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HANDBOOK ON BANK AUDIT

FOR C.A. FINAL STUDENTS

EDITION - 2

CA NITESH KUMAR MORE

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This Book is dedicated to:

- ✓ MAA; who gave me darshan after SHAKTI PEETH PUJA at PANCHMUKHEE BALAJI DARBAR & PANCHMUKHEE BALAJI.
- ✓ My Gurus Sri Ramesh Chachan and Sri Sanjay Agarwal
- ✓ My Parents and All Family Members

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Preface to the FIRST Edition

Dear Friends,

The study material of the ICAI is like a bible. This book is not a substitute for study material. This book has been prepared to provide students a tool for systematic revision. The salient features of the book are:

- ✓ Case Studies.
- ✓ Tabular Presentation.
- ✓ Point wise Presentation (For Quick Revision Before Exams)
- ✓ Important Words – Bold (For Quick Revision Before Exams)
- ✓ Past Exam Questions with Marks and Years.
- ✓ Latest RBI Guidelines (July 2012) & Latest Court's Decision.
- ✓ Questions and Answers from Latest Revision Test Papers (RTP).

My special thanks to Abhishek Bathwal (A CA Final Student), for providing valuable support for the publication.

I look forward for your valuable suggestions and criticism, if any.

Thanks and Warm Regards,

Dated: 29th July 2012
Place: Kolkata

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About The Author:

CA NITESH KUMAR MORE

- ✓ Author of 4 Books: Handbook on Professional Ethics, Handbook on SA, Handbook on Bank Audit, Advanced Auditing And Professional Ethics.
- ✓ Is a Co-opted Member of Company Law Committee of ICAI (EIRC)
- ✓ Has been a Co-opted Member of Permanent Research Committee of ICAI (EIRC).
- ✓ Had been a Co-opted Member of Research Committee of ICAI (EIRC)
- ✓ Has been a Co-opted Member of Internal Audit Committee of ICAI (EIRC)
- ✓ Is a moderator of India's 1st Google Group with Expert Panels On Various Subjects (Member Strength of more than 20,000 Professionals)
- ✓ Is An Editor of Newsletter "Professional Updates"
- ✓ Is a Advisory Board Member of HiRise Business Solutions Private Limited
- ✓ Provided Live Updates of EIRC, ICAI Elections 2012, Railway Budget, Union Budget To Members Jointly with www.shivampublications.webs.com
- ✓ Has Contributed/Written more than 35 Write-ups/ Article in various magazines such as the Management Accountant, Suchitra Times, EIRC Newsletter, EIRC Members Ready Referencer, EIRC Conference, DTPA Conference etc.
- ✓ Executive Committee Member of Panchmukhi Balajee Darbar, Siliguri
- ✓ He is Providing Services to Many Corporate and Other Clients.
- ✓ Presented a Paper on Recent Changes in Direct Tax at CA Student Conference held at Kolkata.
- ✓ Stood 1st in Quiz Contest held at ICAI (Kolkata).
- ✓ Winner of 'Essay Writing Contest' organized by ICAI (EIRC).

LIST OF ABBREVATIONS USED IN THIS BOOK

AGM	Annual General Meeting	**JA**	Joint Auditors
AS	Accounting Standard	**JV**	Joint Ventures
BOD	Board Of Directors	**MD**	Managing Director
CAAT	Computer Assisted Audit Techniques	**MIS**	Management Information System
CAG	Comptroller & Auditor General Of India	**MRL**	Management Representation Letter
CG	Central Government	**NPA**	Non Performing Assets
CIS	Computer Information System	**NTE**	Nature Timing And Extent
CLB	Company Law Board	**PAC**	Public Account Committee
CR	Control Risk	**PFI**	Prospective Financial Information
DD	Due Diligence	**PRB**	Peer Review Board
DR	Detection Risk	**PSU**	Public Sector Unit
DSS	Decision Support System	**PU**	Practice Unit
DSS	Electronic Data Interchange	**QC**	Quality Control
EP	Engagement Partner	**RAP**	Risk Assessment Procedures
ESB	Ethical Standard Board	**SA**	Standard On Auditing
FRF	Financial Reporting Framework	**SG**	State Government
FS	Financial Statements	**SQC**	Standard On Quality Control
FY	Financial Year	**SR**	Special Resolution
GAAP	Generally Accepted Accounting Principles	**TCWG**	Those Charged With Governance
GIC	General Insurance Company	**W.E.F**	With Effect From
GM	General Meeting	**W.R.T**	With Regard To
IC	Internal Control	**WTD**	Whole Time Director

INDEX OF CHAPTERS IN BOOK

1. AUDITS OF BANKS

11.1 Principal Enactments Governing Bank Audit

The principal enactments which govern the functioning of various types of banks are:
i) Banking Regulation Act, 1949
ii) StateBankofIndiaAct,1955
iii) Companies Act, 1956
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) SARFAESI Act, 2002
xi) Credit Information Companies Regulation Act, 2005
xii) Payment and Settlement Systems Act, 2007
Besides, the above enactments, the provisions of the RBI 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.

11.2 Special Features of Banks

i) Custody of **Large Volume** of Monetary Item.
ii) Large Volume and **Variety** of Transactions.
iii) Wide Network of Branches and Departments.
iv) Off-Balance Sheet items (no entry like guarantees etc.)
v) Regulated by Government authorities.

<u>11.3 Books And Accounts</u> - A banking company is required to maintain the books of account in accordance with section 209 of the companies act, 1956. The main **characteristic of a bank's system** of book keeping are as follows.
i) Entries in personal ledger made **directly** from the vouchers instead of being posted from books of prime entry.
ii) The **vouchers** entered into different personal ledgers each day are summarized on a **summary sheet** and the totals of which are posted to control account in general ledger.
iii) The **general ledger trial balance** is extracted and agreed every day.
iv) All entries in the personal ledger and summary sheet are **checked** by persons other than those who have made the entries.
v) A **trial balance of detailed personal ledger** is prepared **periodically** and agreed with general ledger control account.
vi) Except for cash transactions, always **two vouchers** are prepared for each transaction, one for debit and other for credit.

<u>Principal Books of Account:</u> The following are the principal books of account maintained.
i) General ledger
ii) Profit and loss ledger
iii) Personal ledger divided as current accounts, savings accounts, other deposit accounts, loan accounts etc.
iv) Bills register divided as bills purchased, inward bills for collection, outward bills for collection etc.
v) Other subsidiary ledgers
vi) Departmental journal to note transfer entries passed by it.
vii) Memoranda books like receiving cashier's cash book, paying cashier's cash book, clearing book etc.

<u>11.4 Form and Content of Financial Statements</u> - Sub-section (1) of sec. 29 requires every banking company to prepare a B/S and a P/L account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.

<u>i) Form A Of The Third Schedule To The Banking Regulation Act, 1949, Contains The Form Of Balance Sheet.</u>

a. Capital and Liabilities (5 heads)
• Capital • Reserve and Surplus • Deposits • Borrowings • Other liabilities and provision
b. Assets (6 heads)
• Cash and Balance with R131 • Balance with Banks and money at call and short notice.
• Investment • Advances • Fixed Assets • Other assets
c. Contingent Liabilities and Bills for collection (aggregate amount to be shown on face of Balance sheet and details by way of a note).

<u>ii) Form B Contains The Form Of Profit And Loss Account</u>

a. Income - • Interest Earned • Other Income
b. Expenditure - • Interest expended • Operating expenses • Provision and Contingencies
c. Profit / Loss - • Net profit (loss) for the year • Profit / Loss brought forward
d. Appropriations - • Transfer to Statutory Reserve • Transfer to other Reserves • Transfer to Government / Proposed Dividend • Balance carried over to B/S.

<u>iii) Other Disclosures</u> - In addition to the disclosures to be made in the balance sheet and profit and loss account in pursuance of the requirements of the Third Schedule to the Act, the RBI has directed to disclose some other information specified by RBI by way of notes on accounts. This information has been given in Annexure II to this chapter.

<u>iv) Notes and Instructions Issued by Reserve Bank of India</u> - The RBI has issued notes & instructions for compilation of B/S and P/L A/C. These notes and instructions provide an authoritative interpretation of the requirements of Third Schedule to the Act and are thus useful in preparation of FS of banks. Notes & instructions are reproduced as Annexure II.

<u>v) Requirements of Banking Regulation Act, 1949, vis a vis Companies Act, 1956 –</u>
The requirements of the Companies Act, 1956, relating to the B/S and P/L A/C of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the B/S or P/L A/C, as the case may be, of a banking company.

<u>vi) Signature</u> - FS of a banking company incorporated in India to be signed by manager / principal officer and by at least 3 directors that of foreign Banking Company to be signed by Manager / Agent of the Principal Office in India.

<u>11.5 Audit of Accounts</u>

<u>i) Appointment of Auditor</u>

a. Auditor of Banking Company to be appointed at **AGM of shareholders** wherein fee is also determined. Prior approval of RBI is required. Auditor of nationalized Bank is appointed by **BOD**. Prior approval of RBI is required. Fee is determined by RBI in consultation with CG.
b. Auditor of **subsidiaries of SBI** as well as their remuneration is decided by SBI.
c. Auditor of **SBI** and their remuneration by RBI in consultation with Government.
d. RRB's auditors and their fee determined by Bank concerned with approval of CG.

ii) Auditor's Report
a. For Nationalized Bank - Report to CG stating:
• Whether Balance Sheet is full and properly drawn up and True and Fair View.
• Whether Transactions of Banks are within their powers.
• Whether Returns received from offices and branches of Banks are adequate.
• Whether P & L account shows true balance of profit or loss.
b. For Banking Companies - In addition to reporting u/s 227, also to state whether -
• Information and Explanations are satisfactory.
• Transactions of company are within power of company.
• Returns received from branches are adequate.
• P&L show true balance of profit or loss.
• Any other matter to be brought to notice of the share holders of the company.
c. Long Form Audit Report (LFAR) - Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks as well as their branches, require the auditors to also furnish a LFAR. The **matters** which the banks require their auditors to deal with in the long form audit report have been **specified by the RBI**.

11.6 Conducting A Bank Audit - The stages of audit of a bank are:
i) Initial consideration by the Statutory Auditor
ii) Identifying and Assessing the Risks of Material Misstatements
iii) Understanding the Bank and Its Environment including Internal Control
iv) Understand the Bank's Accounting Process
v) Understanding the Risk Management Process
vi) Engagement Team Discussions
vii) Establish the Overall Audit Strategy
viii) Develop the Audit Plan
ix) Audit Planning Memorandum
x) Determine Audit Materiality
xi) Consider Going Concern
xii) Assess the Risk of Fraud including Money Laundering
xiii) Assess Specific Risks
xiv) Risk Associated with Outsourcing of Activities
xv) Response to the Assessed Risks
xvi) Stress Testing
xvii) BASEL II framework.

11.7 Internal Controls
i) General Controls
a. The **staff and officers** of the bank should be shifted from one position to another frequently and without prior notice.
b. The work of one person should be **checked** by another person.
c. A responsible officer should be given **possession of demand drafts**, cheque books etc.
d. The **signature book** & telegraphic code book should be kept with a responsible officer.
e. The bank should take **insurance policies** against loss and employee's infidelity.
f. The **management structure** should be clearly drawn and rights and duties should be properly understood.

ii) Cash
a. Cash should be kept in **joint custody** of at least two responsible officers.
b. Surprise checking should be conducted.
c. The **cashier** should **not have access** to customer's ledger accounts and the day book.
d. Payments should be made only after the **vouchers** are **passed** by a proper officer.

e. Receipt and payment **scrolls** (**memoranda books** maintained by the cashier) should be compared with the cash column of the day back by an independent person.
f. The limits on the **payment powers** of the teller should be laid out.

iii) Constituent's Ledger
a. Before making payment, cheques should be **checked** in respect of signature, date, balance on hand and should be passed by a proper officer.
b. No withdrawals should normally be allowed against clearing cheques deposited on the same day.
c. Ledger keepers should **not** have **access** to voucher **summary sheets**.
d. Interest debited or credited to constituents' account should be independently checked.

iv) Bills for Collection
a. All **documents** accompanying the bill should be received and entered in the register by a proper officer.
b. The **accounts** of the principals should be credited only after realization of the bill.
c. It should be ensured that bills sent by one branch to **another branch** for collection are not included twice in the amalgamated balance sheet.

v) Bills Purchased
a. At the time of purchase of the bills, an officer should verify that all **documents of title** are properly assigned to the bank.
b. Sufficient margin should be kept while purchasing or discounting of a bill.
c. All irregular **outstanding accounts** should be periodically reported to the head office.
d. In case of purchase or discounting of a bill, **proportionate income** should be recognized between the periods.

vi) Loans and Advances
a. The bank should make advances only after critical assessment of borrower's **credit worthiness.**
b. All necessary **documents** should be duly executed by parties before advancing of loan.
c. Sufficient **margin** should be kept against security offered.
d. Securities requiring registration should be **registered** in banks name.
e. Surprise inspection of hypothecated goods should be conducted.
f. 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.
g. All the accounts which exceed the **sanctioned limit** or are against unapproved securities should be brought to the notice of the head office.
h. Periodical review of operation of the account is important.

vii) Telegraphic Transfers and Demand Drafts
a. The bank should have a reliable **private code** known only to responsible officers.
b. The signature on the **demand draft** should be checked with the signature book.
c. All the **telegraphic transfers** and demand drafts sold by a branch should be immediately confirmed by the advices to the branch concerned.
d. 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.

viii) Credit Card Operations
a. There should be effective **screening** of applications with reasonably good credit assessment.
b. There should be **strict control** over storage and issue of credit cards.

c. The system whereby the merchant confirms the **unutilized balance** of the customer with the bank before accepting payment should be properly installed.
d. There should be a system of prompt reporting by the merchants of all **settlements** accepted by them through credit cards.
e. All the **reimbursements** should be immediately charged to the customer's account.
f. Items **overdue** beyond a reasonable period should be identified & attended to carefully.
g. There should be a system of **periodic review** of credit card holder's accounts.

11.8 Verification And Valuation Of Assets And Liabilities
i) Cash; Bank Balances and Money at Call and Short Notice –
a. Cash
• The auditor should count the **balance** of cash on hand.
• **Physical verification** of cash at branch offices should also be conducted at or near the year end.
• There should **not be any cash movement** till the counting is completed.
• Verify physical balance with the **denomination book**.
• **Foreign currency notes** should be verified by actual inspection and should be converted at market rate prevailing on the closing day.

b. Balance with Reserve Bank of India
• Verify ledger balance with **confirmation certificate** from RBI.
• Review the **reconciliation statement**.
• **Special attention** should be given to: Cash transactions remaining un-responded, Revenue items requiring adjustment, Old outstanding balances remaining un-responded for over one year.

c. Balances with Bank (other than Reserve Bank of India) - Apart from procedures described above special attention should be given to:
• **Large transactions** towards the **end of the year** to check any window dressing.
• Examination of old **unadjusted transactions**.

d. Money at Call and Short Notice – The Auditor should check:
• Proper **system of authorization** available for lending money at call and short notice.
• **Certificate** of the borrowers and the call loans receipts held by the bank.
• Whether **balances** as per call loan register agrees with Control A/c in general ledger.
• **Call loans** made by bank should not be **netted off** against call loans received.

Cash Reserve - One of the important determinants of cash balances to be maintained by banking companies and other scheduled banks is the requirement for maintenance of a **certain minimum cash reserve**. While the requirement for maintenance of cash reserve by banking companies is contained in the Banking Regulation Act, 1949, corresponding requirement for scheduled banks is contained in the Reserve Bank of India Act, 1934.

Statutory Liquidity Ratio - Section 24 of the Banking Regulation Act, 1949 requires that every banking company shall maintain in India in cash, gold or unencumbered approved securities an amount of which shall not, at the close of business on any day, be less than **such percentage** not exceeding forty, as the RBI may from time to time specify, of the **total of its demand and time liabilities in India** as on the last Friday of the second preceding fortnight. This is referred to as 'statutory liquidity ratio'.

ii) Investments -
a. Investments in India in - • Government securities • Other approved securities • Shares • Debentures and Bonds • Subsidiaries and/or joint ventures • Others

b. Investments outside India in - • Government securities (including local authorities) • Subsidiaries and/or joint ventures abroad • Other investments (to be specified)

The Following Are Some Of The Terms Which Are Commonly Used In Relation To Investments Of Banks:

a. Approved Securities - Section 5(a) of the Banking Regulation Act, 1949 defines 'approved securities' to mean securities in which a trustee may invest money under clauses (a) to (d) and (f) of section 20 of the Indian Trusts Act, 1882. Approved securities comprise primarily the securities issued or guaranteed by the **CG or SG,** or any other security expressly authorized by the CG by notification in the official gazette.

b. Bank Receipt (BR) - Bank receipt is **acknowledgement from the selling bank** to the buying bank that the former has received payment for certain securities, which it will deliver within a certain time. BR is non-transferable and can be issued by banks and certain specified institutions only.

c. Collateralized Borrowing and Lending Obligation - CBLO is a **discounted instrument** available in **electronic book** entry form for the maturity period ranging from one day to ninety days (can be made available up to one year as per RBI guidelines).

d. Government Security - A government security is an instrument **issued** by the CG or SG, which is redeemable after a fixed period and may either, is coupon bearing or issued at discount to face value.

e. Liquidity Adjustment Facility (LAF) - A **monetary tool** used by the RBI for injecting liquidity or absorption of the liquidity from the banking system. The LAF is operationalised through Repo and Reverse Repo.

f. Negotiated Dealing System (NDS) - It is an electronic platform for **facilitating dealing** in Government Securities and Money Market Instruments. It is **closed user** group network **open only** for its members.

g. NDS OM - Negotiated Dealing System (RBI-NDS-GILTS-Order Matching Segment), NDS-OM for short, is an electronic order matching **trading module for Government securities** on its Negotiated Dealing System.

h. Portfolio Management Scheme (PMS) - In a portfolio management scheme, the bank administering the scheme makes **investments on behalf** of clients for a 'management fee'. This is a fiduciary activity in which the profit or loss from the transactions belongs to the client.

i. Prudential Exposure Limits - The RBI from time to time **prescribes the limits** up to which investments in any one type of security or in any industry group or in any one company/group of companies, etc, can be made by a bank. These limits are known as "Prudential Exposure Limits".

j. Ready-forward Transactions or Repo - Ready-forward or Repo transactions are **arrangements** for current sale of securities and their simultaneous **re-purchase at a future date at a price fixed** at the time of sale. From the viewpoint of the other party, the transaction involves current purchase and subsequent resale of the securities concerned.

k. Repo Constituents' SGL Account (RC SGL Account) - A SGL account of a bank maintained with RBI with authorization to RBI to act as **custodian on its behalf**, where the securities delivered by RBI under Repo is **held.**

l. Reverse Ready-forward Transactions or Reverse Repo - Reverse Ready-forward or Reverse Repo transactions are arrangements for **current purchase** of securities and their **simultaneous re-sale** at a future date at a price fixed at the time of purchase.

m. Reverse Repo Constituents' SGL Account (RRC SGL Account) - A SGL account of a bank **maintained with RBI** with authorization to RBI to act as **custodian** on its behalf, where the securities to be delivered to RBI under Reverse Repo is **held**.

n. Subsidiary General Ledger (SGL) - This is a ledger maintained by the Public Debt Office (PDO) of RBI in which accounts of different banks are maintained regarding their **holding** of select government securities. On a purchase or a sale of the securities, the transaction is **recorded** when the purchasing bank sends to PDO the Subsidiary General Ledger Form (SGL Form), **signed on behalf** of both the transferor and the transferee banks. In case the transaction is transacted at NDS, the CCIL, as central counter party, issues instructions to debiting/crediting of the SGL accounts with PDO. **PDO acts like a depository** in respect of government securities.

o. Treasury Bills - Treasury bills are government securities representing obligations, which **mature in one year or less** and are **issued at a discount** to the face value.

p. Yield-to-Maturity (YTM) - This is the average annual compound rate of return on a security (taking into account both the interest and the redemption value), which the investor will earn **if he holds** it **till maturity**. YTM rates are put out by the PDAI/FIMMDA at periodical intervals.

Audit Procedures

a. Internal Control Evaluation and Review of Investment Policy - The auditors should familiarize themselves with the **instructions issued by the RBI** regarding transactions in securities. They should **review the investment policy** of the bank to ascertain that the policy conforms, in all material respects, to the **RBI's guidelines** as well as to any **statutory provisions** applicable to the bank.

b. Separation of Investment Functions -The auditor should also examine whether the bank, as required by the RBI, is maintaining **separate accounts** for the investments made by it on their own Investment Account, on PMS clients' account, and on behalf of other constituents (including brokers).

c. Examination of Reconciliation -The auditor should examine the reconciliation of the **investment account**, **physically verify** the securities on hand, **obtain confirmations** from counter-party banks for BRs issued by such banks and on hand, obtain confirmation of SGL balances with the PDO, and examine the control and reconciliation of BRs issued by the bank.

d. Examination of Authority - The auditor should ascertain whether the investments made by the bank are within its **authority.** In this regard, the auditor should examine whether the legal requirements governing the bank, in so far as they relate to investments, have been complied with and the investments made by the bank are **not ultra vires** the bank.

e. Physical Verification - The auditor should verify the **investment scrips** physically at the close of business on the date of the balance sheet. Investments are normally dealt with

at the **head office** and not at the branches. However, sometimes, for realization of interest etc., and other similar purposes, some of the investment scrips may be held at branch offices. In such cases, the auditor should examine the **records** maintained at the head office to record details of scrips held at other locations and request the respective branch auditors to physically verify such scrips as a part of their audit. The auditor should obtain a **written confirmation** to this effect from the branch auditors.
In case the investment scrips are held at an **unaudited branch**, the auditor should request the management to obtain the scrips at the head office for his examination.
In respect of scrip less dealings in investments through the **OTC Exchange of India**, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository organization.

f. Examination of Valuation - Investments in securities now-a-days constitute a **substantial part** of total assets of many banks. The auditor should examine whether the **method** of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate.

g. Dealings in Securities on Behalf of Others - Apart from making investments on its account, a bank may also **deal in securities** on behalf of its customers only with the **prior approval from RBI**. These activities of banks are in the nature of trust or fiduciary activities.

h. Examination of classification and shifting - The auditor should examine whether the shifting of the investments from available for sale to hold to maturity is duly **approved by the BOD** of the bank. The auditor should also ensure the **compliance of the RBI guidelines**, issued from time to time, in this regard.

Classification Of Investments - The classification should be **determined at the time of acquisition** of such securities, and the decision should be **recorded** on the **investment proposal**.

i) Basics

- Banks should frame suitable Investment policy.
- Classification of Investment: **a.** Held to maturity **b.** Available for Sale **c.** Held for Trading
- Disclosure in account is same as present 6 categories.

a) Held To Maturity (HTM)

- Intention Basis.
- **HTM < 25**% of Banks total Investment.
- Following not to be Covered /Counted for 25%
  - → Re-capitalization Bonds from govt. of India.
  - → Investment in subsidiary & Joint Venture.
  - → Investment in Debenture/Bonds if deemed to be in nature of advance i.e.
    - If issued for project finance (3 Yrs. or more)
      Or
      If issued for working capital finance (less than 1 yr.)
      and
    - Banks stake is 10% in issue.
      and
    - Issue is part of private placement.
- Profit on sale of such Investment is to be taken to P&L account & thereafter to Capital Reserve account. Loss to P&L account.
- Carried at acquisition cost. If acquisition Cost is more than face value there amortise the premium. Recognize permanent diminution.

b) Held For Trading

• Intention to trade for short term price/Interest rate gain
• To be sold within 90 Days
• Profit or loss on sale to P&L account
• Marked to Market at Monthly/Frequent intervals.

c) Available For Sale

• If not in above 2 categories.
• Profit or Loss on sale to P/L A/c.
• Valuation → individually script-wise Marked to Market at quarterly/frequent interval.
• Fall in value to be provided (appreciation ignored for this purpose) Debit to P&L A/c & equivalent amount to be transferred from Investment Fluctuation Reserve account to P&L account.

Investment Fluctuation Reserve (IFR)

• Banks are required to create IFR at **minimum 5%** of investment within **5** years (only w.r.t. held for trading and available for sale) and Maximum **up to 10%** of Portfolio (only w.r.t held for trading and available for sale)
• Transfer maximum amount of gains realised on sale of Investment in Securities to Investment Fluctuation Reserve (IFR)
• IFR is eligible for inclusion in Tier-2 Capital.
• Transfer to IFR as appropriation to net Profit "below line" after statutory Reserve.

Shifting Among Categories of I

• To/from HTM → Approval of BOD. Shifting can take place once a year at beginning of year.
• From AFS to HFT → with approval of BOD / ALCO/ Investment Committee.
• From HFT to AFS → Generally not allowed only in **exceptional** situation with permission of BOD / ALCO (asset liability committee) / Investment Committee.
• Transfer at least of acquisition Cost/ Book value/ Market value on date of Transfer.

Income Recognition on I

• Accrual Basis on securities, if guaranteed by Central govt.
• Otherwise, if owner's right is established.
• From mutual funds, on cash Basis.

Broken period Interest - Banks not to capitalize BPI paid to seller as part of cost but treat as expenses in P&L account.

iii) Loans and Advances

No banking company can make any loans or advances on the security of its own shares. It also **cannot grant** loans and advances to or on behalf of:
• Any of its directors • Firm in which any of its directors are interested as a partner, manager, employee or guarantor. • Any company in which any of its directors is a director, manager, employee, guarantor or holds substantial interest. • Any individual in respect of whom the director is a partner, guarantor or employee.

Audit of Advances - In carrying out audit of advances, the auditor is primarily concerned with satisfying himself that:
• All advances have been **correctly recorded** in the books. • The basis of **Valuation** of advances and securities is appropriate and applied uniformly and consistently. • The **disclosure** requirements and **guidelines** laid down by the RBI have been complied with.

Evaluation of Internal Control System - Evaluation of the internal control system over advances helps the auditor in determining the nature timing and extent of substantive procedures. Internal Control over advances includes the following:
• All Advances are made after proper assessment of the **creditworthiness** of the applicant.
• All advances are properly **authorized.**
• All necessary **documents** (e.g. agreements, demand promissory notes, letter of security etc.) should have been executed and properly filed. Along with these documents, the auditor should also examine the following documents.

a. In case of a company, the certificate of incorporation, MOA & AOA
b. In case of a partnership firm, the partnership deed.
c. The letter of intent to provide security against advance advances, documents evidencing ownership of security by the borrower/guarantor and documents creating charge on such assets in favour of the bank.
• The auditor should also examine the sufficiency of **margin** of securities provided to the bank.

Verification of Advances - Advances normally form the **largest item** on the assets side of the balance sheet of a bank and is a major source of income to the bank. Therefore, verification of advance is an important function of an auditor of a bank. The auditor should be well equipped regarding documentation, valuation and provisioning of advances. He should look into the following points while undertaking verification of advances for banks.
a. Checking of Advances - The auditor shall review the **following** about all major advances • Quarterly information submitted by borrowers. • Periodic securities statements. • Financial statements of borrowers. • Reports of inspection of stocks • Auditors report in case of borrowers enjoying credit limits of Rs.10 lacs and above for working capital form the banking system.
b. Priority Sector Advances - While examining these advances, the auditor may carry out a **test check of each category** (substandard, doubtful etc) as mentioned in point (vi) in respect of each type of such advance. He should also examine whether appropriate steps have been taken for lodging of claims for guarantees in accordance with the applicable procedure.
c. Consortium Advances - The auditor should examine • Compliance with the limits stipulated by the consortium in lending money to borrowers. • Follow-up with lead banks on pending issue.
d. Checking of Statements and Sanctions - Statements of cash credits, over-drafts, packing credit furnished by the bank should be verified not only with the statements and supporting records but also with sanctioned terms and conditions.
e. Scrutiny of Customers Accounts - Check the balances as shown in the schedule of loans and advances with the ledger accounts. In the event of certain adverse features like over-drawn account, nonpayment of the installments etc., auditor should scrutinize the account with the extreme care. The auditor should particularly look into those accounts where balance at the yearend is brought down by showing repayments and fresh advances are granted immediately in the next year.
f. Classification of Advances and Provisioning for Bad & Doubtful debts - The auditor is also required to satisfy himself regarding the adequacy of provisions made for the different categories of advances as per RBI guidelines discussed in 11.11.
g. Interest Calculations - The auditor should satisfy himself that interest is being charge on all **performing accounts regularly**. He should compare the **rate** of interest with the agreement and the sanction. Calculation of interest should be test checked.
h. Verification of Securities - Shares, quantity of goods hypothecated, weight of ornaments and bullion, assignment of Life Insurance Policy, Fixed Deposit receipts, mortgage deeds and other documents etc held as Security should be **verified physically**. Where the security is not in the effective **possession** of the bank the auditor should verify whether the bank had adequate **legal documents** to take effective possession. The **Valuation** for each of the above should be checked from **market quotations**, invoices, surrender value, architect’s certificates etc as is applicable to see whether it is adequate to cover the advances.
i. Inspection of Godowns - Check Balances in **Stock reports** with the balance in Godown Registers in the case of pledge accounts. Test check **valuation** of goods report old slow moving and non-moving stocks. Ensure pledged goods are under lock and key of the bank and also see that goods are properly insured against theft fire, riot, strike etc.

j. Disclosure Requirements - The auditor should also ensure that advances are classified in the balance sheet in accordance with the Third Schedule to the Banking Regulation Act 1949.

k. Certain Important Areas - Some Common Points for Verification of Loans Are

• 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.

1. 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.

2. 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, cheek procedures to be applied by the bank • Policy documents to be checked.

3. Additional points w.r.t. Loan against Stock Exchange securities - • physically check confirmation from Depository Participant. • Market values of securities to be checked
• Advance would be against fully paid shares • Advance against shares which are on lending list of bank.

4. Additional points w.r.t. Loan Against pledge /hypothecation of goods - • 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 banks policy for advances against the same.

iv) Fixed Assets - The fixed assets have to be classified into **two categories** viz, premises and other fixed assets. In carrying out an audit of fixed assets, an auditor is primarily concerned about their existence and valuation. The audit procedure generally comprises of following activities:

• The auditor should satisfy himself about the **authorization procedures**, control system and documentation with regards to construction, acquisition, and disposal of fixed assets.
• In case of leasehold premises, capitalization and amortization of lease premium, if any, should be examined.
• In case the **title deeds** are held at head office or some other location, the auditor should obtain written representation from branch management and should bring this fact to the notice of central auditor.
• The auditor should examine the **classification of expenditure** on computer software. The software essential for the functioning of the hardware should be classified as part of related hardware. Application software should be treated as intangible asset.

v) Other Assets - The following assets are disclosed under this head:
• Inter Office Adjustments (Net). • Interest Accrued. • Tax Paid In Advance / Tax Deducted At Source. • Stationery and Stamps. • Non Banking Assets Acquired In Satisfaction of Claims. • Others.

The Audit Procedure With Regard To Other Assets Is Considered Below:

Inter Office (Inter Branch) Adjustments: The main transactions between offices of a bank include bills sent by one branch to another for collection, demand drafts, travelers cheques, remittance of cash for one branch to another, etc. The procedure for verification is

as follows:
• See that all the **inter office accounts** are periodically reconciled.
• Examine that the **adjustments** in respect of all amounts are reasonable and supported by adequate documentary evidence as to their validity.
• Ensure that **reversal entries** are made under proper authority and after due explanation and evidence.
• Enquire into items that remain **unadjusted** for a very long time.

vi) Capital - Any **increase** in the authorized capital can be verified from the shareholders resolution and memorandum of association. An **increase** in subscribed and paid-up capital should be verified with reference to prospectus, reports from registrars to the issue, bank statement, etc.

vii) Reserves and Surplus - The auditor should verify the **opening balance** of various reserves with reference to the audited balance sheet of previous year. Any increase or decrease should be verified with reference to **board resolution**. In case of the statutory reserve and share premium, compliance with **legal requirements** should be also verified.

viii) Deposits - The auditor should verify various types of deposits in the following manner:
a. Current Account: The auditor should ensure that **debit balances** are not set off against credit balances on current account. He should also pay special attention to inoperative accounts which are common areas of frauds.
b. Saving Accounts: The auditor should verify that the **total of subsidiary ledger** balances tallies with control account in general ledger. The calculation of interest should be checked on sample basis.
c. Term Deposits: The auditor should satisfy himself about the proper **custody** of unused deposit certificates and that they are issued serially. The auditor should verify the **counterfoils** of deposit certificates with the relevant register.
d. Deposits designated in foreign currency: The auditor should examine the **rates used** for converting them into Indian rupees. It should be noted that interest accrued but not due should be shown under other liabilities and not under deposits.

ix) Borrowings - The auditor may verify the borrowings in the following manner:
a. Borrowings from **R.B.I**. may be verified from the confirmation certificate from R.B.I
b. Rediscounting of bills is **not shown** under this head.
c. Borrowings of money at **call and short notice** should be examined for proper authorization and reasonableness of the terms and conditions.

x) Other Liabilities and Provisions - The following items are disclosed under this head.
a. Bills Payable **b.** Inter Office Adjustments **c.** Interest Accrued but not Due **d.** Others

The auditor may verify the above items in the following manner:-
Bills Payable - Bills Payable include demand drafts, telegraphic transfers, and travelers' cheques, issued by the bank but not presented for payment till the Balance Sheet date. The auditor is generally concerned with • the existence of adequate control system regarding issuance and payment of these bills; and • Old outstanding entries for payment of bills for which no advice has been received.
Inter Office (Inter Branch) Adjustments - The balance of inter office adjustments accounts, if in credit are to be shown under this head.
Others (Including Provisions) - The following items are included under this head:
• Net provision for tax • Surplus in aggregate in provisions for bad and doubtful debts provision account. • Surplus in aggregate in provision for depreciation in securities.

• Contingency funds which are in the nature of provisions but are not disclosed as such.
• Provisions towards standard assets. • Proposed dividend/transfer to Government.

xi) Contingent Liabilities - In case of Contingent liabilities, the Auditor should generally follow the audit procedure given below:
• Examine the system of authorization and internal controls relevant to contracts giving rise to Contingent Liabilities • Ascertain the maintenance of adequate record. • Perform substantive test to establish completeness of recorded obligation. • Obtain representation from the management that all the Contingent liabilities have been identified, quantified and do not include items likely to result in a loss.

The Procedure to Verify the Various Elements of Contingent Liabilities:
i) Claims against the Bank Not Acknowledged as Debt - • Examine external evidences like Correspondence with Lawyers, claimants etc. • Review the minutes of board meetings. • obtain representation from the management about the status of such claims. • Review the subsequent events.

ii) Liability on Partly paid Shares - Examination of Certificates of investment is the best procedure to ascertain such liabilities.

iii) Liability on outstanding Forward Exchange Contracts - The auditors may verify these liabilities with the registers maintained and copies of broker's advice notes.

iv) Guarantees given on behalf of Constituents - • 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 customer's etc. • the auditor should ascertain that unused guarantee forms are in proper custody. • Substantive test of guarantees given may be performed through the guarantee register.

v) Acceptances, Endorsements and other Obligations - These include letters of credit issued and bills discounted or purchased by the bank. The audit procedure should involve evaluation of internal control system and verification of the relevant registers and copies of letter of credit issued.
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:
• 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.
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.
vi) Bills for Collection - These are to be shown at the foot note of the Balance Sheet. The audit Procedure should involve: • Verification of the bills for collection on hand.
• Examination of Collections subsequent to Balance sheet date. • Examination of Procedure for recognition of income on such services. Income should be recognized only of collection of the bills.

11.9 Concurrent Audit - "Audit or verification of transactions or activities of an organization concurrently as the transaction or activity takes place."
i) It is early warning system for timely detection of irregularities
ii) It is done on regular Basis.
iii) Mandatory for Banks to cover at least:
• 50% of total deposits & • 50% of total advances
iv) Following should be considered:
• Large / very Large branches • Special branches • Large problem branches • H.O. department dealing with treasury/funds management & handling Investment Portfolio • Any other branch/department at discretion of bank
v) It can be undertaken by internal inspection staff or independent C.A.

Objectives of Concurrent Audit - Its objective is to see whether transactions or decisions are within the policy parameters laid down by H.O., they don't violate instructions of RBI & they are within authority.

Scope/Areas of Concurrent Audit
i) Cash
• Any abnormal receipts and payments • Proper accounting of cash remittances
• Proper accounting of cash receipts • Expenses by cash involving sizeable amount.
ii) Investment
• Purchase and sale of securities within its delegated power. • Securities held in the books of the branch are physically held by it. • Investments are as per RBI's guidelines. • Sale or purchase transactions are done at beneficial rates.
iii) Deposits
• Check the transactions about deposits received and repaid. • Test check of interest paid on deposits. • Check new accounts opened.
iv) Advances
• Ensure that loans and advances have been sanctioned properly. • Whether the sanctions are as per delegated authority. • Securities and documents have been received and properly charged. • Post disbursement supervision and follow-up is proper or not. • Whether the letters of credit issued by the branch are within the delegated power. • Check the bank guarantees issued. • Proper follow-up of overdue bills of exchange. • Verify classification of advances. • Verify that instances of exceeding delegated powers have been promptly reported to controlling / Head Office.
v) Foreign Exchange
• Check foreign bills • Whether inward/outward remittance have been properly accounted for. • Check extension and cancellation of forward contracts for purchase and sale of foreign currency. • Ensure that balances in Nostro accounts in different foreign currencies are within the limit. • Ensure adherence to the guidelines issued by RBI. • Ensure verification/reconciliation of Nostro and Vostro account.
vi) Housekeeping
• Ensure maintenance and balancing of accounts. • Carry out a test check of calculations of interest, discount, commission and exchange. • Check the transactions of staff accounts.
• Detection and prevention of revenue leakage. • Check cheques returned/bills returned.
vii) Other Items
• Ensure that the branch gives proper compliance to the internal inspection/audit reports.
• Customer's complaints are dealt with promptly. • Verification of statements, returns, statutory returns.

Remuneration of auditor - It is fixed by bank.
Irregularities - Minor irregularities to be rectified on the spot. Serious irregularities reported to H.O. /Z.O.

Reporting - Proper reporting & at proper interval. Reported on 10^{th} of next month/quarter but flash report can be submitted immediately. Normally, the audit report should be divided in **three parts**. The **'first part'** should deal with major irregularities. The **'second part'** should deal with minor irregularities which have not been attended during the course of audit. The **'last part'** should deal with compliance with earlier reports. Before submission of the report the auditor should discuss the important issues on which he wishes to report with the branch manager and concerned officers.

11.10 Vostro & Nostro A/C

- Forex account **maintained by Indian Bank** at other **overseas centers** in NOSTRO.
- VOSTRO is **opposite** of NOSTRO, i.e. **foreign Bank** in another country **maintain** Indian rupees **with their Indian correspondent** local banks. E.g. German Bank maintaining VOSTRO in rupees with Indian Bank
- Check the **reconciliation.**
- Check **Internal controls** w.r.t. inward/outward messages
- Balance **confirmation** certificate to be received, from such another bank.

11.11 Audit Of Compliance With SLR Requirement - Statutory Central Auditor to **verify** compliance with SLR requirements on **12 odd dates** in **different months** of a financial year not being Fridays. Report is given to Management and RBI. Examination has 2 Aspects: **i)** Correctness of figures of **DTL** (Demand & Time Liabilities) on **reporting Friday** (last Friday of second preceding fortnight), **ii)** Maintenance of **liquid asset** on selected date.

11.12 Capital Adequacy

i) Meaning: It is a measure of the adequacy of an entity's capital resources in relation to its current liabilities and also in relation to the risks associated with its assets. An appropriate level of capital adequacy ensures that the entity has sufficient capital to support its activities and that its net worth is sufficient to absorb adverse changes in the value of its assets without becoming insolvent. For example, under BIS (Bank for International Settlements) rules, banks are required to maintain a certain level of capital against their risk-adjusted assets. All Indian scheduled commercial Banks (excluding RRB) & foreign Banks operating in India to maintain CA Ratio at a minimum of 9% (**Master Circular - Prudential norms for Capital Adequacy - Dated 2nd July, 2012**).

ii) Formula

$$\textbf{Capital Adequacy Ratio} = \frac{\text{Capital Funds}}{\text{Risk Weighted Assets \& off B / S Items}} \times 100$$

a. Tier I Capital = (Paid up capital + St. reserve + disclosed free Reserves) - (Equity investments in subsidiary + Intangible Assets + current & B/f loss)
b. Tier II Capital = It includes following i.e. undisclosed Reserve, General Provision & Loss reserves, Hybrid debt capital instruments & subordinated debt.
Tier II Capital can be maximum 100% of Tier I capital.
Various assets are taken after exposing to varying degrees of risk as specified.

11.13 Guidelines Of The Reserve Bank Of India On Asset Classification, Income Recognition, 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.
A non performing asset (NPA) is a **loan or an advance** where:
i) Interest and/or installment of principal remain **overdue for** a period of **more than 90 days** in respect of a term loan.

ii) An **Overdraft/Cash Credit** become NPA (out of order) in **following circumstances**:
• if the outstanding balance remains **continuously** in **excess of the sanctioned limit** or the drawing power, or • If there are **no credits** continuously for 90 days as on the balance sheet date or the credits are not enough to cover the interest debited during the same period.

iii) The **bill remains overdue** for a period of more than 90 days in the case of bills purchased and discounted.

iv) The installment of principal or interest thereon remains overdue for **two crop seasons** for **short** duration crops.

v) The installment 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 **securitization transaction** undertaken in terms of guidelines on securitization dated February 1, 2006.

vii) in respect of **derivative transactions**, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

viii) Any amount to be received remains overdue for a period of more than 90 days in respect of **other accounts**.

<u>Classification Norms Relating To NPAs</u>

<u>Temporary Deficiencies</u> – In The Matter Of Classification of Accounts with Temporary Deficiencies, Banks Have to Follow the **Following Guidelines**:
i) 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 statement. 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.

ii) The outstanding in the account based on **drawing power** calculated from stock statements older than three months is deemed as irregular.

iii) 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.

iv) 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.

<u>Classification of Advances</u> - The Guidelines Require Banks to Classify Their Advances into Four Broad Categories For The Purpose Of Provisioning As Follows:
<u>i) Standard assets</u> - A standard asset is one which does not disclose any problems and which does not carry more than **normal risk** attached to the business. Such an asset is not a non-performing asset.

<u>ii) Sub-standard assets</u> - With effect from March 31, 2005, a sub-standard asset is one which has remained **NPA** for a period less than or equal to **12 months**. In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full.

<u>iii) Doubtful assets</u> - With effect from March 31, 2005, an asset is classified as doubtful if it has remained in the **sub-standard category for a period of 12 months**. Such an asset has all the inherent weaknesses as in a doubtful asset and an added characteristic that the weaknesses make the collection or liquidation in full highly improbable or questionable.

<u>iv) Loss assets</u> - A loss asset is one where loss has been **identified by** • the bank • the internal or external auditors • the RBI inspection, but the amount has not been written off wholly.

<u>Upgradation of Loan Accounts Classified as NPAs</u> - If arrears of **interest and / installment are paid** by the borrower through genuine source, 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.

<u>Treatment of NPAs - Borrower-wise and not Facility-wise:</u>
i) In respect of a borrower having more than one facility with a bank, all the facilities granted by the bank will have to be treated as NPA and not the particular facility or part thereof which has become irregular.

ii) However, in respect of consortium advances or financing under multiple banking arrangements, each bank may classify the borrowal accounts according to its own record of recovery and other aspects having a bearing on the recoverability of the advances.

<u>Credit facilities Guaranteed by Central / State Government:</u> The credit facilities backed by guarantee of the C.G. though overdue should **not be treated as NPA.** This exemption from classification of government guaranteed advances as NPA is not for the purpose of recognition of income. From the year ended March 31, 2006, State Government guaranteed advance and investment in State Government guaranteed securities **would attract** asset classification and provisioning norms.

<u>Project Financing:</u> 'Project Loan' would mean any term loan which has been extended for the purpose of setting up of an economic venture. Banks must fix a Date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan / financial closure (in the case of multiple banking or consortium arrangements).For the purpose of Income Recognition and Asset Classification norms, all project loans may be divided into the following two categories; (i) Project Loans for infrastructure sector (ii) Project Loans for non-infrastructure sector. Detailed guidelines are given in Annex 9.In the case of bank finance given for industrial projects 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 NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.

<u>Provisioning for Loans and Advances</u> - The specific requirements of the Circular in respect of provisioning are as follows:
<u>i) Loss assets</u> - The **entire amount** should be **written off**. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

<u>ii) Doubtful assets</u> - The provisioning for doubtful assets under loans and advances is as under • **Full provision** to the extent of the **unsecured portion** should be made. In doing so, the realizable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. • In regard to the **secured portion**, provision may be made on the following basis, at **the rates** ranging from **20% to 100% of secured portion** depending upon the period for which the asset has remained doubtful.

Period for which the advance has been considered as doubtful	% of provision on secured portion
Up to 1 year	25%
More than 1 year and up to 3 years	40%
More than three years	100%

<u>iii) Sub-standard assets</u>
• A **general provision** of **15 percent** on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.
• The "unsecured exposures" which are identified as "substandard" would attract additional provision of 10%, i.e., a total of 25% on the outstanding balance. However, "unsecured exposures" in respect of infrastructure Loan accounts classified as sub-standard will attract a provisioning of 20% instead of 25%.

<u>iv) Standard Assets</u>
• Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:
~ Direct advances to agricultural and SMEs sectors at 0.25 per cent;
~ advances to Commercial Real Estate (CRE) Sector at 1.00 per cent;
~ Housing loans extended at 2% and
~ Restructured Advances***** as indicated below:
~ All other loans and advances not included above at 0.40 per cent
• It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning.
• The provisions on standard assets should not be reckoned for arriving at net NPA5.
• The provisions towards Standard Assets need **not be netted** from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions Others' in Schedule V of the B/S.

***<u>Restructured Advances</u>**
→ Restructured accounts classified as standard advances will attract a provision of 2 per cent in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract a provision of 2 per cent for the period covering moratorium and two years thereafter; and
→ Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2 per cent in the first year from the date of upgradation

<u>Income recognition in case of NPA</u> - In case if NPA, the interest is recognized when it is actually received and not on accrual basis except for advances secured by NSCs, IVPs, KVPs, and life Insurance policies having adequate margin.
<u>Provisioning for Certain Specific Types of Advances</u> - The **guidelines** also deal with provisioning for certain specific types of advances as follows:
<u>Advances Granted Under Rehabilitation Packages</u> - In respect of advances under rehabilitation package approved by BIFR/term lending institutions, banks are required to **continue with the provision** to be made in respect of dues to the bank on the existing credit facilities as per their classification as substandard or doubtful asset. As regards the

additional facilities sanctioned as per package finalized by BIFR and/or term lending institutions, **provision on additional facilities sanctioned** need **not be made** for a period of **one year** from the date of disbursement.

<u>Advances Guaranteed by ECGC</u> - In the case of advances guaranteed by ECGC, provision should be made only for the **balance in excess** of the amount of such **guarantee**. Further, while arriving at the provision required to be made for doubtful assets, realizable value of the securities should first be deducted from the outstanding balance in respect - of the amount guaranteed by these Corporations and then provision should be made.

<u>Advance covered by CGTSI (Credit Guarantee Fund Trust for Small Industries)</u> - In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in **excess** of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non- performing advances.

	Category of Standard Asset	**Rate Of Provisioning**
Standard Assets	Direct Advances to agricultural & SME	0.25%
	Commercial Real Estate Sectors(for UCBs)	1.00 %
	All other loans and advances not included above	0.40 %
Sub-Standard Assets	15 % of total O/S% + 10% on unsecured exposure	
Doubtful Assets	**Unsecured portion**	100 %
	Secured Portion:	
	< 1 year	20 %
	1 to 3 Year	30 %
	> 3 Years	100 %
Loss Asset		100%
Govt. guaranteed advance becomes NPA		Normal Provisions
Advance against TD, NSC KVP, LIP, IVP becomes NPA		Normal Provisions
Advance covered by ECGC/DICGC		Provision for Excess Only

<u>Restructuring/Re-Schedulement Of Loans {Including Under Corporate Debt Structuring (COR) Scheme}</u>

<u>Eligibility criteria for restructuring of advances</u> - Banks may restructure the accounts **classified** under 'standard', 'sub-standard' and 'doubtful' categories. Banks cannot reschedule / restructure / renegotiate borrowal accounts with retrospective effect. No account can be taken up for restructuring by the banks unless the **financial viability** is established and there is a reasonable **certainty of repayment** from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability **benchmarks determined** by them, which may be applied on a case by case basis, depending on merits of each case. The parameters may, for example, include: • Return on Capital Employed • Debt Service Coverage Ratio • Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance.

<u>Provisioning Norms</u> - Banks is required to hold provision against the restructured advances **as per the existing provisioning norms**.

Prudential Norms for Conversion of Principal into Debt/Equity

Asset Classification Norms - A part of the outstanding principal amount can be converted into debt or equity instruments as part of restructuring. The debt/equity instruments so created will be classified in the same asset classification category in which the restructured advance has been **classified**. • Income Recognition Norms • Standard Accounts
In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognized on accrual basis.
Non- Performing Accounts - In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognized only **on cash basis.**

Organizational Framework for Restructuring of Advances under Consortium/ Multiple Banking/ Syndication Arrangements

i) Corporate Debt Restructuring (CDR) Mechanism

A Corporate Debt Restructuring system has been evolved for restructuring of the corporate debts of viable entities facing problems, which are outside the purview of BIER, DRT and other legal proceedings. All the banks have been advised by RBI to follow the Corporate Debt Restructuring mechanism, which would be a **non-statutory voluntary system** based on debtor creditor agreement and inter creditor agreement. The RBI has issued **separate guidelines** in respect of debt restructuring for small and medium enterprises (SMEs).
The RBI has also suggested that in order to improve effectiveness of the CDR mechanism a clause may be incorporated in the loan agreements involving consortium/syndicate accounts whereby all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.
Corporate Debt Restructuring (CDR) would generally affect the **operations** both at Branch level as well as the Head office level, although, in most of the cases the effects of provisioning due to sacrifice in the interest would be made at the Head Office level.
One of the **main features** of the restructuring under CDR system is the provision of **two categories** of debt restructuring under the CDR system. Accounts, which are classified as 'standard' and 'substandard' in the books of the creditors, will be restructured under the first category (**Category 1**). Accounts which are classified as 'doubtful' in the books of the creditors would be restructured under the second category (**Category 2**).

ii) Debt Restructuring Mechanism for Small and Medium Enterprises (SMEs)

Apart from CDR Mechanism, RBI has also prescribed a separate scheme for restructuring of loans availed by Small and Medium Enterprises (SME5). This mechanism will be applicable to all the borrowers which have funded and **non-funded** outstanding up to Rs.**10 crore** under multiple/consortium banking arrangement. **Major elements** of this arrangement are as under:

• under this mechanism, banks may formulate, with the **approval** of **BOD**, a debt restructuring scheme for SMEs within the prudential norms laid down by RBI. Banks may frame different sets of policies for borrowers belonging to different sectors within the SME if they so desire.
• While framing the scheme, banks may ensure that the scheme is **simple** to comprehend and will, at the minimum, include parameters indicated in these guidelines.
• The main plank of the scheme is that the bank with the **maximum outstanding** may work out the restructuring package, along with the bank having the second largest share.
• Banks should work out the **restructuring package and implement** the same within a maximum period of 90 days from date of receipt of requests.
• The SME Debt Restructuring Mechanism will be **available to all borrowers** engaged in

any type of activity.
• Banks may **review** the progress in rehabilitation and restructuring of SMEs accounts on a quarterly basis and keep the Board informed.

11.14 Basel II - Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. Basel II, initially published in June 2004, was intended to create an international standard for banking regulators to control how much capital banks need to put aside to guard against the types of financial and operational risks banks (and the whole economy) face.

Basel II uses a **"three pillars**" concept – **(1)** minimum capital requirements (addressing risk), **(2)** supervisory review and **(3)** market discipline.

The First Pillar: Minimum Capital Requirements (Addressing Risk) - The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: **A.** credit risk, **B.** operational risk, **C.** market risk, and **D.** Other risks.

A. The credit risk component can be calculated in three different ways of varying degree of sophistication, **(a)** standardized approach, **(b)** Foundation IRB and **(c)** Advanced IRB. IRB stands for "Internal Rating-Based Approach".

B. For operational risk, there are three different approaches – **(a)** basic indicator approach, **(b)** standardized approach, and **(c)** the internal measurement approach.

C. For market risk the preferred approach is VAR (value at risk).

D. Other risks are not considered fully quantifiable at this stage.

The standardized approach sets out specific risk weights for certain types of credit risk. The standard risk weight categories used under Basel 1 were 0% for government bonds, 20% for exposures to OECD Banks, 50% for first line residential mortgages and 100% weighting on consumer loans and unsecured commercial loans. Basel II introduced a new 150% weighting for borrowers with lower credit ratings. The minimum capital required remained at 8% of risk weighted assets, with Tier 1 capital making up not less than half of this amount. Banks that decide to adopt the standardised ratings approach must rely on the ratings generated by external agencies. Certain banks used the IRB approach as a result.

The Second Pillar: Supervisory Review - The second pillar deals with the regulatory response to the first pillar, giving regulators much improved 'tools' over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. It gives **banks a power to review** their risk management system. Internal Capital Adequacy Assessment Process (ICAAP) is the result of Pillar II of Basel II accords.

The Third Pillar: Market Discipline - This pillar aims to complement the minimum capital requirements and supervisory review process by developing a set of disclosure requirements which will allow the market participants to gauge the capital adequacy of an institution.
Recent Development in India - RBI has issued a circular on prudential guidelines on capital adequacy and market decisions dated 1st July 2011 for implementation of Basel II.

CASE STUDIES

Q1. What are the principal enactments governing bank audit?
Hint Ans: Refer to Point No. 11.1

Q2. As a branch auditor of a nationalised bank, how would you verify the following?
(1) Bills Purchased and Discounted

(2) Third Party Guarantees
<u>**Ans:**</u> **(1) Verification of Bills Purchased and Discounted**
(a) The auditor should ascertain that the **policy framed by the bank** conforms to the requirements laid down by the RBI.
(b) Bills purchased and discounted have to be shown separately in the balance sheet as a part of '**advances**'. Further, under the head 'advances outside India' in the balance sheet, bills purchased and discounted outside India have to be shown separately.
(c) In certain eligible cases, the bills purchased or discounted by the bank may be rediscounted by it with the RBI IDBI/SIDBI. Such bills would not be included under advance but would constitute a **contingent liability**.
(d) The auditor should **examine and satisfy** himself that: • all the outstanding bills have been taken in the balance sheet; • all the details, including the nature of the bills and documents are mentioned in the register and that the bills have been correctly classified; • the bills purchased or discounted from different parties are in accordance with the agreements with them and the total of outstanding bills of each party is not in excess of the sanctioned limit; • the bills are not overdue. If there are any overdue bills, the auditors should ascertain the reasons for delay and the action taken by the bank.
(e) The auditor should examine whether **registers of bills purchased and discounted** are properly maintained and the transactions are recorded therein correctly.
(f) Auditor should also examine whether the bills and the **documents accompanying the bills** are properly endorsed and assigned in favour of the bank.

(2) Verification of Third Party Guarantees
(a) The auditor should examine the **guarantee bonds** and the demand promissory notes in order to verify the third party liability.
(b) The auditor should also satisfy himself that the guarantee **is in force as at the date** of the balance sheet.
(c) In the absence of a provision to the contrary, a **guarantee terminates by revocation** or upon death of the surety. The surety is also discharged (unless there is a specific covenant to the contrary) if the creditor arranges with the principal debtor for composition, or agrees to give time or agrees not to sue him, without consulting the surety.
(d) If any **variation is made** in the **terms of the contract** between the principal debtor and the creditor without the surety's consent, it discharges the surety as to transactions subsequent to the variation.
(e) The **guarantee forms** used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies.

<u>**Q3.**</u> As a branch auditor of a nationalised bank, how would you verify the following?
(1) Advances to DOT COM Companies.
(2) Balances in account of a bank situated in a foreign country.
<u>**Hint Ans:**</u> **(1)** Refer Point No. 11.8 (iii-k) & (iii-k-1)
(2) (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 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, no cheque sent or received in clearing is outstanding, 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 year-end, 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 AS 11 on "The Effects of Changes in Foreign Exchange Rates".

Q4. 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.
Hint Ans: Refer Point No. 11.9 – (Scope/Areas of Concurrent Audit – iv)

Q5. 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.
(c) In case of all such advances which have been classified as non-performing for the first time during the current financial year, only the last date of the financial year has been reckoned as the date of account becoming non-performing.
Hint Ans: (a) 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, the recognition of income by the bank on accrual basis is not in order
(b) In case of consortium, 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.
(c) It is wrong to take the Balance Sheet date for purposes of classification. In this context, it is important to note the concept of past due. An amount should be considered as past due when it remains outstanding for more than 90 days beyond due date. For example, if any SSI loan amount, the repayment of term loan installment falls due for payment on December 31 and is not paid; the amount would become past due if it remains unpaid for more than 90 days beyond that date. As per RBI Master Circular on Guidelines of the RBI on Asset Classification, Income Recognition, Provisioning dated 02 July 2012. if the account of the borrowers have been regularised before the balance sheet date by repayment of overdue amounts through **genuine sources and not by sanction of additional facilities**, the account need not be treated as NPA in spite of payment of interest and installment were in arrear for 90 days. Bank should, however, ensure that the account remains in order subsequently.

Q6. While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention?
Hint Ans: Refer to Relevant Part of Point No. 11.8 (v)

Q7. How do you examine claims against the Bank not acknowledged as debts?
Hint Ans: Refer to Point No. 11.8 (xi)

<u>Q8.</u> Feel Good Bank Ltd. appoints Secure & Co, a firm of CAs for a special assignment of ascertaining the quality of its loans and advances portfolio independently. What would be the areas you would focus on such a review?
<u>Hint Ans:</u> Refer Point No. 11.8 (iii-k)

<u>QUESTIONS</u>

<u>Q1.</u> What do you understand by Long-form Audit Report? (2 Marks) **(Nov 2008)**

<u>Q2.</u> 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. (6 Marks) **(Nov 2008)**

<u>Q3.</u> How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank? (5 Marks) **(Nov 2009)**

<u>Q4.</u> While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention? (6 Marks)

<u>Q5.</u> How do you examine claims against the Bank not acknowledged as debts? (4 Marks) **(May 2010)**

<u>Q6.</u> Write a short note on reversal of income under bank audit. (5X4 Marks) **(Nov 2010)**

<u>Q7.</u> "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. (8 Marks) **(May 2011)**

<u>Q8</u>
(a) In course of audit of Good Samaritan Bank as at 31st March 13 you observed the following: **(May 2013)**
(i) In a particular account there was no recovery in past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government? (5 Marks)
(ii) The bank's portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances. (3 Marks)