

Audit of Banks

Question 1

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 ₹ 50 crores to X Ltd Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest the credits in X Ltd's account are to the tune of ₹ 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.*

Answer

- (a) It is not a prudent practice to treat dividend on shares of corporate bodies and units of mutual funds as income unless these are actually received. Accordingly, income from dividend on shares of corporate bodies and units of mutual funds should be booked on cash basis. In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a State government. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9 as well. In the instant case, the recognition of income by the bank on accrual basis is not in order.
- (b) The bank is a consortium member of cash credit facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest, the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with

proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

- (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 30 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 30 days beyond that date. In case of terms loans, if interest or installment of principal is in arrears for any two quarters out of four quarters although default may not be continuously for two quarters during the year by applying past due test, it should be classified as non-performing asset and from that date provision should be made. In the case of other advances, outstanding in the last two quarters would be enough to classify the amount as such non-performing asset if no transaction appears in the last two quarters.

As per RBI Circular dated January 29, 1997, 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 NP A in spite of payment of interest and installment were in arrear for two quarters. Bank should, however, ensure that the account remains in order subsequently and a solitary credit entry made in the account on or before the balance sheet date which extinguished the overdue amount of interest or instalment of principal is not reckoned as the sole criterion for treating the account as a standard asset.

It has been further clarified that in respect of accounts where there are potential threats of recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent for banks to classify them first as sub-standard and then as doubtful after expiry of two years from the date of account has become NPA. It should be straight way classified as doubtful asset or loss asset, as appropriate, irrespective of the period for which it has remained as NPA.

Question 2

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

Answer

Income Recognition: The banks may book income in the following manner: as per the circular issued by RBI DBOD No. BP. BC.20/21.04.048/2008- 09 dated July 1, 2008.

- (i) Interest on advances against term deposits, NSCs, IVPs, KVPs and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

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- (ii) Fees and commissions earned by the banks as a result of renegotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the renegotiated or rescheduled extension of credit.
- (iii) If Government guaranteed advances become NPA, the interest on such advances should not be taken to income account unless the interest has been realised.

Question 3

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

- (i) *Drafts paid without advice*
- (ii) *Branch adjustment account*

Answer

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

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

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

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

- (i) See that all branch accounts are periodically reconciled.

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

Question 4

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

- (i) *Advances to DOT COM Companies.*
- (ii) *Balances in account of a bank situated in a foreign country.*

Answer

(i) Advances to DOT COM Companies

- (i) Evaluate the efficacy of internal control system in general to ascertain whether an advance is made only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance must specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment, etc. Also see that all the necessary documents, e.g., agreements, demand promissory notes, letters of hypothecation, etc. have been executed by the parties before advances are made.
- (ii) Examine loan documents such as certificate of commencement of business (in the case of public limited companies), resolution of board of directors, and resolution of shareholders (in cases covered by Section 293(1)(d) of the Companies Act, 1956).
- (iii) Verify the business plan of the company especially where the revenue model is in place. Verify whether the company depends only on outside funding or can self generate funds.
- (iv) Examine in case the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies.
- (v) Review the operation of advance account to see that limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.
- (vi) Examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the

auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into to identify any irregularities in these accounts.

- (vii) Review periodic statements, cash flow statements, latest financial statements, etc. to assess the recoverability of advances.
 - (viii) Verify whether the advance is secured and determine whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with; whether the security is in the effective control of the bank; and to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.
 - (ix) Ensure that proper provisioning norms have been applied in view of non-observance of terms, coupled with irregular payment of interest and default in repayment of instalments, if any.
- (ii) **Balances in Account of a Bank situated in a Foreign Country**
- (i) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.
 - (ii) Review the reconciliation statements and pay particular attention to the following.
 - (1) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.
 - (2) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.
 - (3) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
 - (iii) Examine the large transactions in inter-bank accounts, particularly towards the 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 "Accounting for the Effects of Changes in Foreign Exchange Rates".

Question 5

Describe the audit procedures to be followed by a Statutory Auditor of a bank for audit of contingent liabilities.

Answer

Verification of Contingent Liabilities: In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. To this end, the auditor should, generally follow the audit procedures given below:

- (i) the auditor should ensure that there exists a system whereby the non fund based facilities or additional/*ad hoc* credit facilities to parties are extended only to their regular constituents, etc.
- (ii) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.
- (iii) The auditor should also ensure that in case of LCs for import of goods, as required by the abovementioned Master Circular on guarantees and co-acceptances, the payment to the overseas suppliers is made on the basis of shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.
- (iv) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls ensure that contingent liabilities are properly identified and recorded.
- (v) Performs substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.
- (vi) 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.
- (vii) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.
- (viii) Obtain representation from the management that
 - (a) all contingent liabilities have been disclosed;
 - (b) the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss/ expense and which, therefore, require creation of a provision in the financial statements;
 - (c) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including any possibility of any reimbursement;

- (d) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulations Act, 1949 has arisen on account of such guarantee; and
- (e) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote, include the management's justification for reaching such a decision in respect of those contingent liabilities.
- (ix) The auditor should also examine whether the bank has given any guarantees in respect of any trade credit (buyer's credit or seller's credit). The period of guarantees is co-terminus with the period of credit reckoned from the date of shipment.
- (x) Verify whether bank has extended any non-fund facility or additional/*ad hoc* credit facilities to other than its regular customers. In such cases, auditor should ensure concurrence of existing bankers of such borrowers and enquire regarding financial position of those customers.

Question 6

Discuss the scope of "concurrent audit" in the banks.

Answer

Scope of concurrent audit: Concurrent audit is an examination which is contemporaneous with the occurrence of transactions or is carried out as near thereto as possible. It attempts to shorten the interval between a transaction and its examination by an independent person not involved in its documentation. There is an emphasis in favour of substantive checking in key areas rather than test checking. This audit is essentially a management process integral to the establishment of sound internal accounting functions and effective controls and setting the tone for a vigilance internal audit to preclude the incidence of serious errors and fraudulent manipulations.

A concurrent auditor may not sit in judgement of the decisions taken by a branch manager or an authorised official. This is beyond the scope of concurrent audit. However, the audit will necessarily have to see whether the transactions or decisions are within the policy parameters laid down by the Head Office, they do not violate the instructions or policy prescriptions of the RBI, and that they are within the delegated authority.

In very large branches, which have different divisions dealing with specific activities, concurrent audit is a means to the incharge of the branch to ensure on an on going basis that the different divisions function within laid-down parameters and procedures.

Coverage

- (i) The Departments/Divisions at the Head Office dealing with Treasury functions viz investments, funds management including inter-bank borrowings bill rediscount and

foreign exchange business are to be subjected to concurrent audit. In addition, all branch offices, undertaking such business and dealing rooms have to be subjected to continuous audit.

- (ii) The coverage of branches should ensure that concurrent audit covers:
 - (a) Branches whose total credit and other risk exposures aggregate to not less than 50% of the total credit and other risk exposures of the bank; and
 - (b) Branches whose aggregate deposits cover not less than 50% of the aggregate deposits of the Bank.
- (iii) To achieve these twin criteria it is suggested that branches may be listed according to credit and other risk exposures and selected in the descending order of exposures to achieve a 50% coverage. If the deposits of these branches do not aggregate to 50% of the Bank's deposits, additional branches in descending order of deposits may be added to achieve a 50% coverage of the branches.
- (iv) While complying with the above parameters, it is necessary to ensure that the coverage encompasses:
 - ◆ exceptionally large branches
 - ◆ very large and large branches
 - ◆ special branches handling foreign exchange business, merchant banking business, large corporate wholesale banking business and forex dealing room operations
 - ◆ large problem branches rated as poor/very poor
 - ◆ Head Office department dealing with treasury/funds management and handling investment portfolio
 - ◆ any other branches or departments where in the opinion of the Bank concurrent audit is desirable.
- (v) Branches subjected to concurrent audit should not normally be included for revenue/income audit.

Types of activities to be covered

- (i) The main role of concurrent audit is to supplement the efforts of the bank in carrying out simultaneous internal check of the transactions and other verifications and compliance with the procedures laid down.
- (ii) The scope of concurrent audit should be wide enough to cover certain fraud-prone areas like handling of cash, deposits, safe custody of securities, investments, overdue bills, exercise of discretionary powers, sundry and suspense accounts, inter-branch reconciliation, clearing differences, foreign exchange business including Nostro accounts, off-balance sheet items like letters of credit and guarantee, treasury functions and credit-card business.

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- (iii) The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Inspector and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors (ACB).
- (iv) In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving small amounts.
- (v) While the detailed scope of the concurrent audit may be determined and approved by the ACB.

Question 7

As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?

Answer

As per the Master Circular-on Statutory Liquidity Ratio issue by RBI No. RBI/2010-11/70.DBOD.No.Ret.BC.23/12.01.001/2010-11 and Consequent upon amendment to the Section 24 of the Banking Regulation Act, 1949 through the Banking Regulation (Amendment) Act, 2007 replacing the Regulation (Amendment) Ordinance, 2007, effective January 23, 2007, the Reserve Bank can prescribe the Statutory Liquidity Ratio (SLR) for SCB in specified assets. The value of such assets of a SCB shall not be less than such percentage not exceeding 40 per cent of its total demand and time liabilities in India as on the last Friday of the second preceding fortnight as the Reserve Bank may, by notification in the Official Gazette, specify from time to time.

Reserve Bank has decided that all SCBs shall continue to maintain a uniform SLR of 25 per cent on their total net demand and time liabilities (NDTL) with effect from the fortnight beginning November 7, 2009, valued in accordance with the method of valuation specified by the Reserve Bank of India from time to time:

- (a) in cash, or
 - (b) in gold valued at a price not exceeding the current market price,
or
 - (c) in unencumbered investment in the following instruments which will be referred to as "statutory liquidity ratio (SLR) securities":
 - (i) Dated securities issued up to September 8, 2009 as listed in the Annex to Notification DBOD.No.Ret.BC.40/ 12.02.001/2009-10 dated September 8, 2009
 - (ii) Treasury Bills of the Government of India;
 - (iii) Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilisation Scheme;
 - (iv) State Development Loans (SDLs) of the State Governments issued from time to time under their market borrowing programme; and
- Any other instrument as may be notified by the Reserve Bank of India.

Compliance with SLR Requirements: The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a financial year not being Fridays. The resultant report is to be sent to the management of the bank and to the Reserve Bank. To verify compliance with SLR requirements, the statutory auditor has to examine two aspects:-

- (i) The correctness of the figure of the demand and time liabilities in India (DTL) at the close of business on the reporting Friday relevant to the dates selected by the auditor, and
- (ii) Maintenance of prescribed percentage of liquid assets on the selected data considering the DTL position on the relevant reporting Friday.

Special points to be noted are:

1. Obtain an understanding of the relevant circumstances of the RBI, particularly regarding composition of items of DTL.
2. Require the branch auditors to verify the correctness of the trial balances relevant to the 12 dates selected by him. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates. The DTL position to the examined will be as on the last Friday of the Second preceding fortnight, i.e., April 11. The position of cash, gold and approved securities shall be as of May 1.
3. Review the relevant returns/received from un-audited branches to identify any obvious errors or omissions or inconsistencies.
4. Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether demand liabilities comprise only those liabilities that must be met on demand.
5. Specifically examine the following items have been excluded from liabilities.
 - ◆ Amount received from deposit insurance and export credit guarantee corporations (ECGC) towards claims in respect of guarantees involved and held pending adjustment of the same towards the related advance.
 - ◆ Amounts received from Court Receiver.
 - ◆ Amount received from insurance companies as a result of "excess claims".
 - ◆ Part amount of recoveries received from the borrowers.
 - ◆ Amounts received in Indian currency against import bills and held in sundry deposits pending receipt of final notes.
 - ◆ Unadjusted deposit/balances buying in link branches for agency business like dividend warrants, interest warrant, refund of application money.
6. Specifically examine that the following items have been included in liabilities
 - ◆ Net credit balance in branch adjustment accounts including these relating to foreign

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branches.

- ◆ Interest on deposit as at the end of the firm half year reversed in the beginning of the next half-year.
7. Verify that in computation of liquid assets, the following are treated as cash.
- ◆ The deposit maintained with RBI by a banking company incorporated outside India under Section 11(2) of the Banking Regulation Act.
 - ◆ Any balances maintained by a scheduled bank with the Reserve Bank in excess of the balance required to be maintained by it under section 42 of the Reserve Bank of India Act.
8. Test check the relevant records to verify the amount of unencumbered approved securities held by the bank on the selected dates. Examine whether the valuation of approved securities has been done with reference to cost price, market price, book value or face value or a combination of these methods as may be specified by the Reserve Bank of India from time to time.

Question 8

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

Answer

Principal Enactments Governing Bank Audit: There is an elaborate legal framework governing the functioning of banks in India. The principal enactments which govern the functioning of various types of banks are:

- ◆ Banking Regulation Act, 1949
- ◆ State Bank of India Act, 1955
- ◆ Companies Act, 1956
- ◆ State Bank of India (Subsidiary Banks) Act, 1959
- ◆ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
- ◆ Regional Rural Banks Act, 1976
- ◆ Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
- ◆ Information Technology Act, 2000
- ◆ Prevention of Money Laundering Act, 2002
- ◆ Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
- ◆ Credit Information Companies Regulation Act, 2005
- ◆ Payment and Settlement Systems Act, 2007

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

Question 9

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

Answer

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

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

Question 10

Write a short note on - Vostro and Nostro Accounts.

Answer

Vostro and Nostro Accounts: Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents. Such foreign currency accounts maintained by Indian banks at other overseas centres are designated by it as "Nostro Account". For example, all banks in India would be maintaining a US Dollar Account with their New York office/branch/correspondents, such account would be designated by the Indian office as Nostro Account. "Vostro Account" is the opposite of Nostro accounts. Here a foreign bank in another country maintains stocks of Indian rupees with their Indian branch/correspondent/local bank. Such Indian Rupee Accounts are designated as a Vostro Account. For example, a German Bank might maintain a Vostro Account in rupees in terms with Indian Bank. While examining the transaction in foreign exchange, the auditor should also pay attention to reconciliation of Nostro Accounts with the respective minor account. The amount in the Nostro account is stock of foreign currency in the form of bank accounts with the overseas branches and correspondents. Unreconciled Nostro Accounts, on an examination,

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may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals, and unauthorized debit to minor account. The auditor should also evaluate the internal control with regard to inward/ outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with, in the books of accounts.

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

Question 11

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines.

Answer

Scope of concurrent audit of banks with reference to RBI guidelines: The following are the areas to be covered:

- (i) Daily cash transactions with reference to abnormal receipts and payments. This will include currency chest transactions, major expenses met by cash, high value receipts and disbursements.
- (ii) Purchase and sale of shares securities etc. Physical verification of investments and rates at which they are entered into.
- (iii) Verification of procedure and documentation to open new current, savings, term deposit accounts, etc. Unusual operations noticed have to be thoroughly examined.
- (iv) Verification of advances, overdrafts, temporary OD, Cash credit accounts, term loans, bills purchase, letters of credit etc. Procedure for sanction and documentation to be verified. Any deviation noticed to be examined in great detail.
- (v) Foreign exchange transactions to be verified with reference to RBI guidelines.
- (vi) Verification of balancing of all ledgers and registers, inter branch reconciliation calculation and verification of interest, discount, commission etc.
- (vii) Revenue leakage to be detected.
- (viii) Special efforts to be made in all fraud prone areas. The attempt should be to ensure that all effective measures are taken to prevent frauds.
- (ix) Verification of high value transactions.
- (x) Procedure for safe custody of security forms with the branch.
- (xi) Whether all procedures for tax deduction at source are followed and the tax so deducted are deposited into Government Account within the time fixed.
- (xii) Verification of returns, statements, calculation of capital adequacy ratio and compliance with requirements of government business.

(xiii) Study of RBI and Internal Inspection reports statutory auditors report and compliance thereto.

(xiv) Whether the customers' complaints are dealt with promptly.

Question 12

How would you verify "Acceptances, Endorsements and other obligations" appearing in the Balance Sheet of a bank?

Answer

Acceptances, Endorsements and Other Obligations: This item includes the following balances:

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

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

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

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

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

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

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

Question 13

How are investments to be classified in the financial statements of a Bank?

Answer

Classification of Investments in the Financial Statements of a Bank

The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories viz., 'Held to Maturity', 'Available for Sale' and 'Held for Trading'.

However, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications viz., (a) Government securities; (b) Other approved securities; (c) Shares; (d) Debentures & Bonds; (e) Subsidiaries/Joint Ventures and (f) Other (CP, Mutual

Fund Units, etc)

Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held to maturity

- (i) The securities acquired by the banks with the intention to hold them up to maturity will be classified under *Held to Maturity*.
- (ii) The investments included under 'Held to maturity' should not exceed 25 per cent of the bank's total investments.
- (iii) The following investments are to be classified under 'Held to Maturity' but will not be counted for the purpose of ceiling of 25% specified for the category:
 - (a) Re-capitalisation bonds received from the Government of India towards their re-capitalisation requirement and held in their investment portfolio.
 - (b) Investment in subsidiaries and joint ventures. [A joint venture would be one in which the bank, along with its subsidiaries, holds more than 25% of the equity.]
 - (c) The investments in debentures/bonds, which are deemed to be in the nature of an advance.
- (iv) Profit on sale of investments in this category should be first taken to the Profit & Loss Account and thereafter be appropriated to the 'Capital Reserve Account', Loss on sale will be recognized in the Profit & Loss Account.

Held for Trading

The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under *Held for Trading*.

The investments classified under held for trading category would be those from which the bank expects to make a gain by the movement in the interest rates/market rates. These securities are to be sold within 90 days.

Available for Sale

The securities which do not fall within the above two categories will be classified under *Available for Sale*.

Profit or Loss on sale of investments in both the categories will be taken to the Profit & Loss Account.

Question 14

Write a short a note on - Contingent Liabilities for Banks.

Answer

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

(a) Contingent liabilities

- (i) Claims against the bank not acknowledged as debts.
- (ii) Liability for partly paid investments.
- (iii) Liability on account of outstanding forward exchange contracts.
- (iv) Guarantees given on behalf of constituents
 - (a) In India.
 - (b) Outside India
- (v) Acceptances, endorsements and other obligations.
- (vi) Other items for which the bank is contingently liable.

(b) Bills for collection.

Question 15

- (i) *What do you understand by Long-form Audit Report?*
- (ii) *As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances.*

Answer

- (i) The long form Audit Report has to be furnished by the auditor of a bank in addition to the audit report as per the statutory requirement. The matters which the banks require their auditor to deal with in the form of Long Form Audit Report have been specified by Reserve Bank of India.
- (ii) The items to be covered in the current audit of advances of a bank are as follows:
 - (a) Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and at the appropriate level).
 - (b) Verify whether the sanctions are in accordance with delegated authority.
 - (c) Ensure that securities and documents have been received and properly charged/registered.
 - (d) Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, renewal of limits, etc.
 - (e) Verify whether there is any mis utilisation of the loans and whether there are instances indicative of diversion of funds.
 - (f) Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.
 - (g) Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.

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- (h) Ensure proper follow-up of overdue bills of exchange.
- (i) Verify whether the classification of advances has been done as per RBI guidelines.
- (j) Verify whether the submission of claims to DICGC and ECGC is in time.
- (k) Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been got confirmed or ratified at the required level.
- (l) Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

Question 16

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

Answer

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

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

Question 17

- (a) *While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention?*
- (b) *How do you examine claims against the Bank not acknowledged as debts?*

Answer

- (a) **Special points to examine Inter Branch adjustments:** The following points require special attention in the examination of Inter Branch transactions.
 - (i) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding in appropriate cases.
 - (ii) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.
 - (iii) Whether the balances include any items in the nature of cash in transit included in this head which remain pending for more than a reasonable period. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.
 - (iv) Whether transactions other than those relating to inter branch transactions have been included in inter branch accounts. Any unusual items put through inter branch accounts as well as old or large entries outstanding in Inter branch accounts should be carefully looked into. The auditor should also seek explanations from the Management in this regard in appropriate cases.
- (b) **Examination of claims against the Bank not acknowledged as debts:** The auditor should examine the relevant evidence, for example correspondence with lawyers, claimants, workers/officers and workmen's/officer's unions. The auditor should also review the minutes of the meeting of the Board of directors/committees of the Board, contracts, agreements and arrangements, list of pending legal cases and correspondence relating to taxes, duties etc., to identify claims against the bank. The auditor should ascertain from the management the status of claims outstanding as at the end of previous year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

Question 18

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

Answer

Reversal of Income: If any advance, including bills purchased and discounted, becomes Non-Performing Assets as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not

realised. This will apply to Government guaranteed accounts also.

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

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

Question 19

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

Answer

Non-Performing Assets: An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.

Criteria for the classification of a Non Performing Asset (NPA) is a loan or an advance where

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

Question 20

As the concurrent auditor of Z Bank Ltd you are requested by its management to draft an internal control policy in respect of loans and advances. What factors do you consider as important while drafting such a policy?

Answer

Factors to be considered for drafting of Internal control policy for Loans and Advances:

The following are the important factors to be considered while drafting internal control policy in respect of loans and advances of a Z bank Ltd):

1. The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.
2. All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
3. Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with Reserve Bank directives. Such margins should be determined by the proper authorities of the bank as a general policy or for particular accounts.
4. All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.
5. All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank.
6. In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.
7. Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.
8. Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.
9. As soon as any increase or decrease takes place in the value of securities proper entries should be made in the Drawing Power Book and Daily Balance Book. These entries should be checked by an officer.
10. All accounts should be kept within both the drawing power and the sanctioned limit at all times.
11. All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.
12. The operation in each advance should be reviewed at least once every year.
13. Post disbursement supervision and follow-up should be proper, such as receipt of stock statements, instalments, renewal of limits, etc
14. There should not be any mis-utilisation of the loans and instances indicative of diversion of funds should be checked.

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15. Letters of credit issued by the branch should be within the delegated power and should be for genuine trade transactions.
16. Bank guarantees issued, should be properly worded and recorded in the register of the bank. They should be promptly renewed on the due dates.
17. Proper follow-up should be made for overdue bills of exchange.
18. The classification of advances should be done as per RBI guidelines.
19. The submission of claims to DICGC and ECGC should be on time.
20. Instances of exceeding delegated powers should be promptly reported to controlling/Head Office by the branch and should be got confirmed or ratified at the required level.

Question 21

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

Answer

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

Thus, he should examine:

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

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

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

Question 22

In course of audit of Good Samaritan Bank as at 31st March 13 you observed the following :

- (i) In a particular account there was no recovery in the 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 ?
- (ii) The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances.

Answer

- (i) If a government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.

Since the bank has not revoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.

The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

- (ii) The audit programme to verify advances against Life Insurance Policies is as under -
1. The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer.
 2. The auditor should also examine whether premium has been paid on the policies and whether they are in force.
 3. Certificate regarding surrender value obtained from the insurer should be examined.
 4. The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.