EDITORIAL COMMENT

CAG Audit of Private Sector Companies

The service Tax Rules were recently amended to provide for a more effective mechanism to cover the service tax audit of the service providers in the private sector by the Comptroller and auditor general (CAG). The amendments were apparently carried out in order to overcome a recent High Court Judgment, which struck down the earlier rule providing for such a power. CAG audit is in addition to the audit, which the service tax authorities may carry out under the said rules.

As a matter of fact, CAG has traditionally been carrying out the audits of the government departments and PSUs. However, in the recent years the scope of CAG audit has been gradually widened to cover projects in public private partnership and the telecom and oil sectors. This has been affirmed by the apex court also thus putting a validity tag on the constitutionality of such audits by CAG.

One can understand the logic of allowing CAG to audit the projects where government has direct investment in some form or the other, but giving sweeping powers to CAG to cover any private sector company providing services on the logic that the government has a revenue stake in the form of service tax seems to stretch CAG's powers too far. On that basis, then all companies or firms in the private sector can be said to have some revenue interest or the other for the government and, therefore, should be subjected to CAG's audit.

Every revenue authority be it Income Tax, Service Tax, VAT, Customs or Excise has its own machinery for the enforcement of its provisions with adequate powers under the relevant laws for audit, scrutiny, search and survey etc. One fails to understand what additional public interest could be served by adding one more layer of scrutiny in the form of CAG audits in addition to the existing provisions.

Every audit, scrutiny and inspection adds to the cost of doing business in India and adversely affects the ease of doing business adversely. In any case, India does not hold an enviable position on the global index of ease of doing business and such moves would only send a negative signal to foreign investors.

Lets us recognize in the context of the global markets, that controls are good but over control is bad as it erodes the reputation of the country resulting in lower investments and causing a permanent damage to the public interest.

R.P. Sharma
Chief Editor

VIEWS

MICROFINANCE IN INDIA

INTRODUCTION:

Microfinance means banking service that is provided to the unemployed or low income groups or individuals who have no other means of gaining access to the financial services. The goal of microfinance is to give low income people to be self reliant by providing them means of saving money, borrowing money and insurance. The evolution of Indian Microfinance sector can be broadly classified into four phases:

a. **The cooperative movement 1900-1960:** During this phase the credit cooperatives were considered as a tool to provide subsidized credit to villages under the sponsorship of government.

b. **Banking 1960-1990:** In this phase, the failure of credit cooperatives led the government to focus on measures such as nationalization of banks, establishing Regional Rural Banks (RRBs), establishment of National Bank for Agricultural and Rural Development (NABARD), establishment of Small Industries Development Bank of India(SIDBI), including starting of government sponsored Integrated Rural Development Programme (IRDP). These steps had both positive and negative impact. While on one hand credit facilities reached out to a large population, but on the other hand there was a large scale misuse of credit which led to creating of a negative image about the credibility of the micro borrowers among banks, which ultimately led to hindering access to banking services for low income people.

c. **SHG (Self Help Group) 1990-2000:** The failure of subsidized banking led to initiation of the Self Help Group (SHG) Bank Linkage Programme (SBLP), aiming to link informal women's groups to formal banks. The program helped increase banking system outreach to otherwise unreached people and initiate a change in the bank's outlook towards low-income families from 'beneficiaries' to 'customers'. The model generated a lot of interest among newly emerging Microfinance Institutions (MFIs), largely of non-profit origin, to collaborate with NABARD under this program.

d. **Commercialization of Microfinance:** Post reforms, rural markets emerged as the new growth drivers for MFIs and banks, the latter taking interest in the sector not only as part of their corporate social responsibility but also as a new business line. On the demand side, NGO-MFIs increasingly began transforming themselves into more regulated legal entities such as Non Banking Finance Companies (NBFCs) to attract commercial investment.

FEATURES OF MICROFINANCE

A. Lend to the Poor.
B. No security
C. Preference of saving over borrowing
D. Small short term loans
E. Cost covering interest rates
F. Group Appraisal and guarantee
G. Prefer women customers over men.

LENDING PROCESS IN MICROFINANCE:

a. **Survey of the region**: Based upon the geo economic information about the region and towns or villages, MFI approaches favorable villages.
b. **Village Appraisal**: Then MFI approaches the village and tries to gather the information like the population of that village, their religion, caste, type of trade, their skills, financial states and their needs.
c. **Selection of Village**: MFI conducts a survey to evaluate potentiality of the village.
d. **Group Formation**: After selection of village, interested persons form a self selected group of four to six persons who as guarantors of each other.
e. **Training:** Training programme are framed to educate the client about the process microfinance loans and creating culture of credit discipline.
f. **Scrutiny of the borrowers:** Current financial status of the customers is recognized to adjudge their repaying capacities.
g. **Financial Transaction:** Meetings are conducted by the field assistants to conduct financial transactions.
h. **Insurance:** Life and health insurances are given to the clients to cover health, accidental and life risks.

KEY CHALLENGES

a. **High Transaction Cost**: An average microfinance loan is small, hence the transaction cost for a microfinance loan is higher. If higher amounts are lent to the customers then it involves evaluation of that customer, which again increases the cost. Intense monitoring and repeated interactions also increases cost.
b. **Credit Risk**: Some of the credit risks are: irregular flow of income, High dependence on monsoon, uncertain market conditions, lack of skilled labor and lack of tangible sources to ascertain income of the customer.
c. **Other Risks**
    1. Rural people do not have credit history background
    2. Rural economic activities have low profitability and are prone to high risk.
    3. It is very difficult to assess whether money given will be used for purpose stated to lender.

d. **Collection Risk**: All the above factors lead to a very heavy collection risk leading to write-offs which often exceed the high I.R.R otherwise expected out of these loans. The amount of loans are so small that they do not justify the recourse to legal machinery which is too costly and time consuming in a country like India to be resorted in case of small loan segments.

e. **Political Risk**: The mass funding of this segment is prone to political risk as has been the experience in some of the states like Andhra Pradesh.

REGULATORY FRAMEWORK:

Reserve Bank of India has issued a master circular on 'Non Banking Financial Company-Micro Finance Institutions (NBFC-MFIs) – Directions containing the regulatory framework of NBFC-MFIs.

NBFC-MFI is a non-deposit taking NBFC (other than a company licensed under Section 25 of the Indian Companies Act, 1956) having which satisfy the following criteria:

a. Minimum Net Owned funds of Rs.5 Crore (For North Eastern Region minimum NOF of Rs. 2 Crores.

b. Not less than 85% of its net assets in the nature of qualifying assets. Qualifying assets means a loan which satisfies following criteria:

i. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. 60,000 or urban and semi-urban household income not exceeding Rs. 1,20,000;

ii. loan amount does not exceed Rs. 35,000 in the first cycle and Rs. 50,000 in subsequent cycles;

iii. total indebtedness of the borrower does not exceed Rs. 50,000;

iv. tenure of the loan not to be less than 24 months for loan amount in excess of Rs. 15,000 with prepayment without penalty;

v. loan to be extended without collateral;

vi. aggregate amount of loans, given for income generation, is not less than 70 per cent of the total loans given by the MFIs;

vii. loan is repayable on weekly, fortnightly or monthly installments at the choice of the borrower

viii. the income an NBFC-MFI derives from remaining 15% of the assets shall be in accordance with the regulations specified in that behalf.

ix. All new NBFC-MFI shall maintain a capital adequacy ratio which shall not be less than 15% of its aggregate risk weighted assets.

x. Total of Tier II capital shall not exceed 100% of Tier I Capital.

xi. The aggregate loan provision to be maintained by NBFC-MFI at any point of time shall not be less than the higher of

a. 1% of the outstanding loan portfolio or
b. 50% of the aggregate loan installments which are overdue for more than 90 days and less than 180 days and 100% of the aggregate loan installments which are overdue for 180 days or more.'

xii. The margin cap may not exceed 10% for large MFI and 12% for others.

xiii. The interest rates charged by NBFC-MFI to its borrower will be lower of the following:

a. The cost of funds plus margin as indicated in para xii above; or
b. The average base rate of the five large commercial banks by assets multiplied by 2.75.

xiv. NBFC-MFI will ensure that the average interest rate on loans during a financial year does not exceed the average borrowing cost plus margin, within the prescribed cap.

xv. Processing charges shall not be more than 1% of gross loan amount.

xvi. NBFC-MFI shall recover only the actual cost of insurance for group, or livestock, life, health for borrower and spouse.

xvii. There should be standard form of loan agreement.

xviii. There should be no penalty charged on delay payment.

xix. NBFC-MFI shall ensure that a Code of Conduct and systems are in place for recruitment, training and supervision of field staff.

xx. Recovery should normally be made at central designated places.

xxi. Master circular issued for NBFCs on Corporate Governance shall be applicable to NBFC-MFI.

xxii. NBFC-MFI are required to submit a Statutory Auditor Certificate at end of March 31 every year, which indicates that company fulfills all conditions stipulated to be classified as an NBFC-MFI.

CASE LAWS

1. **Shah Rukh Khan Vs. Assistant Commissioner of Wealth Tax, Central Circle-29, Mumbai 2014 IN THE ITAT MUMBAI BENCH 'H'**

   'Shahrukh Khan' gave interest-free loan to his wife, Gauri Khan, who in turn, purchased a residential house and jewellery from said loan amount. The department clubbed the value of loan amount in the net wealth of 'Shahrukh Khan'. Extending cash loan, to wife does not come within the definition of asset as provided under Section 2(ea) of the wealth tax Act, thus, it could not be said that there was a transfer of asset; the impugned loan amount was not includible in net wealth of assessee

2. **Naresh Trehan Vs. Rakesh Kumar Gupta 2014 Delhi HC**

   It was held by High Court of Delhi that Income Tax Returns and information's which are provided to income tax authorities by individuals and unincorporated entities are confidential in nature and are exempt for disclosure under RTI Act.

3. **CIT vs The Andhra Petrochemicals Ltd. 2014 (AP)**

   The High Court of Andhra Pradesh held that Lump sum amount paid for transfer of know how without mentioning the period cannot be considered as royalty. Royalty is clearly opposed to an outright transfer.

4. **Madhubala Sharma Vs Anand Pratyabhoot Vitt Nigam Ltd (Delhi)**

   It was held by High Court of Delhi that where any consideration has been paid to any creditor after proper examination of claims and demand and if later on it is found that excess consideration has been paid to creditor then official liquidator has no power to call the excess consideration paid.

5. **Mannalal Chamaria Vs State of West Bangal (SC)**

   It was held by the Honorable Supreme Court of India that complaint under Section 138 of Negotiable Instrument Act cannot be sustained against director who are not in-charge and responsible for conduct of business at the time of execution of instrument.

6. **CC & CE Vs Grey Gold Cements Ltd (AP)**

   It was held by the larger Beanch of Tribunal that Cenvat on transportation to the place of consumer even after place of removal of goods is allowed, service tax is a consumption tax if Cenvat not allowed it will be tax on business and

denial of Cenvat on output transport would lead to counter the fundamental principal of service tax.

7. Pratham Motors (P.) Ltd. Vs Addl. CCT (Karnataka)

It was held by the High Court of Karnataka that where discount is given to customer through credit note the same is allowed as deduction in VAT even when it is not shown separately in the sales bill.

8. Garg Industries Vs Union of India (Allahabad)

It was held by the High Court that High Court has power to extend the stay of demand more than 365 days, the High Court held that Section 35C(2A) limit can not be restricted to a case where assessee is reasonable and delay is due to administrative issue, the time period of 365 days may be extended by the High Court through writ petition.

9. Visaka Industries Ltd Vs CESTAT (Chennai)

It was held by the High Court that pre-deposit of duty before filling of case can be waived where assessee has prima facie strong case and department has no leg to stand. It was held that Undue hardship is not necessary for waiver of pre-deposit of tax but facts of the case also need to be considered for waiving of pre-deposit of tax.

10. Mrs. Kanchan Agarwal Vs SEBI (Delhi)

It was held by the High Court that where any director ceased to be a director on the date of offence he cannot be liable for offence. It was held that the as director has ceased as director before initiating proceeding and before commencement of offence so she is not liable merely because she was a director in defaulting company.

NOTIFICATION

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RESERVE BANK OF INDIA
www.rbi.org.in

RBI/2014-2015/344 December 09, 2014
A.P. (DIR Series) Circular No.48

To

All Category-I Authorised Dealer Banks

Madam / Sir,

Overseas Investments by Alternative Investment Funds (AIF)

Attention of the Authorised Dealer (AD - Category I) banks is invited to Regulation 26 of Notification No. FEMA.120/RB-2004 dated July 7, 2004 [Foreign Exchange Management (Transfer or Issue of any Foreign Security) (Amendment) Regulations, 2004] (the Notification), as amended from time to time and the provisions under A.P.(DIR Series) Circulars No. 49 and 50 dated April 30, 2007 and May 04, 2007 respectively.

2. On a review, it has been decided to permit an Indian Alternative Investment Fund (AIF), registered with Securities and Exchange Board of India (SEBI), to invest overseas in terms of the provisions issued under the A.P. (DIR Series) Circulars No. 49 and 50 dated April 30, 2007 and May 04, 2007 respectively.

3. Necessary amendments to the Notification *ibid* has been issued vide Notification No. FEMA.326/RB-2014 dated November 12, 2014 (copy enclosed) and effective from the date of publication in the Gazette i.e. November 21, 2014.

4. AD - Category I banks may bring the contents of this circular to the notice of their constituents and customers concerned.

5. The directions contained in this circular have been issued under Sections 10(4) and 11(1) of the Foreign Exchange Management Act (FEMA), 1999 (42 of 1999) and are without prejudice to permissions/approvals, if any, required under any other law.

Yours faithfully,

(C D Srinivasan)
Chief General Manager

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RBI/2014-15/340

A.P. (DIR Series) Circular No. 46 **December 8, 2014**

To

All Category – I Authorised Dealer banks

Madam/Sir,

Foreign Direct Investment (FDI) in India – Review of FDI policy –Sector Specific conditions- Defence

Attention of Authorised Dealer Category – I (AD Category-I) banks is invited to Regulation 14 and Annex B of Schedule 1 to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 notified vide Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time to time. In terms of Schedule 1 to the Notification ibid, Foreign Direct Investment (FDI) up to 26 per cent is permitted under Government route in Defence industry subject to license under the Industries (Development & Regulation) Act, 1951. Proposals for FDI above 26 per cent would be subject to approval of Cabinet Committee on Security on case to case basis, wherever it is likely to result in access to modern and 'state-of-art' technology in the country.

2. The extant FDI policy for defence sector has since been reviewed. Department of Industrial Policy and Promotion (DIPP) has now provided a list of defence items as finalised by Department of Defence Production, Ministry of Defence and has clarified that items not in the list would not require industrial license for defence purposes. Dual use items, having military as well as civilian applications, other than those specially mentioned in the list, would also not require Industrial License from Defence angle. Department of Defence Production, Ministry of Defence, has finalised the 'Security Manual for Licensed Defence Industry'.

3. Further, on a review, effective from August 26, 2014, foreign investment i.e. FDI, FIIs, RFPIs, NRIs, FVCIs and QFIs upto 49% under government route shall be permitted in defence sector subject to the conditions specified in the Press Note 7 (2014 Series) dated August 26, 2014. Portfolio investment (RFPI/FII/NRI/QFI) and FVCI investment will not

exceed 24% of the total equity of the investee company. Portfolio investment will be under automatic route.

4. The listed investee company engaged in defence sector, in accordance with the guidance provided by the Press Note 7 (2014 Series) , shall immediately allocate limits for portfolio investment for RFPI (including QFI and FII), NRI (not exceeding 10%) and FVCI within the default portfolio investment limit of 24% being permitted now and approach Reserve Bank, Central Office, Foreign Investment Division, Mumbai so that allocated limits can be monitored by the Reserve Bank.

5. A copy each of Press Note No.3 , No.6, No. 7 (2014 Series) dated June 26, 2014, July 8, 2014 and August 26, 2014 respectively issued in this regard by DIPP, Ministry of Commerce & Industry, Government of India are enclosed.

6. Reserve Bank has since amended the Principal Regulations through the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Thirteenth Amendment) Regulations, 2014 notified vide Notification No. FEMA. 319/2014-RB dated September 5, 2014, c.f. G.S.R. No. 799(E) dated November 13, 2014.

7. Authorised Dealer banks may bring the contents of this circular to the notice of their constituents and customers concerned.

8. The directions contained in this circular have been issued under sections 10(4) and 11(1) of the Foreign Exchange Management Act, 1999 (42 of 1999) and are without prejudice to permissions / approvals, if any, required under any other law.

Yours faithfully,

(B.P. Kanungo)
Principal Chief General Manager

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RBI/2014-15/341

A.P. (DIR Series) Circular No.47 **December 8, 2014**

To

All Category – I Authorised Dealer banks

Madam/Sir,

Foreign Direct Investment (FDI) in India – Review of FDI policy – Sector Specific conditions- Railway Infrastructure

Attention of Authorised Dealer Category – I (AD Category-I) banks is invited to Annex A and Annex B of Schedule 1 to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 notified vide Notification No. FEMA 20/2000-RB dated May 3, 2000, as amended from time to time. In terms of Annex A of Schedule 1 to the Notification ibid, Foreign Direct Investment (FDI) is prohibited in activities / sectors not open to private sector investment e.g. Atomic Energy and Railway Transport (other than Mass Rapid Transport Systems).

2. The extant Foreign Direct Investment (FDI) policy for railways sector has since been reviewed. Department of Industrial Policy and Promotion (DIPP) has now permitted 100% FDI in railway Infrastructure sector under automatic route subject to conditions. Accordingly, it has been decided to permit FDI in the following activities of the Railway Transport sector:
"Construction, operation and maintenance of the following: (i) Suburban corridor projects through PPP, (ii) High speed train projects, (iii) Dedicated freight lines, (iv) Rolling stock including train sets, and locomotives/coaches manufacturing and maintenance facilities, (v) Railway Electrification, (vi) Signaling systems, (vii) Freight
terminals, (viii) Passenger terminals, (ix) Infrastructure in industrial park pertaining to railway line/sidings including electrified railway lines and connectivities to main railway line and (x) Mass Rapid Transport Systems. Further, FDI beyond 49 of the equity of the investee company in sensitive areas from security point of view will be brought before the Cabinet Committee on Security (CCS) for consideration on a case to case basis."

3. A copy of Press Note No. 8 (2014 Series) dated August 27, 2014 issued in this regard by DIPP, Ministry of Commerce & Industry, Government of India is enclosed.

4. Reserve Bank has since amended the Principal Regulations through the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Fourteenth Amendment) Regulations, 2014 notified vide Notification No. FEMA.320/2014-RB dated September 5, 2014, c.f. G.S.R. No. 800(E) dated November 13, 2014.

5. Authorised Dealer banks may bring the contents of this circular to the notice of their constituents and customers concerned.

6. The directions contained in this circular have been issued under sections 10(4) and 11(1) of the Foreign Exchange Management Act, 1999 (42 of 1999) and are without prejudice to permissions / approvals, if any, required under any other law.

Yours faithfully,

(B.P. Kanungo)
Principal Chief General Manager