Chapter 19 "Audit of Banks" (Chart 1 – Basics)

Principal Enactments Governing Bank Audit

- Banking Regulation Act, 1949;
- RBI Act, 1934;
- Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970;
- SBI Act, 1955;
- SBI (Subsidiary Banks) Act, 1959;
- Regional Rural Banks Act, 1976;
- Companies Act, 2013;
- Cooperative Societies Act, 1912;
- Information Technology Act, 2000;
- Prevention of Money Laundering Act, 2002;
- SRFAESI Act, 2002;
- Credit Information Companies Regulation Act, 2005; and
- Payment & Settlement systems Act, 2007

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Scope of Assignment of Statutory Central Auditor

1. Report on adequacy & operating effectiveness of ICFR in case of banks which are registered as companies in terms of Sec. 143(3)(i) of Companies Act, 2013.
2. Long form audit report (LFAR).
3. Report on compliance with SLR requirements.
4. Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
5. Certificate on reconciliation of securities by the bank (both on its own investment account as well as PMS Banks' account).
6. Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI.
7. Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI.
8. Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
9. Certificate in respect of custody of unused Bank Receipt forms and their utilisation.
10. Authentication of capital adequacy ratio & other ratios reported in notes on accounts.
11. Certificate on Corporate Governance in case of banks listed on Stock Exchange.
12. Certification on claim of various interest subsidies and interest subvention.

Requirements of Risk Management System

1	Involvement of TCWG	Risk Management policies should be approved by TCWG having regard to bank's business objectives & strategies, capital strength, mngt expertise, regulatory requirements & types of risks.
2	Identification, Measurement & Monitoring of Risks	Risks that may significantly affect the achievement of bank's goals and objectives should be identified, measured and monitored.
3	Control Activities	Banks must have controls including the following: • effective segregation of duties, • verification and approval of transactions, • setting of limits, • reporting and approval of exception.
4	Monitoring Activities	Risk mng models, methodologies and assumptions used to measure and manage risk need to be evaluated by Independent risk management unit
5	Reliable Information System	must exist so as to provide adequate financial, operational and compliance information on a timely and consistent basis to management and TCWG.

Special considerations in CIS Environment

The key security control aspects that an auditor needs to consider when undertaking bank audit in a CIS include the following:

1. To ensure that date available for processing is authorised, accurate and complete.
2. To ensure that unauthorised amendments to the programmes are being prevented.
3. To ensure that access and authorisation rights given to staff are appropriate.
4. To ensure that bank charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised.
5. To verify whether exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials.
6. To verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
7. To ensure that balance in general ledger tallies with the balance in subsidiary book.
8. To ensure that the backup media is stored in fireproof cabinet secured with lock and key and also that the off-site backups are preserved for the emergency.
9. To check that the anti-virus software of latest version is installed in servers/PCs of branches to prevent data corruption.
10. To ensure that access to computer room is restricted to authorised persons only.

Chapter 19 "Audit of Banks"(Chart 2 – Evaluation of Internal Controls)

1. Bills for Collection

1. Documents accompanying bill should be received & entered in the register by a proper officer.
2. Account of principal should be credited only after realisation of the bill.
3. Ensure that bills sent by one branch to another for collection are not included twice in balance sheet.

3. Loans and Advances

- Evaluation of Customer creditworthiness.
- Sanctioning by proper authority.
- Execution of Necessary Documents.
- Keeping Sufficient Margin.
- Safe custody of securities held.
- Registration of charges in favour of bank.
- Inspection of securities on regular basis.
- Determination of market value of securities.
- Adjustment in drawing power with decrease in value of assets.
- Reporting of Irregular accounts to Head office
- Review of accounts on timely basis.

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5. Telegraphic Transfers and Demand Drafts

1. Codes for TT should be known only to responsible officers.
2. Coding and Decoding should be done only by authorised officers.
3. Signatures on documents used for TT and DD should be checked by an officer.
4. All TT & DD sold by a branch should be immediately confirmed by advices to the branches concerned.
5. If the paying branch does not advice from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.

2. Bills Purchased

1. Verify that all documents of title are properly assigned to the bank.
2. Sufficient margin should be kept while purchasing or discounting of a bill.
3. Irregular outstanding accounts should be periodically reported to the head office.
4. Proportionate income should be recognised between the periods.

4. Credit Card Operation

1. Effective screening of applications.
2. Strict control over storage and issue of cards.
3. Existence of a system to confirm status of unutilised limit before accepting the settlement.
4. Existence of system of prompt reporting by the merchants of all settlements accepted.
5. Reimbursement to merchants only after verification of valid acceptance of cards.
6. Reimbursements should be immediately charged to the customer's account.
7. Existence of system to ensure that statements are sent regularly and promptly to the customer.
8. Existence of a system to monitor and follow-up of customers' payments.
9. Identifying the items overdue beyond a reasonable period.
10. Existence of a system for periodic review of credit card holders' accounts.

Chapter 19 "Audit of Banks" (Chart 3 – Verification of Investments)

AUDIT PROCEDURE

1	**Internal control evaluation**	To ensure they are in accordance with RBI Guidelines. Investment policy must confirm to RBI Guidelines.
2	**Separation of Investment Functions**	Own investment account need to be separated from PMS client accounts.
3	**Examination of Reconciliation**	
4	**Examination of Documents**	To ensure that investments made are within authority and supported by documentation.
5	**Physical verification**	• Should be carried out on balance Sheet date, • In exceptional case, carry out the physical verification as near to balance sheet date as possible. • In case of scripless dealings, verify the yearend confirmations of depository.
6	**Examination of Valuation**	Method of accounting including yearend valuation is appropriate. If inappropriate, consider the effect of adoption of such policy on F.S.
7	**Dealing in securities on behalf of Others**	Income from such activities to be recorded fairly. *Compiled by: CA. Pankaj Garg*
8	**Examination of Classification and Shifting**	

SPECIAL PURPOSE CERTIFICATES

Central Auditors are required to issue following certificates:

1. Certificate on reconciliation of securities by the bank (both on its own investment account as well as PMS Client's account).
2. Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by RBI.

CLASSIFICATION AS PER PRUDENTIAL NORMS

1	**Held to Maturity (HTM)**	Securities acquired by bank with the intention to hold till maturity.
2	**Held for Trading (HFT)**	Securities acquired by bank with the intention of trading, i.e. to be sold within 90 days.
3	**Available for Sale (AFS)**	Securities which do not qualify for being classified as HTM or HFT.

Category of investment should be decided at the time of acquisition and recorded on investment proposal.

NON PERFORMING INVESTMENTS

Those investments where interest/principal is due and remains unpaid for >90 days and includes:

1. Preference Shares where dividend is not paid.
2. Unquoted equity shares value @1.
3. Securities issued by a person who has been given credit facility which is a NPA.
4. Equity, debentures etc. received as a result of conversion of NPA.

INCOME RECOGNITION NORMS

1	**Performing Investments**	Accrual basis provided interest rate is predetermined.
2	**NPI**	Realisation Basis
3	**Govt. Guarantee**	Accrual basis, provided interest is serviced regularly.
4	**Dividend**	Accrual basis, if right to receive dividend is established.
5	**Discount on discounted instruments**	Accrual basis over the remaining period of maturity.
6	**Units of Mutual Funds**	Cash Basis
7	**Sale of Investments**	Profit or loss to be shown in Profit & Loss Account.

Chapter 19 "Audit of Banks" (Chart 4 – Verification of Advances)

General Audit Procedure

1. Evaluation of Internal Control

(a) Examine the loan documentation, validity of the recorded amounts; and existence, enforceability and valuation of the security;
(b) Ensure compliance with the terms of sanction; end use of funds; and loan Policy of Bank as well as RBI norms including appropriate classification and provisioning
(c) Review the operation of the accounts.

2. Substantive Audit Procedure

- Verify that amounts included in B/S in respect of advances are outstanding at the date of the B/S.
- Verify that advances represent amount due to bank.
- Ensure that outstanding amount is appropriately supported by Loan documents.
- Ensure that there are no unrecorded advances.
- Verify appropriateness of basis of valuation of advances.
- Ensure that the recoverability of advances is recognised in their valuation.
- Check that the advances are disclosed, classified & described in accordance with recognised accounting policies and relevant statutory and regulatory requirements.
- Ensure that appropriate provisions towards advances have been made as per the RBI norms.

3. Examination of Recoverability

(i) Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.
(ii) Review latest financial statements of borrowers.
(iii) Review reports on inspection of security.
(iv) Review Auditors' reports in the case of borrowers enjoying aggregate credit limits of Rs.10 lakh or above for working capital from the banking system.

Audit Procedure in Special Cases

1. Asset Classification

- Examine the appropriateness of classification made by the branch, particularly, to find out any threats to recovery.
- Examine whether the secured and the unsecured portions of advances have been correctly segregated.
- Check whether the provisions have been calculated properly.

2. Drawing Power (DP) Calculation

- Ensure that the DP is calculated as per the BOD guidelines of the respective bank and agreed upon by concerned statutory auditors.
- Ensure that due consideration has been given to proper reporting of sundry creditors for the purposes of calculating DP.
- Ensure that bank has conducted stock audit for all accounts having exposure of more than stipulated limit.
- Special focus need to be given in examining the DP calculation in case of working capital advances to companies engaged in construction business.

3 Limits not reviewed

- As per RBI norms, accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of ad hoc sanction, need to be classified as NPA.
- Auditors should ensure that ad hoc sanctions are not done on repetitive basis.

4 Govt. guaranteed Advances

- Credit facilities backed by guarantee of the C,G. though overdue should be treated as NPA only when the govt. repudiates its guarantee when invoked. This exemption is only for purpose of asset classification and provisioning and not for the purpose of recognition of income. Interest on such advances should not be taken to income account unless it has been realized.
- Credit facilities backed by S.G. guarantee should be classified as NPA in normal way.

5 Agricultural Advances

- Ensure that NPA norms have been applied in accordance with the crop season as determined by the State Level Bankers' Committee in each State.
- Ensure that NPA norms on basis of crop season are made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector.
- Ensure that in respect of agricultural loans (other than priority sector), identification of NPAs has been done on the same basis as non-agricultural advances.

Verification of Security Against Advances

Verification of advances made against LIC

- Inspect policies & ensure policies assigned in favour of bank.
- Examine whether premium has been paid and policy is in force.
- Obtain Certificate regarding surrender value (SV).
- If SV is subject to payment of premium, such premium need to be deducted from SV.

Verification of Advances against Stock

1. Examine Sanction letter & loan documents.
2. Verify stock statement to ascertain quantity and value.
3. Physically inspect the inventory.
4. Review the stock audit report.
5. Insurance policies assigned in favour of bank.
6. Inspect document of title of goods.

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Chapter 19 "Audit of Banks" (Chart 5 – Verification of Advances)

Verification of Provision for NPA

- Study the latest Master Circular of RBI to get familiarise with the norms prescribed by RBI in relation to provisioning requirements for NPA.
- Provisioning norms as laid down in the master circular should be construed as the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, ensure that higher provision is made by the bank.
- Examine whether the classification made by the branch into Standard, Sub-standard, doubtful and loss assets is appropriate.
- Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.
- As per the RBI 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.
- Date of NPA is of significant importance to determine the classification and hence specific care be taken in this regard and ensure that the classification is made as per the position as on date & hence classification of all standard accounts be reviewed as on balance sheet date.

Verification of Accounts falling under CDR

(a) Review the present classification of the account under IRAC norms adopted by the bank and corresponding provision made in the books of accounts, if any.

(b) If the account is already treated as NPA, the same cannot be upgraded only because of the CDR package.

(c) Review the Debtor-Creditor Agreement (DCA) and Inter Creditor Agreement (ICA) with respect to availability of such agreements.

(d) Ascertain the terms of rehabilitation along with the sacrifices, if any, to verify whether such sacrifices have been accounted in the books of accounts of the lender.

(e) Ascertain whether any additional financing / conversion of loan into equity have been envisaged in the restructuring program.

(f) Ascertain whether account has been referred to BIFR, as such cases are not eligible for restructuring under CDR system. Large value BIFR cases may be eligible for restructuring under CDR if specifically recommended by CDR core group.

(g) Ensure that accounts wherein recovery suits have been filed, the initiative to resolve under CDR system is taken by at least by 75% of the creditors by value and 60% in number.

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Verification of Sale/Purchase of NPA

- A NPA in the books of a bank is eligible for sale to other banks only if it has remained a NPA for at least two years in the books of the selling bank.
- NPA can be sold only on 'without recourse' basis.
- Subsequent to sale of NPA, selling bank do not assume operational, legal or any other type of risks relating to the financial assets sold.
- NPAs can be sold to other banks only on cash basis.
- Entire sale consideration should be received upfront.
- The sale price should not be lower than NPV of estimated cash flows associated with realisable value of the available securities net of the cost of realisation.
- Purchasing bank can further sold NPA only after 15 months.

Asset Classification Norms

- NPA purchased, may be classified as 'standard' in the books of purchasing bank for a period of 90 days from the date of purchase. Thereafter, the asset classification shall be determined on the basis of recovery.

Provisioning Norms:

- When a bank sells its nonperforming financial assets to other banks, the same will be removed from its books on transfer.
- In the books of purchasing bank, the asset shall attract provisioning requirement appropriate to its asset classification status.

Chapter 19 "Audit of Banks" (Chart 6 – Verification of Other Items)

Money at Call and Short Notice

(a) Verify whether there is a proper authorisation, general or specific, for lending of the money at call or short notice.

(b) Examine whether the instructions or guidelines laid down by the head office or controlling office of the branch in regard to such transactions are being complied with.

(c) Verify the call loans with the certificates of the borrowers and the call loan receipts held by the bank.

(d) Check whether the aggregate balances of money at call and short notice as shown in the relevant register agree with the control accounts as per the general ledger.

(e) Examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end.

Inter-office Adjustments (Branch Adj. Accounts)

(a) Examine origin and validity of old outstanding unmatched entries, particularly debit entries.

(b) Whether there are any reversal entries indicating the possibilities of irregular payments or frauds.

(c) Examine whether the balances include any items in nature of cash-in-transit, which remain pending for more than a reasonable period.

(d) Whether transactions, other than those relating to inter-branch have been included in inter-branch accounts.

(e) The auditor may also seek explanations from the management for old outstanding unmatched entries and transactions other than inter branch transactions.

CONTINGENT LIABILITIES

Disclosure requirements as per 3rd Schedule	(i) Claims against the bank not acknowledged as debts. (ii) Liability for partly paid investments. (iii) Liability on account of outstanding forward exchange contracts. (iv) Guarantees given on behalf of constituents- In India & Outside India. (v) Acceptances, endorsements and other obligations. (vi) Other items for which the bank is contingently liable.
Verification Aspects	(a) Ascertain existence of adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so. (b) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations. (c) Perform substantive audit tests to establish the completeness of the recorded obligations. (d) Review the reasonableness of the year end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities. (e) Obtain representation from the management that all contingent liabilities have been disclosed. (f) Ensure Compliance of AS 29, "Provisions, contingent liabilities and contingent assets".

Claims against the bank not acknowledged as debt	Guarantees
• Examine relevant evidence like correspondence with lawyers, claimants, workers/officers etc. • Review the minutes of the meeting of the BOD, contracts, agreements, pending legal cases & correspondence relating to taxes etc., to identify claims against the bank. • Ascertain from the management the status of claims outstanding as at the end of previous year. • Review subsequent events to obtain evidence about completeness and valuation of claims. ***Compiled by: CA. Pankaj Garg***	• Examine the adequacy of internal controls exercised over issuance of guarantees,. • Examine the adequacy of controls exercised over unused guarantee forms. • Examine whether prescribed procedure of marking off the expired guarantees is being followed or not. • Examine relevant guarantee registers with the list of outstanding guarantees to ensure that all outstanding guarantees are included in the amount disclosed. • Examine that expired guarantees are not included in this head. • Verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. • Verify the securities held as margin. • Ensure whether a provision is required in terms of the requirements of AS 29.

Chapter 19 "Audit of Banks" (Chart 7 – Miscellaneous)

STATUTORY LIQUIDITY RATIO

Central statutory auditors are required to verify the compliance of SLR on 12 odd dates in different months not having Fridays. To verify compliance with SLR requirements, the statutory auditor has to examine two aspects:

(a) Correctness of the figure of DTL at the close of business on the reporting Friday relevant to the dates selected by the auditor, and

(b) Maintenance of prescribed percentage of liquid assets on the selected date.

STEPS OF VERIFICATION

1. Examine the composition of items of DTL as per circulars/instructions of RBI.
2. Verification of trial balance and cash balance for 12 selected dates by Branch auditors.
3. Inclusion of demand and time liabilities in Consolidated Statement based on the returns received from the unaudited branches.
4. Examine whether Net credit balance in Branch Adjustment Account has been included in liabilities.
5. In computation of liquid assets, deposits maintained with RBI, cash balance with itself or RBI, excess balance maintained with RBI, net balance in current account are all treated as cash.
6. Price of gold taken does not exceed market price.
7. Specify number of unaudited branches.

CAPITAL ADEQUACY RATIO

Meaning: Measurement of adequacy of capital resources of bank in relation to risks associated with its operation.

Requirement: Public Sector: 9%; Private Sector: 10%

Computation: $\dfrac{\text{Capital Funds}}{\text{Risk Adjusted Assets \& Off Balance Sheet Items}}$

Components of Capital Funds

- Capital Funds are classified in two categories: Tier I and tier II.
- Tier I Fund includes Paid Up capital, Statutory Reserves, Free Reserves as reduced by equity investments in subsidiaries, intangible assets & current b/f losses.
- Tier II Fund includes undisclosed reserves, general provision and loss reserves, hybrid debt capital instruments and subordinated assets.
- Tier II Capital cannot exceed 100% of Tier I Capital.

LONG FORM AUDIT REPORT (LFAR)

- LFAR has to be furnished by the auditor of a bank in addition to the audit report as per the statutory requirement.
- The matters which the banks require their auditor to deal with in the form of Long Form Audit Report have been specified by the RBI.

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CONCURRENT AUDIT

Meaning	Examination which is contemporaneous with the occurrence of transactions. It attempts to shorten the interval between a transaction and its examination by an independent person not involved in its documentation. Emphasise substantive checking rather than test checking.
Coverage	Concurrent audit should cover the following: (a) Branches whose total credit aggregate to not less than 50% of the total credit of the bank; and (b) Branches whose aggregate deposits cover not less than 50% of the aggregate deposits of the Bank. In addition, bank should ensure the coverage of following: (a) Exceptionally large, very large and large branches; (b) Special branches handling foreign exchange business; (c) Branches rated as poor/very poor; (d) Head Office department dealing with treasury/funds management and handling investment portfolio.
Scope	1. Daily cash transactions with reference to abnormal receipts and payments. 2. Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. 3. Verification of advances, OD, CC, term loans, bills purchase, LC etc. Procedure for sanction & documentation to be verified. 4. Verification of Foreign exchange transactions. 5. Verification of ledgers, inter branch reconciliation & verification of interest, discount, commission. 6. Revenue leakage. 7. Verification of high value transactions. 8. Procedure for safe custody of security forms with branch. 9. Ensure adequacy of procedures for tax deduction at source. 10. Verification of returns, statements, calculation of capital adequacy ratio and compliance with RBI Guidelines. 11. Study of RBI and Internal Inspection reports, statutory auditor's report and compliance thereto.