



AUDIT OF BANKS

The difference between ordinary and extraordinary is that little “extra.”

DISCLOSURE OF ADVANCES

Lending constitutes a major activity of a bank. The banking business revolves primarily around garnering funds through acceptance of deposits for the purpose of onward lending. As a corollary, advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are also a major source of its income:

Amount disclosed in the balance sheet under the head 'Advances' comprise:

- a) Money lent by the bank to its customers and interest accrued and due thereon (including guarantees invoked / Letters of credit devolved on Bank);
- b) Debit balances in deposit accounts
- c) Amount of participation on risk-sharing basis under inter-bank participation schemes in capacity as a participating bank (net); and
- d) Amount receivable from Government of India under the Agricultural Debt Waiver Scheme 2008.

**PRINCIPLE ENACTMENTS GOVERNING BANK AUDIT**

- 1 • Reserve Bank of India Act, 1934
- 2 • Banking Regulations Act, 1949
- 3 • State Bank of India Act, 1955
- 4 • Companies Act, 2013
- 5 • Powers & Duties of Auditor
- 6 • State Bank of India (Subsidiary Banks) Act, 1959
- 7 • Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- 8 • Regional Rural Banks Act, 1976
- 9 • Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- 10 • Information Technology Act, 2000
- 11 • Prevention of Money Laundering Act, 2002
- 12 • Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- 13 • Credit Information Companies Regulation Act, 2005
- 14 • Payment and Settlement Systems Act, 2007

CONDUCTING A BANK AUDIT**INITIAL CONSIDERATION BY THE STATUTORY AUDITOR**

- (i) Declaration of indebtedness
- (ii) Internal Assignments in Banks by Statutory Auditors
- (iii) Planning

- (iv) Communication with Previous Auditor
- (v) Terms of Audit Engagement Risk
- (vi) Initial Engagements
- (vii) Assessment of Engagement Risk
- (viii) Establish the Engagement Team
- (ix) Understanding the Bank and its Environment.

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENTS

SA 315 requires the auditor to identify and assess the risks of material misstatement at the financial statement level and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures.



UNDERSTANDING THE BANKS AND ITS ENVIRONMENT INCLUDING INTERNAL CONTROL

An understanding of the bank and its environment, including its internal control, enables the auditor;

- To identify and assess risk;
- To develop an audit plan so as to determine the operating effectiveness of the controls, and to address the specific risks.

UNDERSTANDING THE BANK'S ACCOUNTING PROCESS

The accounting process produces financial and operational information for management's use and it also contributes to the bank's internal control. Thus, understanding of the accounting process is necessary to identify and assess the risks of material misstatement whether due to fraud or not, and to design and perform further audit procedures.

UNDERSTANDING THE RISK MANAGEMENT PROCESS

Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:



Oversight and involvement in the control process by those charged with governance: Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

Identification, measurement and monitoring of risks: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

Control Activities: A bank should have appropriate controls to manage its risk, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions and results, setting of limits reporting and approval of exceptions, physical security and contingency planning.

Monitoring Activities: Risk Management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.

Reliable Information Systems: Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

ENGAGEMENT TEAM DISCUSSIONS

The engagement team should hold discussions to gain better understanding of banks and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.



ESTABLISH THE OVERALL AUDIT STRATEGY

SA 300, states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:

- Establish the overall audit strategy, prior to the commencement of an audit; and
- Involve key engagement team members and other appropriate specialists while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.

DEVELOP THE AUDIT PLAN

SA 300, deals with the auditors responsibility to plan an audit of financial statements in an effective manner. It requires the involvement of all the key members of the engagement team while planning an audit. Before starting the planning of an audit, the auditor must perform the procedures as defined under SA 220, for reviewing the ethical and independence requirements. In addition to this, the auditor is also required to comply with the requirements of SA 210.

AUDIT PLANNING MEMORANDUM

The audit should summarize their audit plan by preparing an audit planning memorandum in order to:

- Describe the expected scope and extent of the audit procedures to be performed by the auditor.
- Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
- Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risk, specific risks, and other matters affecting the audit engagement.

DETERMINE AUDIT MATERIALITY

The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit. The determination of audit materiality is a matter of professional judgement and depends upon the knowledge of the bank, assessment of engagement risk, and the reporting requirements for the financial statements.

CONSIDER GOING CONCERN

In obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

ASSESS THE RISK OF FRAUD INCLUDING MONEY LAUNDERING

As per SA 240, the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain SAAE on those identified misstatements and to respond appropriately. The attitude of professional scepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. The RBI has from time to time issued guidelines ("KYC Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognize and report money laundering activities.



ASSESS SPECIFIC RISKS

The auditors should identify and assess the risks of material misstatements at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions.

RISK ASSOCIATED WITH OUTSOURCING OF ACTIVITIES

The modern day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of a services of an expert not available internally. There are, however, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

RESPONSE TO THE ASSESSED RISKS

SA 330 “The Auditor’s Responses to Assessed Risks” requires the auditor to design and implement overall responses to address that assessed risks of material misstatement at the financial statement level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risk of material misstatement at the assertion level.

STRESS TESTING

RBI has required that all commercial banks shall put in place a Board approved “Stress Testing Framework” to suit their individual requirements which would integrate into their risk management systems.

BASEL III FRAMEWORK

The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the sub-prime crisis. In the document titled ‘Basel III: A global regulatory framework for more resilient banks and banking systems’, released by the BCB in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital.

CONCURRENT AUDIT

MEANING

Concurrent audit, as the name suggests, is an audit or verification of transactions or activities of an organization concurrently as the transaction/activity takes place. It is not a pre-audit. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place.

The Reserve Bank of India (RBI) has issued certain guidelines for the conduct of this audit. These guidelines are mandatory and all banks are required to cover 50 percent of total deposits and 50 per cent of total advances under this audit.

SCOPE OF CONCURRENT AUDIT OF BANKS WITH REFERENCE TO RBI GUIDELINES

- (i) Daily cash transactions with reference to abnormal receipts and payments. This will include currency chest transaction, major expenses met by cash, high value receipts and disbursements.
- (ii) Purchase and sale of shares securities etc. Physical verification of investments and rates at which they are entered into.
- (iii) Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. Unusual operations noticed have to be thoroughly examined.
- (iv) Verification of advances, overdrafts, temporary OD, Cash credit accounts, term loan, bills purchase, letters of credit etc. Procedure for sanction and documentation to be verified. Any deviation noticed to be examined in great detail.

- (v) Foreign exchange transactions to be verified with reference to RBI guidelines.
- (vi) Verification of balancing of all ledgers and registers, inter branch reconciliation calculation and verification of interest, discount, commission etc.
- (vii) Revenue leakage to be detected.
- (viii) Special efforts to be made in all fraud prone areas. The attempt should be to ensure that all effective measures are taken to prevent frauds.
- (ix) Verification of high value transactions.
- (x) Procedure for safe custody of security forms with the branch.
- (xi) Whether all procedures for tax deduction at source are followed and the tax so deducted are deposited into Government Account within the time fixed.
- (xii) Verification of returns, statements, calculation of capital adequacy ratio and compliance with requirements of governing business.
- (xiii) Study of RBI and internal inspection reports, statutory auditor's report and compliance thereto.
- (xiv) Whether the customers complaints are dealt with promptly.

AUDIT COMMITTEE

- Bank is required to constitute an Audit Committee of its Board.
- The membership of the audit committee is restricted to the Executive Director, nominees of the Central Government and the RBI, Chartered Accountant director and one of the non-official directors.
- One of the functions of this committee is to provide direction and also oversee the operations of the total audit function in the bank.
- The committee also has to review the internal inspection/audit function in the bank, with special emphasis on the system, its quality and effectiveness in terms of follow up.
- The committee has to review the system of appointment and remuneration of concurrent auditors.



INTERNAL CONTROLS

CONSTITUENT'S LEDGER

- Before making payment, cheques should be checked in respect of signature, date, balance on hand and should be passed by a proper officer.
- No withdrawal should normally be allowed against clearing cheques deposited on the same day.
- An officer should check all the entries made in the ledger with the original documents particularly noting that the correct accounts have been debited or credited.
- Ledger keepers should not have access to voucher summary sheets.
- Interest debited or credited to constituent's account should be independently checked.

LOANS AND ADVANCES

- The bank should make advances only after critical assessment of borrower's credit worthiness.
- All the necessary documents should be duly executed by the parties before advancing the loan
- Sufficient measures should be kept against security offered.
- Securities requiring registration should be registered in bank's name.
- Surprise inspection of hypothecated goods should be conducted.
- Market value of the security should be checked by the officers of the bank and the same should be entered in the drawing power book.
- All the accounts which exceed the sanctioned limit or are against unapproved securities should be brought to the notice of the head office.
- Periodical review of operation of the account is important.



TELEGRAPHIC TRANSFERS AND DEMAND DRAFTS

- The bank should have a reliable private code known only to responsible officers.
- The signature on the demand draft should be checked with the signature book.
- All the telegraphic transfers and demand drafts sold by a branch should be immediately confirmed by the advances to the branch concerned.
- If the paying branch does not receive proper confirmation of any telegraphic transfer or demand draft or does not receive credit from the issuing branch, it should take immediate steps to ascertain the reasons.

CREDIT CARD OPERATIONS

- There should be effective screening of applications with reasonable food credit assessments.
- There should be strict control over storage and issue of cards.
- There should be a system whereby a merchant confirms the status of unutilized limit of a credit-card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.
- There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.
- Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.
- All the reimbursements (gross of commission) should be immediately charged to the customer's accounts.
- There should be a system to ensure that statements are sent regularly and promptly to the customer;
- There should be a system of monitor and follow-up of customer's payments.
- Items overdue beyond a reasonable period should be identified and attended carefully. Credit should be stopper by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.
- There should be a system of periodic review of credit card holders account. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.



AUDIT OF COMPLIANCE WITH SLR REQUIREMENT

COMPLIANCE WITH SLR REQUIREMENTS

The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements on 12 odd dates in different months of a financial year not being Fridays. The resultant report is to be sent to the top management of the bank and to the Reserve Bank.

EXAMINATION OF 2 ASPECTS

The report of the statutory auditors in relation to compliance with SLR requirements has to cover two aspects:

- (i) Correctness of the computation of DTL position; and
- (ii) Maintenance of liquid aspects.

MAINTENANCE OF LIQUID ASSETS

Every Scheduled Commercial bank shall continue to maintain in India assets as detailed below, the value of which shall not, at the close of the business on any day, be less than 21.5% on the total net demand and time liabilities as on the last Friday of the second preceding fortnight valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

- (i) Cash or
- (ii) Gold valued at a price not exceeding the current market price; or
- (iii) Investment in the following instruments which will be referred to as "Statutory Liquidity Ratio (SLR) securities";
 - (a) Dated securities issued up to May 06, 2011 as listed in the Annex to Notification DBOD.No.Ret.91/12.02.001/2010-11 dated May 09, 2011;
 - (b) Treasury bills of the Government of India;
 - (c) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilization Scheme;
 - (d) State Development Loans (SDLs) of the State Government issued from time to time under the market borrowing programme; and
 - (e) Any other instrument as may be notified by the Reserve Bank of India. It is also provided that the securities (including margin) referred to above, if acquired under the Reserve Bank – Liquidity Adjustment Facility (LAF), shall not be treated as an eligible asset for this purpose.

AUDIT APPROACH AND PROCEDURE

- (i) Obtain an understanding of the relevant circumstances of the RBI, particularly regarding composition of items of DTL.
- (ii) Require the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him. The branch auditors should also be specifically requested to examine the case balance at the branch on the selected dates.
- (iii) Examine, on a test basis, the consolidations regarding DTK position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.
- (iv) While examining the computation of DTL, specifically examine that the following items have been excluded from liabilities-



- a. Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
 - b. Amounts received in India Currency against import bills and held in sundry deposits pending receipts of final rates.
 - c. Un-adjusted deposits/balances lying in the link branches for agency business like dividend warrants, interest warrants, refund of application money, etc. in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.
 - d. Margins held and kept in sundry deposits for funded facilities.
- (v) Similarly, specifically examine that the following items have been included in liabilities –
- a. Net credit balance in branch adjustment accounts including these relating to foreign branches.
 - b. Interest on deposits as at the end of the firm half year reversed in the beginning of the next half-year.
 - c. Borrowings from abroad by banks in India needs to be considered as “Liabilities to other” and thus, needs to be considered at gross level unlike ‘liabilities towards banking system in India’, which are permitted to be netted off against ‘assets towards banking system in India’. Thus, the adverse balances in Nostro Mirror Account needs to be considered as ‘Liabilities to other’
 - d. The reconciliation of Nostro Accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyse and ascertain if any inwards remittances unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.
- (vi) Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches.
- (vii) It may be noted that, even though interest accrues on a daily basis, it is recorded in the books only at periodic intervals. Thus, examine whether such interest accrued but not accounted for in books is included in the computation of DTL.
- (viii) The auditor at the central level should apply the audit procedures listed above to the overall consolidated prepared for the bank as a whole. Where such procedure is followed, the central auditor should adequately describe the same in his report.
- (ix) While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion. Recently, there has been introduction of Automated Data Flow (ADF) for CRR & SLR reporting and the auditors should develop necessary audit procedures around this.
- (x) Test check the relevant records maintained by the bank in respect of investments to verify the amount of approved securities held by the bank on the dates selected by him. Examine whether the valuation of approved securities has been done by the bank is in accordance with the guidelines prescribed by the RBI.
- (xi) While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion.

CAPITAL ADEQUACY

MEANING

“Adequacy of Capital Resources of a Bank in relation to risks associated with its operations” All Indian Scheduled Commercial banks (excluding RRB) & Foreign banks operating in India to Maintain Capital Adequacy Ratio at a minimum of 9%

FORMULA

Capital Adequacy Ratio = (Capital Funds / Risk Weighted Assets & off B/S items) x 100

1. Tier I capital consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses.
2. Tier II capital consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

INTER-OFFICE ADJUSTMENTS

1. Inter-branch accounts are normally reconciled by each bank at the central level. While practices with various banks may differ, the inter-branch accounts are normally sub-divided into segments or specific areas, e.g. 'Drafts paid / payable', 'inter-branch remittances', 'H.O. A/c', etc.
2. The auditor should report on the year-end status of inter-branch accounts indicating the dates up to which all or any segments of the accounts have been reconciled.
3. The auditor should also indicate the number and amount of outstanding entries in the inter branch accounts, giving the relevant information separately for debit and credit entries.
4. The auditor can obtain the relevant information primarily from branch audit reports.

CONTINGENT LIABILITIES

CLAIMS AGAINST THE BANK NOT ACKNOWLEDGED AS DEBT

- a. Examine external evidences like Correspondence with Lawyers, claimants etc.
- b. Review the minutes of board meetings.
- c. Obtain Written Representations from the management about the status of such claims.
- d. Review the subsequent events.



LIABILITY ON PARTLY PAID SHARES

Examination of certificates of investment is the best procedure to ascertain such liabilities.

LIABILITY ON OUTSTANDING FORWARD EXCHANGE CONTRACTS

The auditors may verify these liabilities with registers maintained and copies of broker's advice notes.

GUARANTEES GIVEN ON BEHALF OF CONSTITUENTS

- a. The auditor should ascertain adequacy of internal control over issuance of guarantees, e.g. whether guarantees are issued under proper sanction, whether margins are taken from customers etc.
- b. The auditor should ascertain that unused guarantee forms are in proper custody.
- c. Substantive test of guarantees given may be performed through the guarantee register.

ACCEPTANCES, ENDORSEMENTS AND OTHER OBLIGATIONS

These include letters of credit issued and bills discounted or purchased from bank. The audit procedure should involve evaluation of internal control system and verification of the relevant registers and copies of letter of credit issued.

Letter of credit: Evaluate the adequacy of the internal controls over LC Forms e.gg. custody, maintenance of records, periodical verification, reconciliation, etc.

- Verify the balance of LC from the Register maintained by the bank to ascertain the amount of LC and payments made under them.
- Examine the guarantees of the customers, copies of the LC issued & securities obtained for issuing LC

- In respect of other acceptances and endorsements the following procedures may be adopted.
 - Examine the arrangements made by the bank with its customers
 - Test checks the amounts of bills with the register maintained by the bank.
 - Verify whether such bills are marked off in the register on payment at maturity.

Letter of Comfort: Where letters of comfort has been issued, verify whether the bank has incurred a potential financial obligation under such a letter. If an obligation has been cast under letters of comfort, ensure that the amount has been shown as contingent liability in the Balance Sheet.

BILLS FOR COLLECTION

- a. Verification of the bills for collection on hand.
- b. Examination of Collections subsequent to Balance Sheet date.
- c. Examination of Procedure for recognition of income on such services, income should be recognized only on collection of the bills.



VOSTRO AND NOSTRO ACCOUNTS

NOSTRO ACCOUNTS

Banks maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign currency accounts maintained by Indian Banks at other overseas centres are designated by “Nostro Account”

For example, all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian Office as Nostro Account.

VOSTRO ACCOUNTS

“Vostro Account” is the opposite of Nostro Accounts. Here a foreign bank in another country maintains stocks of Indian Rupees with their Indian Branches / correspondents / local bank. Such Indian Rupee Accounts are designated by Vostro Account.

For example, an American Bank might maintain an Vostro Account in rupees in terms with Indian Bank.

AUDIT OF NOSTRO ACCOUNTS

While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro Account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/outward messages. The inward/outward messages should be properly authenticated and discrepancies notices, should be properly dealt with, in the books of account.



AUDIT OF VOSTRO ACCOUNTS

The auditor should also verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

VERIFICATION OF LOANS AND ADVANCES

SOME COMMON POINTS FOR VERIFICATION OF LOANS

- Loan documents to be checked
- Check the securities hypothecated against loan
- Check the internal control procedures for loans applied by the bank.
- Whether loan agreements (sanction limits) are within authority of bank.
- Whether bank is properly following up the loan
- Check NPA and their provisions.
- Interest calculations should be examined
- Whether there is healthy turnover in account
- Whether repayment schedule is made considering repayment capacity of borrower
- If borrower is a company, whether there is proper resolution to borrow amount from bank.



ADDITIONAL POINTS W.R.T. LOAN TO DOT COM COMPANY

- Examine the feasibility of revenue model submitted by the Dot Com Company to the bank. He may obtain Expert's advice as well.
- Ensure that there is appropriate capital base in the company i.e. it is not solely dependent on outside sources only.

ADDITIONAL POINTS W.R.T. LOAN AGAINST LIFE INSURANCE POLICIES

- Security value is considered as surrender value of policy
- Whether Premium is deposited on time
- At maturity of policy, check procedures to be applied by the bank.
- Policy documents to be checked.

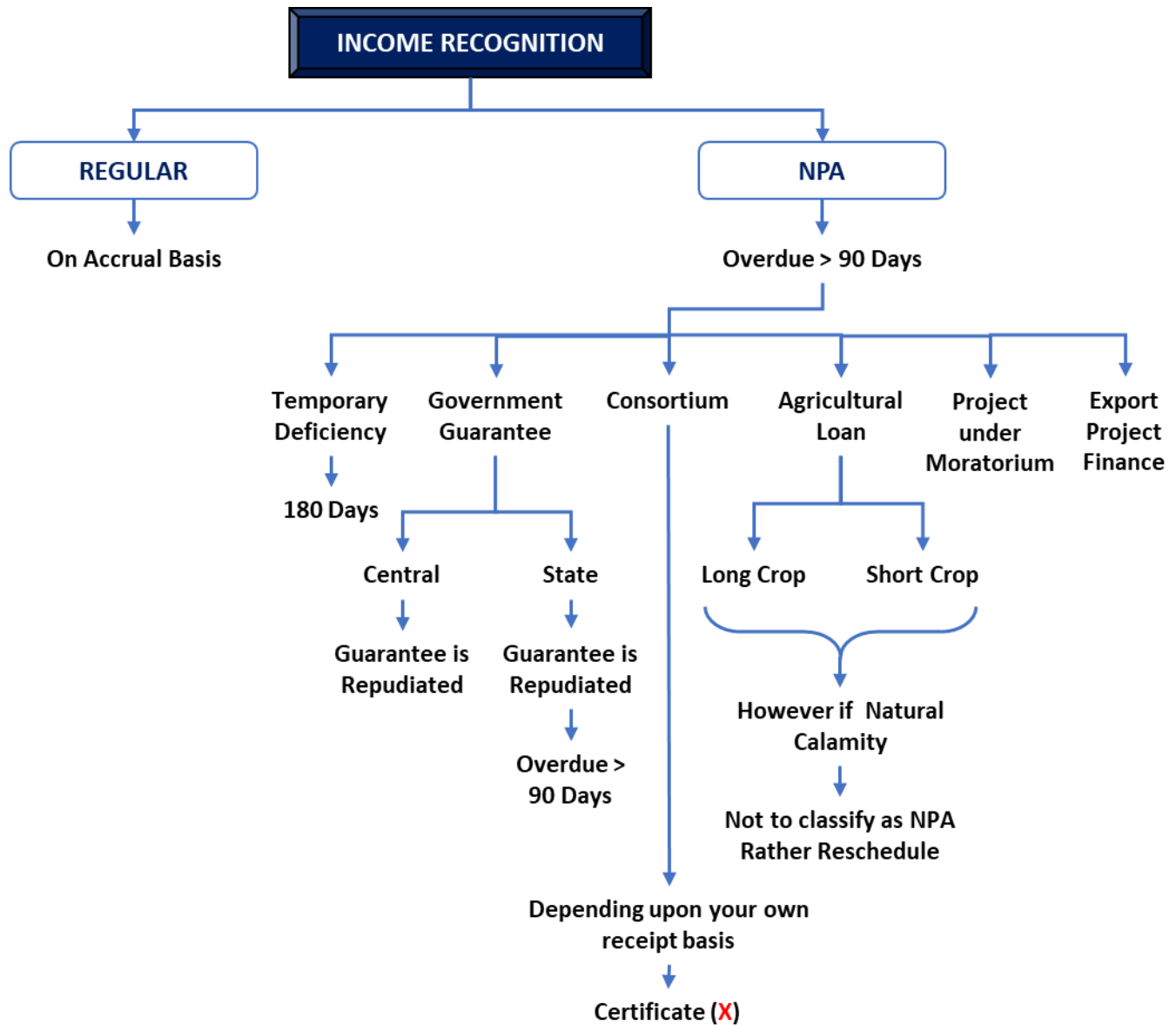


ADDITIONAL POINTS W.R.T. LOAN AGAINST STOCK EXCHANGE SECURITIES

- Margin should be maintained
- Goods should be in original packing / periodic surprise visits
- Physically check / stock statements.
- Godowns & stock adequately insured.
- Basis of valuation of goods.
- Slow moving or fast moving goods.
- Check bank's policy for advances against the same.

ADDITIONAL POINTS W.R.T. GOLD ORNAMENTS AND BULLION

- The auditor should inspect and weigh (on a test basis) the ornaments on the closing date.
- He should also see the certificate regarding the net gold content of the ornaments and their valuation.
- Valuation should also be checked with reference to the current market price of gold.
- In respect of gold and silver bars, the auditor should inspect the bars on a test basis and see that the mint seals are intact.
- The weights mentioned on the bars may generally be accepted as correct.



CLASSIFICATION OF INVESTMENTS

CLASSIFICATION OF INVESTMENTS

- (i) Held-to-maturity (HTM): This category would comprise securities acquired by the bank with the intention to hold them up to maturity.
- (ii) Held-for-trading (HFT): This category would comprise securities acquired by the bank with the intention of trading, i.e. to benefit from short-term price/interest rate movements.
- (iii) Available-for-sale (AFS): This category will comprise securities. Which do not qualify for being categories in either of the above categories, i.e. those that are acquired neither for trading purpose nor for being held till maturity.



VALUATION

1. Held-to-Maturity Securities:

Investments classified under held to maturity category need not be marked to market

They should be carried at acquisition cost unless it is more than face value, in which case the premium should be amortized over the period remaining to maturity.

Any diminution, other than temporary should be recognised in the value of their investments in subsidiaries/JVs and provided for. Such diminution should be determined and provided for each investment individually.

2. Held-for-trading Securities:

The individual scrips in the held for trading category should be marked to market at monthly or add more frequent intervals in the similar manner except in the following cases.

Equity shares should be mark to market preferably on daily basis, but at least on a weekly.

Banks which are under take shots in transactions the entire HFT portfolio including the short position should be mark to market on daily basis.

3. Available-for-sale Securities:

The individual scrip's in the available for sale category will be mark to market at quarterly or at more frequent intervals.

It is further required that net depreciation in respect of each of the categories in which investments are presented in the balance sheet should be provided for while any similar net appreciation should be ignored.

NON-PERFORMING INVESTMENTS

A Non-Performing Investment (NPI), is one where

- i. Interest/Installment (including maturity proceeds) are due and remain unpaid for more than 90 days.
- ii. The above would apply mutatis-mutandis to preference shares where the fixed dividend is not paid.
- iii. If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPA and vice versa. However, if only the preference shares are classified as NPI, the investment in any of the Other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA.
- iv. The investment in debentures/bonds which are deemed to be in the nature of Advance, would also be subjected to NPI norms as applicable to Investments
- v. In case of conversion of non-performing loans into equity, debentures, bonds, etc. such instruments should be treated as NPI ab-initio in the same asset classification in which the relevant non-performing loans were classified and provision should be made as per the norms.

These guidelines will apply to state government guaranteed securities also.

Banks should make appropriate provisions for such NPIs by way of depreciation in the value of the investment.

The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

INCOME RECOGNITION

The banks may book income in the following manner:

- i) Banks may book income on accrual basis on securities of corporate bodies / public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or State Government, provided interest is services regularly and as such is not in arrears.
- ii) Banks may book interest income from all other performing investments on accrual basis provided interest rates on these instruments are pre-determined.
- iii) Discount earned on discounted instrument like commercial papers, zero bonds should be booked on accrual basis. The discount may either be accrued equally over the remaining period to maturity or by following the constant yield method.
- iv) Interest income from non-performing investments should be booked on realization.

- v) Dividend on shares may be booked on accrual basis provided it is approved by corporate body in its Annual General Meeting and the owner's right to receive dividend is established.
- vi) Income from units of mutual funds should be booked on cash basis.
- vii) Discount on interest bearing government securities classified under HTM should be recognized on redemption of the investments.
- viii) Profit and loss on sale of investments should be shown under Profit/Loss on sale of investments.

CLASSIFICATION NORMS RELATING TO NON PERFORMING ASSETS

ACCOUNTS WITH TEMPORARY DEFICIENCY

- (a) Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statements. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.
- (b) The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.
- (c) A working capital borrowing account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory
- (d) The accounts where regular/ad hoc credit limits have not been reviewed / renewed within 180 days from the due date / date of ad hoc sanction, the account should be treated as NPA.

UPGRADATION OF LOAN ACCOUNTS CLASSIFIED AS NPAs

If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs. The accounts should no longer be treated as non-performing and can be classified as 'standard' accounts.

ACCOUNTS REGULARIZED NEAR ABOUT THE BALANCE SHEET DATE

The asset classification of borrowal account where a solitary or a few credits are recorded before the balance sheet date should be verified properly and without scope for subjectivity. Where the account indicated inherent weakness on the basis of the data available, the account should be deemed as a NPA.

ASSET CLASSIFICATION TO BE BORROWER-WISE AND NOT FACILITY-WISE

All the facilities granted by a bank to a borrower will have to be treated as NPA and not the particular facility or part thereof which has become irregular.

ADVANCES UNDER CONSORTIUM ARRANGEMENTS

Asset classification of accounts under consortium should be based on the record of recovery of the individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and / or where the bank receiving the remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of the other member banks and therefore, be treated as NPA. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

ACCOUNTS WHERE THERE IS EROSION IN THE VALUE OF SECURITY

- i) A NPA need not go through various stages of classification in cases of serious credit impairment and such assets should be straightaway classified as doubtful or loss asset as appropriate. Erosion in the value of security can be

reckoned as significant when the realizable value of the security is less than 50 percent of the value assessed by the bank or accepted by RBI as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

- ii) If the realizable value of the security, as assessed by the bank/approved valuers / RBI is less than 10 percent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

ADVANCES AGAINST TERM DEPOSITS, NSCS, KVP/IVP, ETC.

Advances against term deposits, NSCs eligible for surrender IVPs, KVPs and life policies need not be treated as NPAs. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.

LOANS WITH MORATORIUM FOR PAYMENT OF INTEREST

In the case of bank finance given for industrial project or for agricultural plantations etc. where moratorium is available for payment of interest, payment of interest becomes 'due' only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence do not become NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.

In case of housing loan or similar advances granted to staff members where the interest is payable after recovery of principal, interest need not be considered as overdue from the first quarters onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of interest on the respective due dates.

AGRICULTURAL ADVANCES AFFECTED BY NATURAL CALAMITIES

Master Circular issued by RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Bank may decide on their own relief measures, viz, conversion of the short term production loan into term loan or re-schedulement of the repayment period and the sanctioning of fresh short term loan, subject to the guidelines contained in RBI's latest Master Circular on Prudential Norms. In such case, the NPA classification would be governed by such rescheduled terms.

ADVANCES UNDER REHABILITATION APPROVED BY BIFR/TLI

Banks are not permitted to upgrade the classification of any advance in respect of which the terms have been re-negotiated unless the package for re-negotiation terms has worked satisfactorily for a period of one year.

POST SHIPMENT SUPPLIER'S CREDIT

Where the credit extended by banks are guaranteed by EXIM Bank, the extent to which payment has been received from EXIM bank on guarantee the advance may not be treated as NPA.

GOVERNMENT GUARANTEED ADVANCES

The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked.

Advances sanctioned against State Government guarantees should be classified as NPA in the Normal Case.

TAKE-OUT FINANCE

Under this arrangement, the institution/the bank financing infrastructure projects have an arrangement with any financial institution for transferring to the latter the outstanding in respect of such financing in their books in a pre-determined basis. The norms of asset classification have to be followed by the concerned bank/financial institution in whose books the account stands as balance sheet item as on the relevant date. If the lending institution observes that the asset has turned NPA on the basis of the record of recovery, it should be classified accordingly. The lending institution cannot recognize income in accrual basis and account for the same only when it is paid by the borrower/taking over institution (if the arrangement so provides). The lending institution is required to make

provisions against any asset turning into NPA pending its takeover by taking over institution. As and when the asset is taken over by the taking over institution, the corresponding provisions could be made treating the account as NPA from the actual date of it becoming NPA though the account was not on that date in the books of taking over institution.

EXPORT PROJECT FINANCE

Where the actual importer has paid the dues to the bank abroad and the proceeds have not been made good to the bank granting finance due to any political reasons, such account need not be classified as NPA if the bank is able to establish through documentary evidence that the imported has cleared the dues in full. The account will however, have to be considered as NPA if at the end of one year from the date amount was deposited by the importer in the bank abroad, the amount has not still been remitted to the bank.

NET WORTH OF BORROWER / GUARANTOR OR AVAILABILITY OF SECURITY

Since income recognition is based on recoveries, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise. Likewise, the availability of security/guarantee is not relevant for determining whether or not an account is NPA.

PROJECT FINANCE UNDER MORATORIUM PERIOD

In case of bank finance given for industrial projects or for agricultural plantation etc. where moratorium is available for payment of interest, payment of interest becomes due only after the moratorium or gestation period is over, and not on the date of debit of interest.

ADVANCES TO STAFF

Interest bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment on interest on the respective due dates.

PROJECTS UNDER IMPLEMENTATION

Project under implementation need not be treated as NPA for 2 years from deemed date of completion of project but for time overrun > 2 years NPA irrespective of recovery record.

PRUDENTIAL NORMS ON INCOME RECOGNITION, ASSET CLASSIFICATION, PROVISIONING AND OTHER RELATED MATTERS

NON-PERFORMING ASSETS

An asset, including a leased asset, becomes non performing when it ceases to generate income for the bank.

- (i) Interest and/or instalment of principal remains overdue for a period of more than 90 days in respect of a term loan.
- (ii) The account remains 'out of order' as indicated below, in respect of an Overdraft/Cash Credit (CC),
- (iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- (iv) The instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops.
- (v) The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.
- (vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

- (vii) In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative control, if these remain unpaid for a period of 90 days from the specified due date for payment.
- (viii) Credit card account will be treated as non performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month.
- (ix) Banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

'OUT OF ORDER' STATUS

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance is the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits continuously for 90 days as on the date of Balance Sheet or credits are enough to cover the interest debited during the same period, these accounts should be treated as 'out-of-order'.

INCOME RECOGNITION ON NPA

INCOME RECOGNITION

- The policy of income recognition has to be objective and based on the record of recovery. Internally income from nonperforming assets (NPA) is not recognised on accrual basis, but is booked as income only when it is actually received. **Therefore, the banks should not charge and take to income account interest on any NPA.**
- However, interest on advances against term deposits, NSCs, IPs, KVPs and Life policies may be taken to income account on the due date provided adequate margin is available in the accounts.
- Fees and commissions earned by the banks as a result of renegotiations or rescheduling or outstanding debts should be recognized on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.
- If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

REVERSAL OF INCOME

- If any advance, including bills purchased and discounted, become Non-Performing Assets as at the close of any year, the entire interest accrued and credited to income account in the past period should be reversed or provided for if the same is not realized. This will apply to Government guaranteed advances also.
- In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in current period and should be reversed or provided for with respect to past periods, if uncollected.
- Further, in case of banks which have wrongly recognized income in the past should reverse the interest if it was recognized as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).



LEASED ASSETS

The finance charge component of finance income [as defined in 'AS 19 Leases' issued by the Council of ICAI] on the leased asset which has accrued and was credited to income account before the asset became nonperforming, and remaining unrealized, should be reversed or provided for in the current accounting period.

ON TAKE-OUT FINANCE

In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realized from the borrower/taking-over institution (if the arrangement so provides).

ON PARTIAL RECOVERIES IN NPAs

In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e. towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.

ASSET CLASSIFICATION OF NPA

ASSET CLASSIFICATION

The banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing and the realizability of the dues:

1. **SUB-STANDARD ASSETS:** Substandard asset would be one, which has remained NPA for a period less than or equal to 12 months
2. **DOUBTFUL ASSETS:** If it remained in the sub-standard category for 12 months
3. **LOSS ASSETS:** A Loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection, but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuances as bankable assets is not warranted although there may be some salvage or recovery value.

UPGRADATION OF LOAN ACCOUNTS CLASSIFIED AS NPAs

If arrears of interest and/ instalment are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts.

CORPORATE DEBT RESTRUCTURING

RESTRUCTURING OF CASES

RBI has given the revised guidelines for treatment of restructured accounts by its circular. The auditor should verify compliance with the requirement of the circular issued in this regard. Once the bank receives an application/proposal in respect of an account for restructuring, it implies that the account is intrinsically weak. Thereby during the time the account remains pending for restructuring, the auditors need to take a view whether provision needs to be made in respect of such accounts pending approval for restructuring.

UPGRADATION OF ACCOUNT

The auditor should examine all the accounts upgraded during the year to ensure that the upgrading of each account is strictly in terms of RBI guidelines.

Auditor has to ensure that any upgrading of accounts classified as 'Sub-standard' or 'Doubtful' category wherein restructuring / rephasing of principal or interest has taken place should be upgraded to the 'Standard Asset' category only after a period of one year after the date when first payment of interest or of principal, whichever is earlier, falls due under the rescheduled terms, subject to satisfactory performance during the period. The total amount becoming due during this one year should be recovered and there should be no overdues to make it eligible for upgradation. If the amount which has become due during this one year period is on a lower side vis a vis total amount outstanding, the other aspects of the account, viz financial performance, availability of security, operations in account etc. should be reviewed in detail and only if found satisfactory, the account should be upgraded.

AUDIT PROCEDURE FOR ACCOUNTS FALLING UNDER CORPORATE DEBT RESTRUCTURING (CDR) PROGRAMME

Following audit procedures are to be carried out to assess/gain an undertaking about the borrower account:

- Review the present classification of the account adopted by the bank and corresponding provision made in the books of account, if any. If the account is already treated as NPA in the books of the bank, the same cannot be upgraded only because of the CDR package,
- Review the Debtor-Creditor Agreement (DCA) and Inter Creditor Agreement (ICA) with respect to availability of such agreements and necessary provisions in the agreement for reference to CDR cell in case of necessity, penal clauses, stand-still clause, to abide by the various elements of CDR system etc.
- Auditor has to ascertain the terms of rehabilitation along with the sacrifices, if any, assumed in the rehabilitation program to verify whether such sacrifices have been accounted in the books of account of the lender. Ascertain whether any additional financing / conversion of loan into equity have been envisaged in the rehabilitation / restructuring program.
- Auditor should also 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. Auditor has to verify the necessary approvals / recommendations by CDR core group if auditor comes across any BIFR cases.
- Auditor has to ensure that accounts wherein recovery suits have been filed, the initiative to resolve under CDR system is taken by atleast 75% of the creditors by value and 60% in number provided the account meets the basic criteria for becoming eligible under CDR mechanism.

SALE/PURCHASE OF NPAs

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

The auditor should also examine that:

- (i) Only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.
- (ii) The assets have been sold/purchased “without recourse” only
- (iii) Subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs
- (iv) The NPA has been sold at cash basis only
- (v) The bank has not purchased an NPA which it had originally sold.

In case of sale of an NPA, the auditor should also ensure that:

- (i) On the sale of the NPA, the same has been removed from the books of the account.
- (ii) The short fall in the net book value has been charged to the profit and loss account.
- (iii) Where the sale is for a value higher than the NBV, no profit is recognized and the excess provision has not been reversed but retained to meet the shortfall/loss on account of sale of other non-performing financial assets.

Similarly in case of purchase of NPAs, the auditor should verify that:

- (i) The NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank.
- (ii) Any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognized as profit.
- (iii) For the purpose of capital adequacy, banks has assigned 100% risk weights to the NPAs purchased from other banks.

Q1) Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. State your views on the following issues which were brought to your notice by your Audit Manager:

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

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

Answer:

(a) It is not a prudent practice to treat dividend on shares of corporate bodies and units of mutual funds as income unless these are actually received. Accordingly, income from dividend on shares of corporate bodies and units of mutual funds should be booked on cash basis. In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a State government. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9 as well. In the instant case, therefore, the recognition of income by the bank on accrual basis is not in order.

(b) The bank is a consortium member of cash credit facilities of Rs. 50 crores to X Ltd. Bank's own share is Rs. 10 crores only. During the last two quarters against a debit of Rs. 1.75 crores towards interest, the credits in X Ltd's account are to the tune of Rs. 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

Q2) What is the income recognised in the case of 'non-performing' assets of bank?

Answer: Income Recognition:

As per the master circular issued by RBI relating to Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, the banks may book income in the following manner:

- (i) Income from NPAs is not recognised on accrual basis but is booked as income only when it is actually received. However, interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.
- (ii) Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.
- (iii) If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Q3) Describe the procedure for verification of the following balances appearing in the account books of a bank:

(a) Drafts paid without advice

(b) Branch adjustment account

Answer:

(a) Drafts Paid Without Advice: This balance is in the nature of a suspense account in as much as it represents payments made on account of drafts issued by other branches but for which the relevant advice from those branches have not been received. It is, therefore, most important to examine the system of internal control operating in the bank in this respect. The testing of the internal control system has to be made mainly with regard to the following:

- (i) the system of verifying the authenticity of the draft by reference to specimen signature of the signing authority and the prima facie correctness and completeness of the draft in all respects;
- (ii) the system of co-relating drafts paid with advices subsequently received; and
- (iii) the system of sending reminders where advices are not received within a reasonable time and the recording of reasons for their non receipt.

The composition of the balances appearing in this account should be verified with particular reference to any long outstanding items. The auditor should also verify whether the items appearing in this account have been subsequently cleared on receipt of the relevant advices. It would also be useful to have on record the names and addresses of the payees of such drafts. The auditor may also seek confirmation of transactions relating to such outstanding cases.

(b) Branch Adjustment Account: In the final balance sheet of the bank, this balance represents the difference between inter branch debits and credits and should normally comprise items which are in transit as on the closing date. This account is the one which is most commonly used by unscrupulous persons in committing a fraud. The verification of this account is, therefore, of great importance. The procedure for verification is as follows:

- (i) See that all branch accounts are periodically reconciled.
- (ii) Check all adjustments in the account and ensure that the adjustments are done properly and supported by adequate documentary evidence as to its validity.
- (iii) Verify that reversal entries are made under proper authority and after due explanation and evidence.

Q4) As a branch auditor of a nationalised bank, how would you verify the following?

(a) Advances to DOT COM Companies.

(b) Balances in account of a bank situated in a foreign country.

Answer:

(a) Advances to DOT COM Companies

- (i) Evaluate the efficacy of internal control system in general to ascertain whether an advance is made only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance must specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment, etc. Also see that all the necessary documents, e.g., agreements, demand promissory notes, letters of hypothecation, etc. have been executed by the parties before advances are made.
- (ii) Examine loan documents such as certificate of commencement of business, resolution of board of directors, and resolution of shareholders.

- (iii) Verify the business plan of the company especially where the revenue model is in place. Verify whether the company depends only on outside funding or can self generate funds.
- (iv) Examine in case the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies.
- (v) Review the operation of advance account to see that limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.
- (vi) Examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the postbalance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into to identify any irregularities in these accounts.
- (vii) Review periodic statements, cash flow statements, latest financial statements, etc. to assess the recoverability of advances.
- (viii) Verify whether the advance is secured and determine whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with; whether the security is in the effective control of the bank; and to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.
- (ix) Ensure that proper provisioning norms have been applied in view of non-observance of terms, coupled with irregular payment of interest and default in repayment of instalments, if any.

(b) Balances in Account of a Bank situated in a Foreign Country

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

Q5) Write a short note on - Principal Enactments Governing Bank Audit.

Answer: Principal Enactments Governing Bank Audit:

There is an elaborate legal framework governing the functioning of banks in India. The principal enactments which govern the functioning of various types of banks are

- (i) Banking Regulation Act, 1949.
- (ii) State Bank of India Act, 1955.
- (iii) Companies Act, 2013.
- (iv) State Bank of India (Subsidiary Banks) Act, 1959.
- (v) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.
- (vi) Regional Rural Banks Act, 1976.

- (vii) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.
- (viii) Information Technology Act, 2000.
- (ix) Prevention of Money Laundering Act, 2002.
- (x) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
- (xi) Credit Information Companies (Regulation) Act, 2005.
- (xii) Payment and Settlement Systems Act, 2007.

Besides, the above enactments, the provisions of the Reserve Bank of India Act, 1934, also affect the functioning of banks. The Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

Q9) What are the exceptions to the general rule of treating advances as Non-performing Assets (NPAs)?

Answer: Non-performing Assets:

RBI has laid down norms for classification of assets and provisioning norms for NPAs. However, certain exceptions to these norms are discussed below

- (i) **Temporary deficiencies**, e.g., non availability of current drawing power due to nonreceipt of latest stock statement, temporary delay in renewals of limits on due date, etc.
- (ii) **Natural Calamities:** Where, in the wake of natural calamities, short-term agricultural loans are converted into term loans or there is rescheduling of repayment period or fresh short-term loans are sanctioned, the term loan as well as fresh short term loan may be treated as current dues and need not be classified as NPA.
- (iii) **Facilities Backed by Central Government Guarantees:** Credit facilities backed by guarantee of the Central Government though overdue should be treated as NPA only when the government repudiates its guarantee when invoked (this exemption is only for the purpose of asset classification and provisioning and not for the purpose of recognition of income).
- (iv) **Advances to “On Lending” arrangements** are also exempted under this category.

Q10) Write a short note on - Vostro and Nostro Accounts.

Answer: Vostro and Nostro Accounts:

Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign currency accounts maintained by Indian banks at other overseas centres are designated by it as “Nostro Account”. For example, all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian office as Nostro Account. “Vostro Account” is the opposite of Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/ correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example, a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination, may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts.

The auditor should also verify whether prescribed procedure in relation to inter bank confirmation in the Vostro account is followed or not. In case balance confirmation certificate have been received but the same have not been reconciled, or where confirmation has not been received the same should be reported, in respect of each Vostro Account.

Q11) How would you verify “Acceptances, Endorsements and other obligations” appearing in the Balance Sheet of a bank?

Answer: Acceptances, Endorsements and Other Obligations:

This item includes the following balances

- (a) letters of credit opened by the bank on behalf of its customers and
- (b) bills drawn by the bank's customers and accepted/endorsed by the bank.

Letters of credit: Evaluate the adequacy of the internal controls over LC Forms e.g. custody, maintenance of records, periodical verification, reconciliation etc.

Verify the balance of LC from the Register maintained by the bank to ascertain the amount of LC and payments made under them.

Examine the guarantees of the customers, copies of the LC issued & security obtained for issuing LC.

In respect of other acceptances and endorsements the following procedure may be adopted:

- (i) Examine the arrangements made by the bank with its customers.
- (ii) Test check the amounts of bills with the register maintained by the bank.
- (iii) Verify whether such bills are marked off in the register on payment at maturity.

Letters of comfort: Where letters of comfort has been issued, verify whether the bank has incurred a potential financial obligation under such a letter. If an obligation has been cast under letters of comfort, ensure that the amount has also been shown as contingent liability in the Balance Sheet.

Q12) Briefly explain the disclosure requirement of Contingent Liabilities for Banks.

Answer: Contingent Liabilities for Banks:

The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet.

- (a) Contingent liabilities
 - (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
 - (1) In India.
 - (2) Outside India.
 - (v) Acceptances, endorsements and other obligations.
 - (vi) Other items for which the bank is contingently liable.
- (b) Bills for collection.

Q13)

(a) What do you understand by Long-form Audit Report?

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

Answer

(a) Long Form Audit Report: The long form Audit Report 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 Reserve Bank of India.

The LFAR is to be submitted before 30th June every year. To ensure timely submission of LFAR, proper planning for completion of the LFAR is required. While the format of LFAR does not require an executive summary to be given, members may consider providing the same to bring out the key observations from the whole document.

(b) Audit of Advances of a Bank: The items to be covered in the concurrent audit of advances of a bank are as follows

- (i) Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and at the appropriate level).
- (ii) Verify whether the sanctions are in accordance with delegated authority.
- (iii) Ensure that securities and documents have been received and properly charged/ registered.
- (iv) Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, renewal of limits, etc.
- (v) Verify whether there is any mis utilisation of the loans and whether there are instances indicative of diversion of funds.

- (vi) Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.
- (vii) Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.
- (viii) Ensure proper follow-up of overdue bills of exchange.
- (ix) Verify whether the classification of advances has been done as per RBI guidelines.
- (x) Verify whether the submission of claims to DICGC and ECGC is in time.
- (xi) Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been got confirmed or ratified at the required level.
- (xii) Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

Q14) How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank?

Answer: Evaluation of Internal Control System in the area of Credit Card Operations in a bank:

- (i) There should be effective screening of applications with reasonably good credit assessments.
- (ii) There should be strict control over storage and issue of cards.
- (iii) There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.
- (iv) There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.
- (v) Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.
- (vi) All the reimbursement (gross of commission) should be immediately charged to the customer's account.
- (vii) There should be a system to ensure that statements are sent regularly and promptly to the customer.
- (viii) There should be a system to monitor and follow-up customers' payments.
- (ix) Items overdue beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.
- (x) There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.

Q15)

(a) While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention?

(b) How do you examine claims against the Bank not acknowledged as debts?

Answer:

(a) Special Points to Examine Inter Branch Adjustments: The following points require special attention in the examination of Inter Branch transactions

- (i) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding in appropriate cases.
- (ii) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.
- (iii) Whether the balances include any items in the nature of cash in transit included in this head which remain pending for more than a reasonable period. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.
- (iv) Whether transactions other than those relating to inter branch transactions have been included in inter branch accounts. Any unusual items put through inter branch accounts as well as old or large entries outstanding in Inter branch accounts should be carefully looked into. The auditor should also seek explanations from the Management in this regard in appropriate cases.

(b) Examination of Claims against the Bank not Acknowledged as Debts: The auditor should examine the relevant evidence, for example correspondence with lawyers, claimants, workers/officers and workmen's/officer's unions. The auditor should also review the minutes of the meeting of the Board of directors/committees of the Board, contracts,

agreements and arrangements, list of pending legal cases and correspondence relating to taxes, duties etc., to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of previous year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

Q16) Write a short note on reversal of income under bank audit.

Answer: Reversal of Income:

If any advance, including bills purchased and discounted, becomes NonPerforming Assets as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

Q17) “An asset, including a leased asset, becomes non-performing when it ceases to generate income for the Bank.” Define the criteria for classification of non-performing assets.

Answer: Classification of Non-Performing Assets:

An asset, including a leased asset, becomes nonperforming when it ceases to generate income for the bank.

The following criteria are to be applied for determining the status of various types of credit facilities:

- (a) **Term Loans:** A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days.
- (b) **Cash Credits and Overdrafts:** A cash credit or overdraft account is treated as NPA if it remains out of order as indicated above.
- (c) **Bills Purchased and Discounted:** Bills purchased and discounted are treated as NPA if they remain overdue and unpaid for a period of more than 90 days.
- (d) **Securitisation:** The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.
- (e) **Agricultural Advances:** A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.
- (f) **Credit Card Accounts:** RBI vide its Circular on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Credit Card Accounts” advised that a credit card account will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month.

Q18) As a bank branch auditor, what aspects will be considered while reporting on credit appraisal, sanctioning /disbursement and documentation in respect of advances in the LFAR?

Answer: Verification of Advances in the Long Form Audit Report (LFAR): The auditor has to comment on various specific issues as mentioned in the Long Form Audit Report of the bank. While evaluating the efficacy of internal controls over advances, the auditor should particularly examine those aspects on which he is required to comment in his long form audit report.

Thus, he should examine

- (i) Whether the loan applications are complete and in prescribed form;
- (ii) Procedural instructions regarding grant/ renewal/ enhancement of facilities have been complied with;
- (iii) Sanctions are within delegated authority and disbursements are as per terms of the sanction;
- (iv) Documentation is complete; and supervision is timely, effective and as per prescribed guidelines.

The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the branch management in appropriate cases.

The auditors must familiarise themselves with those issues and guidance relating to the same and should cover the same during the regular course of audit of advances.

Q19) As a Statutory Auditor, how would you verify advances against Goods?

Answer: Verification of Advances against Goods (Banking Companies):

- (i) **Sanction:** Examine the sanction letter, letter of hypothecation and note the important terms and conditions of the advances.
- (ii) **Stock statements:** Verify the quantity and value of goods hypothecated based on the stock statements received from the borrower. Test check the Godown Register and examine the valuation of goods to ascertain the reasonableness of the same.
- (iii) **Inspection:** Ascertain as to whether the premises of the borrowers are periodically visited by the bank officials to verify the quantity as per the periodic stock statements.
- (iv) **Stock Audit:** See whether the bank has got a system of obtaining stock and receivables audit report in respect of such advances. If so, review the stock audit report and identify adverse comments, if any.
- (v) **Hypothecation/Pledge:** Examine the letter of hypothecation and certificate of registration of charge, in respect of goods pledged with the bank.
- (vi) **Insurance:** Examine the insurance policies for their validity, adequacy etc. and see that policies are in favour of the bank.
- (vii) **Documents of title:** Inspect the documents of title to goods like bill of lading, dock warrant, railway receipts etc to ensure that they are endorsed registered in favour of the bank.
- (viii) **Third party certificate:** Where the hypothecated goods are in possession of third parties, such as clearing and forwarding agents, transporters, bankers, etc. undertaking has been obtained by the bank that they will handover the goods or sale proceeds thereof to the bank only. In such cases, certificate should be obtained by the bank from such third parties regarding quantities on hand, on balance sheet date. The valuation of such goods should be checked by the auditor.

Q20) While doing the audit of a nationalized bank, your Audit Assistant informed you that there are a lot of irregularities in Telegraphic Transfers and Demand Drafts. What guidance would be given to the Audit Assistant?

Answer: In respect of Telegraphic Transfers and Demand Drafts, the audit assistant would be given the following guidance:

- (i) The bank should have a reliable private code known only to responsible officers of its branches, coding and decoding of telegrams should be done only by such officers.
- (ii) The signatures on a demand draft should be checked by an officer with the Signature Book.
- (iii) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.
- (iv) If the paying branch does not receive proper confirmation of any T.T. or D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.

Q21) Shy & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2016. In the audit planning, the partner of Shy & Co. observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose. He needs your assistance in incorporating the criteria prescribed for determination of NPA norms in respect of agricultural advance, in audit plan.

Answer: NPA Norms in respect of Agricultural Advance:

A loan granted for short duration crops will be treated as Non Performing Asset, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

As per the guidelines, "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops. The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him.

The above norms should be made applicable to all direct agricultural advances as listed in the Master Circular on Lending to Priority Sectors. In respect of all other agricultural loans, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.

If natural calamities impair the repaying capacity of agricultural borrowers, banks may decide on their own as a relief measure conversion of the short-term production loan into a term loan or re-schedulement of the repayment period; and the sanctioning of fresh short-term loan, subject to guidelines issued by RBI.



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