FEMA FROM AUDITOR's PERSPECTIVE

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1. INTRODUCTION

There are various Regulatory Laws applicable to different entities in India like Companies Act 2013, Limited Liability Partnership Act 2008,, Competition Act 2002, Securities and Exchange Board of India Act 1992, law relating to pollution control etc. and each such law has its regime and applications..

Foreign Exchange Management Act (FEMA) is one such law which regulates foreign exchange (forex) transactions. With most countries having opened up its economy for foreign investment as well as for trade and services, the volume of forex / cross border transactions have increased multifold. Further, since last two decades, considerable liberalization has taken place in FEMA permitting majority of cross border transactions, however, this very general permission at times leads to non compliance and therefore leading to penal implications. In view of this, it can have direct implications on the financials of the company including presentation. Hence, it becomes imperative even from Audit perspective to have fair idea about some of the implications that may arise under FEMA.

2. CASTING OF RESPONSIBILITY ON STATUTORY AUDITORS:

The only place under FEMA where RBI has specifically put an onus / casted responsibility on Statutory Auditor of Indian Company is to ensure whether compliances have been done as per prescribed FEMA guidelines or not in relation to Downstream Investment.

As per Rule 23 of Non Debt Instrument Rules, 2019 ("NDI Rules"), Downstream Investment means investment by an Indian entity which has total foreign investment in it or an Investment Vehicle in capital instruments or capital of another Indian entity. So if an Indian entity which has received foreign investment and if such Indian entity has made downstream investment in another Indian Company then the auditor of Indian Company making downstream investment has to issue certificate on annual basis with respect to compliance of downstream investment guidelines. Further in case of qualified report of Auditor the same shall be immediately brought to the notice of regional office of Reserve Bank of India ("RBI") in whose jurisdiction the registered office of company is located.

In entire FEMA this is the only regulation where specific responsibility has been case on Statutory Auditor of Indian Company which has made Downstream Investment to see whether all guidelines for downstream investment are fulfilled every year and report to that effect has also to be issued every year.

3. UNDERSTANDING FINANCIAL STATEMENTS FROM FEMA POINT OF VIEW:

During the course of audit for any transaction wherein foreign exchange is involved and having FEMA implications an auditor needs to check whether the transaction is in compliance of FEMA provisions or not and whether all compliances relating to transaction as prescribed under FEMA have been properly done. Let us understand some of transactions which have FEMA impact and are important to be reviewed while carrying out an audit of a particular entity. We can divide transactions into two type viz. one involving inward remittance from outside India and others involving outward remittance from India to overseas countries.

3.1 TRANSACTIONS OF INWARD REMITTANCE:

3.1.1 SHARE CAPITAL:

The transaction of receipt of funds from non-resident for investment in Share Capital of an Indian entity is governed by Non Debt Instruments Rules, 2019 ("NDI Rules"). An auditor while reviewing the transaction has to take care that any transaction of receipt of foreign investment is in compliance to NDI Rules. Key Points to be taken into consideration while auditing transaction of Share Capital are as under:

a. **Check whether transaction is in nature of Foreign Direct Investment ("FDI") or Foreign Portfolio Investment ("FPI")** - Investment made by a person resident outside India ("PROI") in equity instruments of an Indian Company or capital of a LLP is termed as Foreign Investment. Further there is distinction between Foreign Direct Investment ("FDI") and Foreign Portfolio Investment ("FPI").

Investment in Equity Instruments of unlisted Indian Company or 10% or more paid up capital of Listed Indian Company is treated as FDI whereas investment in less than 10% of paid up capital of Listed Indian Company is treated as FPI.

With regards to characterization of investment whether it is FDI or FPI it is necessary to check the limits qua investor and not combined for all investors.

b. **Check whether provisions for FDI are complied with or not -** FDI is freely permitted in almost all sectors. FDI can be made either under automatic route or approval route. Entity receiving FDI must ensure that while receiving FDI all applicable entry route conditions, sectoral caps, pricing guidelines and reporting requirements are followed. However, FDI is prohibited in sectors / activities like lottery business, gambling, betting, chit funds, Nidhi Company, Transferable Development Rights, Real Estate Business or Construction of Farm Houses (Development of townships, construction of commercial / residential premises, roads or bridges is not considered as Real Estate), manufacturing of Cigars and tobacco related items, atomic energy, railway operations etc.

c. **FDI must be in only Equity Instruments –** FDI can be made only in following Equity Instruments:

i. Equity Shares

ii. Fully, compulsorily and mandatorily convertible debentures.

iii. Fully, compulsorily and mandatorily convertible preference shares.

iv. Share Warrants.

d. **Reporting has been done –** For all FDI Transactions whether it is fresh investment or transfer of existing investment reporting forms as prescribed viz. FCGPR Form - for reporting of allotment of equity instruments, FCTRS Form – for reporting of transfer of equity instruments need to be filed. All entities having FDI are also required to file Annual FLA return every year. In case of non filing or delayed filing of reporting forms results in contravention.

e. **No assured exit price -** In case of FDI by PROI an assured exit price cannot be agreed upon. Equity instruments can contain optionality clause subject to minimum lock in period of 1 year or as prescribed by specific sector whichever is higher but without any option or right to exit at an assured price. Classic example for this is matter of Tata Teleservices and NTT Docomo, Japan, where matter is under International arbitration.

f. **Deferred Consideration -** In case of transfer of shares of Indian Company amount not exceeding 25% can be deferred up to 18 months from date of transfer agreement, that if resident shareholder has sold the shares, he has to receive upfront consideration of at least 75% and balance can be deferred up to a period of 18 months.

g. **Date of transfer cannot be prior to Date of receipt of consideration in case of transfer of shares -** In case of transfer of shares of Indian Company, date of transfer of shares cannot be prior to date of receipt of consideration. Any delay in receipt of consideration even by 1 day is treated as contravention under FEMA.

h. **Reporting of shares allotted under Demerger -** If PROI who is shareholder of an existing Indian Company is allotted shares of resulting demerged entity then Form FCGPR is to be filed for reporting of such allotment even if consideration or remittance for same is not made.

i. **FDI through receipt of funds in EEFC account -** Indian Company cannot credit the funds received through inward remittance for purpose of FDI to its EEFC account.

j. **Issue of Shares against pre-incorporation expenses, import of capital goods and any funds payable to foreign parent –** Indian Company having FDI can issue shares against pre-incorporation expenses incurred by overseas parent on behalf of Indian Company. An auditor has to ensure that payment of expenses has been made by overseas parent directly to vendors on behalf of Indian Company and copy of FIRC to that effect is obtained. Statutory Auditor has to issue certificate to this effect for submitting to AD Bank for converting such pre-incorporation expenses to equity instruments.

   Equity Instruments can also be issued against outstanding import of capital goods or any funds payable. In case of any such transaction an auditor must ensure that all requisite documentation and reporting has been done by Indian Company and such transactions have been brought on record of RBI.

3.1.2 EXTERNAL COMMERCIAL BORROWINGS (“ECB'):

ECB is governed by FEMA Notification No. 3R/2018-RB Foreign Exchange Management (Borrowing and Lending) Regulations 2019 (“ECB Regulations”). ECB means borrowings by an eligible resident entity from outside Indian in accordance with framework decided by RBI in consultation with Government of India. ECB can be raised either under automatic route or approval route. ECB has to be comply with parameters like Eligible Borrowers, Recognized Lenders, Minimum Average Maturity Period, All-in-cost ceiling, End Use Restrictions etc. The parameters apply in totality and not on stand-alone basis.

Following are reporting requirements for ECB:

a. **Obtaining Loan Registration Number ("LRN"):** Form ECB has to be filed for obtaining LRN for ECB. Any draw down of ECB must happen only after receipt of LRN from RBI. Chartered Accountant (be it auditor) has to ensure that proper disclosure of terms and conditions of ECB has been done in Form ECB.

b. **Changes in Terms and Conditions of ECB:** Changes in parameter of ECB should be reported to RBI within 7 days of such change.

c. **Prepayment requires prior RBI approval –** All ECBs must strictly comply with minimum average maturity period for which ECBs have been raised. Prepayment of ECB is not allowed and requires prior RBI approval.

d. **Monthly Reporting:** Actual transactions are to be reported in Form ECB2 return to RBI through AD bank on monthly basis within 7 working days from close of month to which it relates. Monthly ECB 2 Return is certified by Chartered Accountant. So if any auditors are certifying monthly ECB2 return they should ensure that all terms and conditions of ECB have been complied with because ECB2 return involves reporting of utilization of funds, reporting of drawdown and actual transactions relating to ECB for any particular month.

3.1.3 EXPORT OF GOODS AND SERVICES:

Export of Goods and Services is a Current Account Transaction and governed by provisions of FEMA Notification No. 23R/2015-RB Foreign Exchange Management (Export of Goods and Services) Regulations, 2015 ("Export Regulations"). Being a Current Account Transactions there is no restriction on same however procedures as prescribed in Export Regulation need to be followed. An auditor has to check following points while reviewing export transactions:

a. **Declaration** - It is duty of exporter of goods or software in physical form or through any other form is required to furnish declaration for same supported by evidence containing true and correct particulars of export like full value of goods or software exported. In case of export of services same can be undertaken without furnishing any declaration.

b. **Realization and repatriation** - Exporter is under obligation to realize and repatriate full value of proceeds of export of goods/software/services within 9 months from date of export. This time limit is 15 months in case goods are exported to a warehouse established outside India. In case, export dues are not received within specified period, it is obligation of exporter to seek extension.

c. **Manner of receipts** – Payment of exported goods shall be received through AD Banks only and not through anyone else for e.g. payment cannot be received from trading houses.

d. **Reconciliation of open export transactions with Export Data Processing and Monitoring System (EDPMS) report of RBI** – While auditing export transactions an auditor must obtain list of overdue outstanding export transactions. It is duty of auditor to ensure that client has obtained extensions for all such overdue export transactions. With regards to advance against exports which are more than 1 year old against which goods are not exported no refund of such advance can be done without obtaining prior RBI approval.

Further, an auditor must insist client to get list of all open export transactions from EDPMS system of RBI and reconcile such open transactions with client records to ensure that there is no mismatch in reporting as per books of accounts and as per EDPMS.

e. **Export proceeds credited to special accounts** - Export proceeds can be credited by exporter to Exchange Earners Foreign Currency Account ("EEFC"), Resident Foreign Currency Domestic (RFC-D). However it is to be noted that the funds received in the account during a calendar month should be converted to rupees on or before last day of succeeding calendar month after adjusting utilization of balances for approved purposes or forward commitments. Further these accounts will be a non-interest bearing.

f. **Write off Export Proceeds -** At times it is seen that entities who have old unrealized export proceeds usually write off in their books without following conditions of write off prescribed in Export of Goods and Services Regulation and without intimating AD Bank. This can result in shipping bill open in records of EDPMS system of RBI and can even put exporter under caution list of RBI.

Export proceeds which remain to be unrealized despite best efforts of exporter for realizing the same may be either written off under self write off approach (5% of total exports proceeds realised in previous calendar year) or exporter may go to AD bank (10%) for allowing the write off.

The write off shall be subject to following conditions:

i. The relevant amount has remained outstanding for more than one year;

ii. Satisfactory documentary evidence is furnished indicating that the exporter had made all efforts to realise the export proceeds;

iii. The exporter is a regular customer of the bank for a period of at least 6 months, is fully compliant with KYC/AML guidelines and AD Category – 1 Bank is satisfied with the bonafides of the transaction.

iv. Overseas buyer has been insolvent or goods exported have been auctioned or destroyed by Port/Customs, overseas buyer is not traceable, cost of resorting to legal action is high etc.

Exporter seeking write off is required to submit all requisite documentary evidences AD Bank along with CA certificate indicating details of write off, amount of realization based on which write off limit is calculated.

g. **Third Party Payments –** It can so happen that export must have been made to one party but payment for export proceeds actually are received from another party. It is to be ensured that such transactions involving third party payments i.e. wherein payments have been received from different party conditions relating to third party payments like it should be backed by tripartite agreement, name of third party who will make payment must be present on order or invoice, AD Bank must be satisfied with bonafides of transaction, it should be routed only through banking channels, it should be declared in export declaration form by exported.

3.2 TRANSACTIONS OF OUTWARD REMITTANCE:

3.2.1. OVERSEAS DIRECT INVESTMENT:

Indian Party viz. Company or Limited Liability Partnership or Registered Partnership Firms are allowed to make overseas direct investment in capital of overseas entities. The transactions of Overseas Direct Investment ("ODI") are governed by provisions of FEMA Notification No. 120 Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations 2004 ("ODI Regulations"). Some important points which need to be checked during audit while reviewing ODI transactions are as under:

a. **Unique Identification Number (UIN) Obtained or not** – In case of any first remittance for ODI by Indian party, UIN has to be compulsorily obtained. Any further remittance can be made only after receipt of UIN. Form ODI Part I is to be filed for obtaining UIN within 30 days of remittance.

b. **Net worth** – ODI can be made up to 400% of net worth of Indian Party and this net worth is to be calculated based on latest audited financial statements.

c. **First remittance always towards Equity Capital** – First remittance in overseas entity should be always towards equity capital. It cannot be in form of loan. Post contribution to equity, loan can be given.

d. **Reporting of subsequent remittances –** All subsequent remittances towards investment in overseas entity also need to be reported to RBI in Form ODI Part I.

e. **Annual Performance Report (APR) –** Every year APR has to be filed in Form ODI Part II with RBI based on audited financial statements of overseas entity by December.

f. **Post Investment Changes –** Any post investment changes need to be reported within 30 days of such change.

g. **Disinvestment -** Disinvestment involving sale / liquidation / winding up / mergers / amalgamation etc. need to be reported to RBI in Form ODI Part III within 30 days of event.

h. **No write off without or provision without reporting to RBI –** It should be ensured that if overseas entity is incurring losses in such scenarios investment cannot be written off directly in books to the extent of diminution in value of investment without obtaining prior RBI approval in terms of ODI regulations.

i. **Conversion of export receivable or other dues which are receivable from overseas entity into Equity Capital –** In case export receivables or any other receivables which are outstanding and time limit for realization has not yet expired same can be converted to equity under automatic route. However with regards to dues outstanding beyond prescribed period, prior approval needs to be obtained.

j. **Investment by resident individual –** Resident individual can make ODI investment in JV/WOS abroad within limit of USD 2,50,000 of Liberalized Remittance Scheme (LRS) provided JV/WOS is an operating entity and it does not have any step down investment. Resident Individual can only invest in Equity Capital or CCPS of JV/WOS. It cannot give loan. Such investment cannot be sold or transferred within 1 year of its investment.

k. **Certifying ODI Forms –** Statutory Auditor has to certify ODI forms filed by Indian Party or resident individual and hence auditor has to ensure that the overseas investment transactions is in compliance of ODI regulations and as per provisions of FEMA Notification 120.

3.2.2 IMPORT OF GOODS AND SERVICES:

Import of Goods and Services is a Current Account Transaction and governed by Master Direction No. 17/2016-17. Being a Current Account Transactions there is no restriction on same however procedures as prescribed in Master Direction need to be followed. An auditor has to check following points while reviewing export transactions:

a. **Time Limit for Settlement –** Remittance against import must be made within 6 months from date of shipment. AD Banks may permit settlement of import dues due to disputes, financial difficulties etc. for a period up to 3 years.

b. **Time Limit for Deferred Payment -** Deferred Payment Arrangements (suppliers and buyers credit) up to five years, are treated as Trade Credit and guidelines relating to same must be followed.

c. **Change in nature of transaction due to passage of time –** One of very important thing to be taken into consideration is change in nature of transaction due to passage of time. As already discussed Import transactions are considered as Current Account Transaction. However import dues outstanding more than 3 years partake the character of Capital Account Transactions and are considered to be Deemed ECB.

Generally Trade Payables more than six months and up to 3 years are allowed by RBI. In case of Trade Payable outstanding more than 6 months extension needs to be obtained. Trade Payables which are outstanding more than 3 year are treated as Deemed ECB thereby requiring for compliance of ECB guidelines. Reference of some of Compounding Orders where RBI has treated delayed import dues as Deemed ECB are given below:

- TWI India Pvt. Ltd - CA Order No. 3945/2016 dated-31.08.2016
- AMC Diamonds - CA Order No. 3934/2016 – dated 13.07.2016
- Intercat Equipment - CA Order No. 3861/2015 - dated 02.06.2016

d. **Merchanting Trade –** Nowadays many entities are resorting to Merchanting Trade Transactions (“MTT”). In this type of transactions goods do not enter in Domestic Tariff Area of India. Goods are imported from one country and directly exported to other country. An auditor while dealing with such type of transactions has to ensure that the transactions are bonafide and all regulations relating to import and export leg are duly complied with. Such transactions must be routed through same AD Bank only. MTT shall be completed within overall period of 9 months. Any receipt of export leg must be separately parked in EEFC account for payment of import leg and it shall be ear-marked/lien marked for import leg payments. There must be one-to-one matching of each MTT and defaults if any are reported by AD Bank to RBI. Therefore it is duty of auditor to see that there are no defaults.

Merchant traders with outstanding of 5% or more of their annual export earnings shall be liable for caution listing. The merchanting trade shall result in profit which shall be determined by subtracting import payments and related expenses from export proceeds for the specific MTT.

3.3 SET OFF OF EXPORT AND IMPORT TRANSACTIONS:

This is another important area which needs to be looked upon. There can be instance where Indian entity must be having export and import transactions with same foreign party. Usually it is tendency that if amount to be received is more than amount to be paid then net proceeds are received thereby setting off import dues against export dues of same foreign party. At times this goes unnoticed even by auditor. However it is to be noted that due procedure for such set off needs to be followed only then outstanding import dues and export dues can be set off for same foreign party. Following points need to be looked upon while dealing with such transactions of set off:

a. Export receivable and import payables must be from/to same overseas buyer/supplier.

b. Set off of export receivable and import payables with overseas group/associate companies will be allowed on net basis or gross basis through an in-house or outsourced centralized settlement arrangement.

c. AD Bank must be satisfied with bionafides of transaction.

d. Invoices must not be under investigation of Enforcement Directorate or Central Bureau of Investigation or any other investigative agency.

e. Set off of export receivables against goods shall not be allowed against import payables for services and vice-versa.

f. Set off of export receivable of services against import payable of services is also not allowed because it is not prescribed.

g. Set off shall be allowed between export and import leg transaction taking place during same calendar year.

h. AD Bank may seek Auditors/CA Certificates wherever felt necessary.

i. AD Bank must settle transaction in EDPMS/IDPMS systems by utilizing set off indicator.

4. NOCLAR REPORTING - REQUIREMENT TO REPORT IN AUDIT REPORT IN CASE OF ANY QUALIFICATION:

Presently there is no requirement to report any qualification arising on account of non-compliance of any other law applicable to an entity. The Institute of Chartered Accountants of India (ICAI) in its revised Code of Ethics, 2019 has introduced for Non Compliance with Laws and Regulations (NOCLAR) reporting. This was initially to be implemented from 1st July 2020. However last year ICAI deferred the same till further notice. Recently ICAI in its council meeting announced that NOCLAR which was earlier deferred till further notice will now be made applicable and implemented effective from 1st April 2022.

What exactly NOCLAR is? Answer to this question lays in Volume I of Revised Code of Ethics, 2019. It refers to any act of omission or commission, committed by a client contrary to prevailing laws or regulations. Recognizing that such a situation of omission or commission can often be difficult for a Professional Accountant (PA) and accepting that he has prima facie responsibility not to turn a blind eye to the matter NOCLAR has been introduced to help guide Professional Accountants (PA) in dealing with situation and in deciding how best to serve the public interest in these circumstances.

Applicability of NOCLAR:

a. As already mentioned will be made applicable and implemented effective from 1st April 2022.

b. For now only applicable to listed entities.

c. Applicable only to audit assignments.

d. Scope of laws and regulations – laws and regulations that have direct effect on determination of material amounts and disclosures in financial statements, other laws and regulations compliance with which may be fundamental to entity's business and operations or to avoid material penalties.

e. Some of examples of laws given by ICAI are Fraud, Corruption and Bribery, Money Laundering, Terrorist Financing and Proceeds of Crime, Banking and Other Financial products and services, securities market and trading, data protection, tax and pension liabilities and payments, environment protection, public health and safety.

Above laws are just some of examples give by ICAI whereby NOCLAR can be applicable. Impact due to non compliance of FEMA law also can get covered in above NOCLAR reporting and therefore while doing audit due care must be taken by auditor for review of transactions having FEMA implications.

5. WAY FORWARD FOR AUDITORS:

Clients are not well versed and aware of FEMA regulations as a result of which at times clients end up in entering into transactions which are not permitted or not allowed or miss on requisite reporting compliances. Even if at present as an auditor one is not required to report about qualifications if any arising in relation to transactions having FEMA implications, however it is important that an auditor looks into and reviews the transactions from FEMA perspective also at the time of audit. With NOCLAR coming into place responsibility of auditors will increase many fold and one must be ready for same.