) it holds at least 90% of its net assets in the form of investments in equity, preference shares, bonds, debentures, debt or loans in group companies; "and"

(ii) its investments in equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its net assets.

CICs with assets size of 100 crores or less irrespective of whether they are accessing public funds or CICs with assets size of more than 100 crores and not accessing public funds have been exempted from taking registration from the RBI. As this is the exemption granted under Section 45NC of the RBI Act, 1934, they are not required to approach the RBI at all.

Para 3(iii) of CARO, 2020

Para 3(iii) of CARO, 2020, which is in supersession, of the earlier order viz., CARO, 2016, is a chain of reporting requirements wherein in case of loans and advances, anything that could be suspicious or unintentionally escaped by a company, has been covered step-by-step and needs to be reported as such by the auditors.

Coverage of the para 3(iii)

The clause, typically, covers the following five items:

(i) Investments made (I);

(ii) Loans given (L);

(iii) Advances in the nature of loans given (AL);

(iv) Guarantee provided (G); and

(v) Security provided (S)

Clause 3(iii)(a)

As the first step, the clause requires to report on two aspects viz., aggregate amount of loan, advances in the nature of loan, guarantee and security provided by the company during the year and balance outstanding on the balance sheet date. This reporting is to be made separately for subsidiaries, associates and joint ventures, and for other remaining parties. Other parties may very well include any other person including employees of the company. The order does not specify what types of loans are covered, therefore, all loans whether secure or unsecured, short-term or long-term are to be considered for reporting purposes. So far as guarantees are concerned, only financial guarantees are to be considered for reporting purposes, e.g., guarantees

given by holding company for the loan taken by the subsidiary company.

Points for consideration:

- There is no requirement for party-wise disclosures in this clause and accordingly amounts in aggregate are to be reported.
- Loans which have been squared off during the year are also to be reported being an aggregate amount of loan provided by the company.
- Gross amount of loan that is the amount without subsequent settlements during the year are to be considered for reporting purposes.

Clause 3(iii)(b)

This is the only clause which in fact covers all the items provided supra. The clause requires an auditors' comments on whether terms and conditions of all items are prejudicial to the interest of the company. The auditor of the company is required to determine terms and conditions for grant of loans or advances in the nature of loans and terms and conditions for investments made, guarantee and securities provided. Terms and conditions for loans or advance in the nature of loans would generally include rate of interest, whether such loans are secured or not, repayment schedule and the nature of borrower whether it is an established entity or a start-up, etc. Terms and conditions for investments may include the company's ability and need to make investments, financial position of investee company and the valuation of such investments. Terms and conditions, for a guarantee, like the process of issuing guarantee, financial stability of the entity (on whose behalf guarantee has been given), entity's ability to borrow and the nature of security provided by such borrowing entity, may be considered by an auditor.

Points for consideration:

- Financial support to a loss making subsidiary company by a holding company cannot be termed as prejudicial to the interest of such holding company as the control actually lies with same person or group of persons.
- Section 186 of CA, 2013 requires companies to charge a minimum interest rate on loans. In case the loans provided are interest free or provided at a lower rate, it may be concluded by the auditor that the terms and conditions of such loans are not in compliance with Section 186 of CA, 2013 and accordingly prejudicial to the interest of the company.
- Free of cost financial guarantee or security, wherein no guarantee fee has been charged, provided by a company on behalf of other entity may also lead to terms and conditions being prejudicial in the interest of the company.

Clause 3(iii)(c)

In order to operate in accordance with the clause, a company needs to present both schedule of repayment of principal and payment of interest in loan agreement entered with the borrower. The auditor, in this clause, is to comment on two things viz., whether both the schedule of repayment of principal and payment of interest have been provided in the agreement and in case schedules have been provided whether the repayment of principal and receipt of interest are regular.

At times, an auditor may find tenor of the loan in loan agreement. Schedule is different from tenor of the loan. Schedule should clearly specify *what* amount needs to be repaid and *when* it needs to be repaid. Tenor, on the other hand, does not specify amount and periodicity of repayments. The same principle is applied where loans are repayable on demand. Further, 'regular' should be taken to mean that principal and interest should be received whenever they fall due.

Clause 3(iii)(d)

The clause is the continuation of the above clause. Clause 3(iii)(c) requires the repayment and payment of principal and interest respectively to be regular. Auditor may find instances of irregularities in such repayment and payment. The clause requires an auditor to identify cases of overdue amount and report the total amount overdue for more than ninety days. An amount is considered to be overdue when the payment has not been received on the due date.

The clause, further, requires an auditor to comment on the reasonable steps taken by the company in order to recover such amount including interest overdue. The auditor will have to consider facts and circumstances of each case. A reasonable step may not necessarily be a legal step. Depending on the amount overdue and circumstances of the case, the quantum of reminders sent to borrower, sending of an advocate's notice, obtaining enhanced security, increase in interest rate, may be concluded as 'reasonable steps' by an auditor.

Clause 3(iii)(e)

In case of overdue amount, a lender company may respond in two ways:

(a) take reasonable steps to recover overdue amounts (which has been covered under clause 3(iii)(d); or

(b) renew / extend / grant fresh loans to settle overdue amounts.

If the lender company opts for the second option, the auditor is required to report the aggregate amount of such dues renewed or extended or settled by fresh loans and percentage of the aggregate to total loans granted during the year. Loans or advances in the nature of loans which have fallen due at the end of the year and has been renewed or extended or settled by fresh loans post balance sheet date but before the date of audit report shall also be considered for reporting under this clause.

Clause 3(iii)(f)

Clause 3(iii)(c) discussed supra, requires a company to present the repayment schedule of principal and interest in order to act in accordance with CARO, 2020. In case the repayment schedules are not stipulated, an auditor is required to comment as such only and no further details are to be reported under the same clause.

However, in respect of such loans or advances in the nature of loans which are either repayable on demand or without specifying any terms or period of repayment, clause 3(iii)(f) requires an auditor to report:

(i) aggregate amount;

(ii) percentage to total loans and advances granted; and

(iii) aggregate amount of loans granted to Promoters, related parties as defined as per CA, 2013.

To summarise, the first loans granted during the year and balances out standing need to be reported. Secondly, in case the terms and conditions are unfavourable to the lending company, such facts are to be reported by an auditor. There is a requirement to have repayment schedules in loan agreements. In case there are no repayment schedules or even where loans are repayable on demand, such transactions are also required to be reported. Even if loan agreements do contain proper repayment schedules, regularity of repayments have to be verified by the auditors. If repayments are not regular and the amount is overdue for a period of more than 90 days, the lending company must take reasonable steps for recovery. If fresh loans or extension has been provided to settle overdue amount, reporting is required to be made. A comprehensive reading suggests that Para 3(iii) does not seem to miss anything at all so far as loans and advances are concerned.

Conclusion

In the end, in some cases ignorance may not serve as an excuse if confronted with non-compliance issues. Therefore, it is always best practice to know what one is a getting into before delving into familiar-unfamiliar territory. There are other provisions under different laws that regulate loans and advances which have not been mentioned here. NBFCs and registered CICs have to additionally comply with RBI regulations like prudential norms. Such a huge number of regulations can only mean how significant these transactions are for the regulators in India. From the auditor's point of view, they need to evaluate every aspect of loans and advances from occurrence to presentation & disclosure, and to reporting without overlooking anything that may cause non-compliance issue on their part.

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