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Audit of Banks

18.1 – Legal and Regulatory Framework

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;
- SARFAESI Act, 2002;
- Credit Information Companies Regulation Act, 2005; and
- Payment & Settlement Systems Act, 2007

Authority appointing the Auditors

- Auditor of a banking company is appointed at AGM of shareholders.
- Auditor of a nationalised bank is appointed by concerned bank acting through its Board.
- In either case, approval of the RBI is required before the appointment is made.
- Auditors of SBI are appointed by CAG in consultation with C.G.
- Auditors of RRBs are appointed by the concerned bank with approval of C.G.

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.

Contents of Audit Report

- In case of nationalised bank, the auditor is required to make a report to the C.G. in which the auditor should state the following:
1. Whether, in the auditor's opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank.
 2. In case the auditor had called for any explanation or information, whether it has been given and whether it is satisfactory.
 3. Whether or not the transactions of the bank, which have come to the auditor's notice, have been within the powers of that bank.
 4. Whether or not the returns received from the offices & branches of the bank have been found adequate for the purpose of audit.
 5. Whether the profit and loss account show a true balance of profit or loss for the period covered by such account.
 6. Any other matter which the auditor considers should be brought to the notice of the Central Government.

18.2 – Conducting Bank Audit

Requirements of Risk Management System	
1	<p>Involvement of TCWG</p> <p>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.</p>
2	<p>Identification, Measurement & Monitoring of Risks</p> <p>Risks that may significantly affect the achievement of bank's goals and objectives should be identified, measured and monitored.</p>
3	<p>Control Activities</p> <p>Banks must have controls including the following:</p> <ul style="list-style-type: none"> • effective segregation of duties, • verification and approval of transactions, • setting of limits, • reporting and approval of exception.
4	<p>Monitoring Activities</p> <p>Risk mngt models, methodologies and assumptions used to measure and manage risk need to be evaluated by Independent risk management unit.</p>
5	<p>Reliable Information System</p> <p>Must exist so as to provide adequate financial, operational and compliance information on a timely and consistent basis to management and TCWG.</p>

Need for Special Audit Considerations
<p>Special audit considerations arise in the audit of banks because of:</p> <ol style="list-style-type: none"> 1. particular nature of risks associated with financial transactions undertaken by banks; 2. voluminous scale of banking operations and the resultant significant exposures which can arise within short period of time; 3. extensive dependence on IT for process of transactions; 4. various statutory and regulatory requirements; and 5. the continuing development of new products and services and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices.

Special considerations in CIS Environment
<ol style="list-style-type: none"> 1. Ensure that date available for processing is authorised, accurate and complete. 2. Ensure that unauthorised amendments to the programmes are being prevented. 3. Ensure that access & authorisation rights given to staff are appropriate. 4. Ensure that bank charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised. 5. Verify whether exceptional transaction reports are being authorised & verified on a daily basis by the concerned officials. 6. Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system. 7. Ensure that balance in general ledger tallies with the balance in subsidiary book. 8. 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. Check that the anti-virus software of latest version is installed in servers/PCs of branches to prevent data corruption. 10. Ensure that access to computer room is restricted to authorised persons only.

Stress Testing
<ul style="list-style-type: none"> • All commercial banks (excluding RRBs) shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems. • Stress tests are designed to understand whether a bank has enough capital to survive adverse economic conditions and to maintain enough buffer to stay afloat under extreme scenarios.

Basel III Framework
<ul style="list-style-type: none"> • Basel III norms relate to the Capital Adequacy requirement compliance which the Bank has to achieve as contained in the BASEL III accord. • It is global regulatory standard on capital adequacy of banks, stress testing as well as market liquidity risk. • Basel III accord strengthens the regulation, supervision and risk management of the banking sector and aims at: <ol style="list-style-type: none"> (a) improving the banking sector's ability to absorb shocks arising from financial and economic stress, irrespective of reasons thereof; (b) improving risk management and governance practices; and (c) strengthening banks' transparency and disclosure standards.

18.3 – Internal Control Procedures

General Controls	Demand Drafts
<ol style="list-style-type: none"> (1) The staff and officers of the bank should be shifted from one position to another frequently and without prior notice. (2) The work of one person should be checked by another person. (3) A responsible officer should be given possession of demand drafts, cheque books etc. (4) The signature book should be kept with a responsible officer. (5) The bank should take insurance policies against loss and employee's infidelity. (6) The management structure should be clearly drawn and rights and duties should be properly understood. 	<ol style="list-style-type: none"> (1) The signatures on a DD should be checked by an officer with the Signature Book. (2) All the D.Ds. issued by a branch should be immediately confirmed by the advices to the paying branch. (3) If the paying branch does not receive proper confirmation of any 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. <div style="text-align: center; background-color: yellow; border: 1px solid black; padding: 5px; margin-top: 10px;"> <p style="color: red; font-weight: bold;">Compiled by: CA. Pankaj Garg</p> </div>
Bills for Collection	Bills Purchased
<ol style="list-style-type: none"> (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. 	<ol style="list-style-type: none"> (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.
Loans and Advances	Credit Card Operations
<ol style="list-style-type: none"> (1) Evaluation of Customer creditworthiness. (2) Sanctioning by proper authority. (3) Execution of Necessary Documents. (4) Keeping Sufficient Margin. (5) Safe custody of securities held. (6) Registration of charges in favour of bank. (7) Inspection of securities on regular basis. (8) Determination of market value of securities. (9) Adjustment in drawing power with decrease in value of assets. (10) Reporting of Irregular accounts to Head office (11) Review of accounts on timely basis. 	<ol style="list-style-type: none"> (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.

18.4 – Verification of Investments

Audit Procedure

1	Internal control evaluation	<ul style="list-style-type: none"> To ensure they are in accordance with RBI Guidelines. Investment policy must confirm to RBI Guidelines.
2	Separation of Investment Functions	<ul style="list-style-type: none"> Own investment account needs to be separated from PMS client accounts. As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors.
3	Examination of Reconciliation	<ul style="list-style-type: none"> Examine the reconciliation of the investment account.
4	Examination of Documents	<ul style="list-style-type: none"> To ensure that investments made are within authority and supported by documentation.
5	Physical verification	<ul style="list-style-type: none"> 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 year end 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.
8	Examination of Classification and Shifting	Examine whether the shifting of the investments from “Available for sale” to “Held to maturity” is duly approved by the Board of Directors of the bank.

Special Purpose Certificates

Central Auditors are required to issue following certificates:

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

Income Recognition Norms

1	Performing Investments	Accrual basis provided interest rate is predetermined.
2	Non-performing Investments	Realisation Basis
3	Govt. Guarantee	Accrual basis, provided interest is serviced regularly.
4	Dividend	Accrual basis, if right to receive dividend is established.
5	Units of Mutual Funds	Cash Basis

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18.5 – Verification of Advances (Part I)

General Audit Procedure	
1.	<p>Evaluation of Internal Control</p> <p>(a) Examine the loan documentation, validity of the recorded amounts; and existence, enforceability and valuation of the security;</p> <p>(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;</p> <p>(c) Review the operation of the accounts.</p>
2.	<p>Substantive Audit Procedure</p> <ul style="list-style-type: none"> • 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.	<p>Examination of Recoverability</p> <p>(i) Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.</p> <p>(ii) Review latest financial statements of borrowers.</p> <p>(iii) Review reports on inspection of security.</p> <p>(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.</p>

Audit Procedures in Special Cases	
1.	<p>Asset Classification</p> <ul style="list-style-type: none"> • 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. • Where it appears that an account has inherent weakness and few credits near the balance sheet tries to make it regular, the account should be classified as NPA. If 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. • Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower, the auditor should carefully assess whether the repayment was out of genuine sources or not.
2.	<p>Drawing Power (DP) Calculation</p> <ul style="list-style-type: none"> • 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.	<p>Limits not reviewed</p> <ul style="list-style-type: none"> • 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.	<p>Govt. guaranteed Advances</p> <ul style="list-style-type: none"> • 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.	<p>Agricultural Advances</p> <ul style="list-style-type: none"> • 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.

18.5 – Verification of Advances (Part II)

Verification of Provision for NPA

- Study the latest Master Circular of RBI to get familiarise with the norms prescribed by RBI.
- Provisioning norms as laid down in master circular should be construed as minimum provisioning requirements & wherever a higher provision is warranted, 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 secured & 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

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 account, 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 account of the lender.
- (e) Ascertain whether any additional financing/conversion of loan into equity have been envisaged in 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 & 60% in number.

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 2 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 non-performing 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.

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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.

18.6 – Verification of Other Items

Money at Call and Short Notice
<p>(a) Verify whether there is a proper authorisation, general or specific, for lending of the money at call or short notice.</p> <p>(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.</p> <p>(c) Verify the call loans with the certificates of the borrowers and the call loan receipts held by the bank.</p> <p>(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.</p> <p>(e) Examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end.</p>

*Compiled by:
CA. Pankaj Garg*

Inter-office Adjustments (Branch Adj. Accounts)
<p>(a) Examine origin and validity of old outstanding unmatched entries, particularly debit entries.</p> <p>(b) Whether there are any reversal entries indicating the possibilities of irregular payments or frauds.</p> <p>(c) Examine whether the balances include any items in nature of cash-in-transit, which remain pending for more than a reasonable period.</p> <p>(d) Whether transactions, other than those relating to inter-branch have been included in inter-branch accounts.</p> <p>(e) The auditor may also seek explanations from the management for old outstanding unmatched entries and transactions other than inter branch transactions.</p>

Contingent Liabilities	
Disclosure requirements as per 3rd Schedule	<ol style="list-style-type: none"> (1) Claims against the bank not acknowledged as debts. (2) Liability for partly paid investments. (3) Liability on account of outstanding forward exchange contracts. (4) Guarantees given on behalf of constituents- In India & Outside India. (5) Acceptances, endorsements and other obligations. (6) Other items for which the bank is contingently liable.
Verification Aspects	<ol style="list-style-type: none"> (1) Ascertain existence of adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so. (2) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations. (3) Perform substantive audit tests to establish the completeness of the recorded obligations. (4) 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. (5) Obtain representation from the management that all contingent liabilities have been disclosed. (6) Ensure Compliance of AS 29, "Provisions, contingent liabilities and contingent assets".
Claims against the bank not acknowledged as debt	Guarantees
<ul style="list-style-type: none"> • 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. 	<ul style="list-style-type: none"> • 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.

18.7 – 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.

Long Form Audit Report

- 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.

Concurrent Audit

Meaning	<ul style="list-style-type: none"> ✓ 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	<p>Concurrent audit should cover the following:</p> <ol style="list-style-type: none"> (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. <p>In addition, bank should ensure the coverage of following:</p> <ol style="list-style-type: none"> (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	<ul style="list-style-type: none"> ✓ Daily cash transactions with reference to abnormal receipts and payments. ✓ Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. ✓ Verification of advances, OD, CC, term loans, bills purchase, LC etc. Procedure for sanction & documentation to be verified. ✓ Verification of Foreign exchange transactions. ✓ Verification of ledgers, inter branch reconciliation & verification of interest, discount, commission. ✓ Revenue leakage. ✓ Verification of high value transactions. ✓ Procedure for safe custody of security forms with branch. ✓ Ensure adequacy of procedures for tax deduction at source. ✓ Verification of returns, statements, calculation of capital adequacy ratio and compliance with RBI Guidelines. ✓ Study of RBI and Internal Inspection reports, statutory auditor's report and compliance thereto.
Focus points in verification of Foreign Exchange Transactions	
<ol style="list-style-type: none"> 1. Check foreign bills negotiated under letters of credit. 2. Check Foreign Currency Non-Resident and other non-resident accounts to ensure that only permissible transactions route through these accounts. 3. Check whether inward/outward remittance have been properly accounted for. 4. Examine extension and cancellation of forward contracts for purchase and sale of foreign currency. Ensure that they are duly authorised and necessary charges have been recovered. 5. Ensure that the overbought/oversold position maintained in different currencies is reasonable considering the foreign exchange operations. 6. Ensure compliance of the guidelines issued by RBI/HO of the bank. 7. Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank. 8. Verify transactions of Nostro and Vostro account and their reconciliation statements. 	

Compiled by:
CA. Pankaj Garg