11

Audit of Banks

11.1 Introduction

Lending constitutes a major activity of a bank. The core business of banks is accepting deposits for onward lending. Advances, generally, constitute the largest item on the assets side of the balance sheet of a bank and are major source of its income.

Advances generally comprises of:

a) money lent by the bank to its customers including interest accrued and due;
b) debit balances in the account of the depositors;
c) Inter-Bank Participation Certificates.

Audit of advances is one of the most important areas covered by auditors. It is necessary that auditors should have adequate knowledge of the banking industry and the regulations governing the banks. Auditors must be aware of the various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls.

11.2 Legal Framework

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, 2013
- 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
- Credit Information Companies (Regulation) Act, 2005
11.2 Advanced Auditing and Professional Ethics

- 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.

11.3 Form and Content of Financial Statements

Sub-sections (1) and (2) of section 29 of the Act deal with the form and content of financial statements of a banking company and their authentication. These sub-sections are also applicable to nationalised banks, State Bank of India, subsidiaries of the State Bank of India, and Regional Rural Banks.

Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI.

11.4 Audit of Accounts

Sub-section (1) of section 30 of the Act requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

Qualifications of Auditor - Students may refer section 141 of the Companies Act, 2013 discussed in Chapter - 6 (The Company Audit) of this Study Material.

Appointment of Auditor - As per the provisions of the relevant enactments, the auditor of a banking company is to be appointed at the annual general meeting of the shareholders, whereas the auditor of a nationalised bank is to be appointed by the bank concerned acting through its Board of Directors. In either case, approval of the Reserve Bank is required before the appointment is made. The auditors of the State Bank of India are to be appointed by the Comptroller and Auditor General of India in consultation with the Central Government. The auditors of the subsidiaries of the State Bank of India are to be appointed by the State Bank of India. The auditors of regional rural banks are to be appointed by the bank concerned with the approval of the Central Government.

Remuneration of Auditor - The remuneration of auditor of a banking company is to be fixed in accordance with the provisions of section 142 of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine). The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.

Powers of Auditor - The auditor of a banking company or of a nationalised bank, State Bank
of India, a subsidiary of State Bank of India, or a regional rural bank has the same powers as those of a company auditor in the matter of access to the books, accounts, documents and vouchers.

**Auditor’s Report** - In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

(a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;

(c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor’s report in the case of a nationalised bank.

**Format of Audit Report** - The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of Revised SA 700, “Forming an Opinion and Reporting on Financial Statements”, SA 705, “Modifications to the Opinion in the Independent Auditor’s Report” and SA 706, “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report”. The auditor should ensure that not only information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report. Such disclosure in the audit report is not only in accordance with the best international trends but also provides useful information to users of financial statements.

In addition to matters on which he is required to report to the shareholders under the Companies Act, 2013, the auditor of a banking company is required to state in his report:

(a) Whether or not the information and explanations required by him have been found to be satisfactory;

(b) whether or not the transactions of the company which have come to his notice have been within the powers of the company;

(c) whether or not the returns received from the branch offices of the company have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and
any other matter which he considers should be brought to the notice of the shareholders of the company.

*It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report in respect of matters covered by Section 143 of the Companies Act, 2013. However, it is pertinent to mention that the reporting requirements relating to the Companies (Auditor’s Report) Order, 2016 is not applicable to a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949.*

As per reporting requirements cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 the auditor’s report shall also include their views and comments on the following matters, namely:

i) whether the bank has disclosed the impact, if any, of the pending litigations on its financial position in its financial statements.

ii) whether the bank has made provision, as required under the law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts.

iii) whether there has been any delay in transferring amounts, required to be transferred to the Investment Education and Protection Fund by the bank.

**Long Form Audit Report** - 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 long form audit report (LFAR). The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

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

**Reporting to RBI** - The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:

“If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action”.

As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI. In this regard, attention of the members is also invited to Clause 1 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, which states that a chartered accountant in practice shall be deemed guilty of professional misconduct, if he
discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force.

Under the said provision, if a member of the Institute suo motu discloses any information regarding any actual or possible fraud or foul play to the RBI, the member would be liable for disciplinary action by the Institute. However, a member is not held guilty under the said clause if the client explicitly permits the auditor to disclose the information to a third party. If the above-mentioned requirement of the Circular is included in the letter of appointment (which constitutes the terms of audit engagement) then it would amount to the explicit permission by the concerned bank (client) to disclose information to the third party, i.e., the RBI.

Auditor should also consider the provisions of SA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”. The said Standard explains that the duty of confidentiality is over-ridden by statute, law or by courts.

SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

**Duty to report on Frauds under the Companies Act, 2013** - As per sub-section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

[Note: For detailed understanding on duty to report on fraud under Companies Act, 2013, students may refer Chapter-6 (The Company Audit) of this Study Material]

11.4.1 Conducting an Audit - The audit of banks or of their branches involves the following stages -

1. Initial consideration by the Statutory auditor
2. Identifying and Assessing the Risks of Material Misstatements
3. Understanding the Bank and Its Environment including Internal Control
4. Understand the Bank’s Accounting Process
5. Understanding the Risk Management Process
6. Engagement Team Discussions
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7. Establish the Overall Audit Strategy
8. Develop the Audit Plan
9. Audit Planning Memorandum
10. Determine Audit Materiality
11. Consider Going Concern
12. Assess the Risk of Fraud including Money Laundering
13. Assess Specific Risks
14. Risk Associated with Outsourcing of Activities
15. Response to the Assessed Risks
16. Stress Testing
17. BASEL III framework.

1. Initial consideration by the statutory auditor

(i) Declaration of Indebtedness: The RBI has advised that the banks, before appointing their statutory central/circle/branch auditors, should obtain a declaration of indebtedness.

(ii) Internal Assignments in Banks by Statutory Auditors: The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year.

(iii) Planning: Standard on Auditing (SA) 300, “Planning an Audit of Financial Statements” requires that the auditor shall undertake the following activities prior to starting an initial audit:

(a) Performing procedures required by SA 220, “Quality Control for Audit Work” regarding the acceptance of the client relationship and the specific audit engagement; and

(b) Establish understanding of terms of engagement as per SA 210, “Agreeing the Terms of Audit Engagements”

(iv) Communication with Previous Auditor: As per Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him in writing.

(v) Terms of Audit Engagements: SA 210, “Terms of Audit Engagements” requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork. It is imperative that the terms of the engagement are documented, in order to prevent any confusion as to the terms that have been agreed in relation to the audit and the respective responsibilities of the management and the auditor, at the beginning of an audit relationship.

(vi) Initial Engagements: The auditor needs to perform the audit procedures as mentioned in SA 510 “Initial Audit Engagements-Opening Balances” and if after performing that procedures, the auditor concludes that the opening balances contain misstatements which materially affect the financial statements for the current period and the effect of the same is
not properly accounted for and adequately disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

(vii) Assessment of Engagement Risk: The assessment of engagement risk is a critical part of the audit process and should be done prior to the acceptance of an audit engagement since it affects the decision of accepting the engagement and also in planning decisions if the audit is accepted.

(viii) Establish the Engagement Team: The assignment of qualified and experienced professionals is an important component of managing engagement risk. The size and composition of the engagement team would depend on the size, nature, and complexity of the bank’s operations.

(ix) Understanding the Bank and its Environment: SA 315 “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

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

3. Understanding the Bank and Its Environment including Internal Control: An understanding of the bank and its environment, including its internal control, enables the auditor:
   ◆ to identify and assess risk;
   ◆ to develop an audit plan so as to determine the operating effectiveness of the controls, and to address the specific risks.

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

5. Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:
   ◆ Oversight and involvement in the control process by those charged with governance: Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank’s business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.
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- **Identification, measurement and monitoring of risks:** Risks that could significantly impact the achievement of bank’s goals should be identified, measured and monitored against pre-approved limits and criteria.

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

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

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

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

7. **Establish the Overall Audit Strategy:** SA 300 “Planning an Audit of financial Statements” states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:

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

8. **Develop the Audit Plan:** SA 300 deals with the auditor’s responsibility to plan an audit of financial statements in an effective manner. It requires the involvement of all the key members of the engagement team while planning an audit. Before starting the planning of an audit, the auditor must perform the procedures as defined under SA 220, “Quality Control for an Audit of Financial Statements” for reviewing the ethical and independence requirements. In addition to this, the auditor is also required to comply with the requirements of SA 210, "Agreeing the Terms of Audit Engagement".

9. **Audit Planning Memorandum:** The auditor should summarise their audit plan by preparing an audit planning memorandum in order to:

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

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

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

12. **Assess the Risk of Fraud including Money Laundering**: As per SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, the auditor’s objective are to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

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

13. **Assess Specific Risks**: The auditors should identify and assess the risks of material misstatement at the financial statement level which refers to risks that relate pervasively to the financial statements as a whole, and potentially affect many assertions.

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

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

16. **Stress Testing**: RBI has required that all commercial banks shall put in place a Board approved ‘Stress Testing framework’ to suit their individual requirements which would integrate into their risk management systems.

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

[Note: For detailed understanding of stages involved for conducting an audit, as discussed above, students may refer Guidance Note on Audit of Banks.]

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<tr>
<th>Demonetisation</th>
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<tr>
<td>On 8th November, 2016, the Government announced Demonetisation Program by declaring withdrawal of legal tender status to currency notes denomination of ₹ 1000 and ₹ 500 (herein referred as Specified Bank Notes (SBN)) effective from November 09, 2016. Consequent to the announcement, there have been a series of announcements and notifications by the RBI regarding exchange facility, withdrawal limit, etc.</td>
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<td>The most important aspect of Demonetisation program is to reconcile the balance of SBN and its movement by banks to ensure no misuse by branch officials. Reporting of the said details by banks has also been prescribed.</td>
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11.4.2 Special Considerations in a CIS Environment - As in today’s environment all banks have embarked upon a large scale computerization, this has resulted in changes in the processing and storage of information and affects the organisation and procedures employed by the entity to achieve adequate internal control. Thus, while the overall objective and scope of audit do not change simply because data is maintained on computers, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and the nature, timing and extent of his other audit procedures are affected in a CIS environment.

11.4.3 Internal Audit and Inspection - Banks generally have a well organised system of internal audit. Their internal auditors pay frequent visit to the branches. They are an important link in the internal control of the bank. The systems of internal audit in different banks also have a system of regular inspection of branches and head office. The internal audit and inspection function is carried out by a separate department within the bank by firms of chartered accountants.

11.5 Internal Control in Certain Selected Areas

11.5.1 General

(a) The staff and officers of a bank should be shifted from one position to another frequently and without prior notice.

(b) The work of one person should always be checked by another person (usually by an officer) in the normal course of business.

(c) The arithmetical accuracy of the books should be proved independently every day.

(d) All bank forms (e.g. Cheque books, demand draft books, travellers’ cheques etc.) should be kept in the possession of an officer, and another responsible officer should occasionally verify the stock of such stationery.
(e) The mail should be opened by a responsible officer. Signatures on all the letters and
advices received from other branches of the bank or its correspondence should be checked by
an officer with the signature book.

(f) The signature book and the telegraphic code book should be kept with responsible
officers and used and seen by authorised officers only.

(g) The bank should take out insurance policies against loss and employees’ infidelity.

(h) The powers of officers of different grades should be clearly defined.

(i) There should be surprise inspection of head office and branches at periodic interval by
the internal audit department. The irregularities pointed out in the inspection reports should be
promptly rectified.

11.5.2 Cash

(a) Cash should be kept in the joint custody of two responsible officers.

(b) In addition to normal checking by the chief cashier, cash should be test-checked daily and
counted in full occasionally by a responsible officer unconnected with the cash department. Actual
cash in hand should agree with the balance shown by the Day Book every day.

(c) The cashier should have no access to the customer’s ledger accounts and the Day Book.
This is an important safeguard. Bank managements are often tempted to use cashiers
because of their shorter working hours as ledger clerks in the absence of regular staff on
leave, etc. This can be a very expensive price of economy.

(d) The counterfoil cash receipt vouchers (e.g. counterfeits of pay-in-slips lodged by the
depositors) should be signed by an officer in Cash Department, in addition to the receiving
cashier.

(e) Payments should be made only after the vouchers (e.g. cheques, demand drafts etc.)
have been passed for payment by the proper officer and have been entered in the customer’s
account.

(f) Receipt and payment scrolls or their totals should be compared with the cash column of
the Day-Book by independent persons.

(g) Where the teller system is prevalent-

   (i) A limit should be placed on the powers of tellers to make payment.

   (ii) All vouchers relating to the accounts of customers which the tellers handle should
first be sent to them and entered by them in the ledger cards.

   (iii) Total payment made by a teller should be reconciled with the cash columns of the
Voucher Summary Sheet of the ledger concerned every day.

   (iv) There should be frequent rotation of tellers.

11.5.3 Clearings

(a) Cheques received by the bank in clearing should be checked with the list accompanying
them. Independent list should be prepared for cheques debited to different customers
accounts and those returned unpaid and these should be checked by officers. The total number and amount of cheques included in these lists should be agreed with the list first mentioned by a person unconnected with both the customers, ledgers and the clearing department.

(b) The total number and amount of cheques sent out by the bank for clearing should be agreed with the total of the clearing pay-in-slips, by an independent person.

(c) The unpaid cheques received back in return clearing should be checked in the same manner as the cheques received.

11.5.4 Constituents’ Ledgers

(a) Before making payment, cheques should be properly checked in respect of signature, date, balance in hand etc. and should be passed by an officer and entered into constituents’ accounts.

(b) No withdrawals should normally be allowed against clearing cheques deposited on the same day.

(c) An officer should check all the entries made in the ledger with the original documents particularly noting that the correct accounts have been debited or credited.

(d) Ledger keepers should not have access to Voucher Summary Sheet after they have been checked by an officer and to the Day Book.

(e) Interest debited or credited to constituents’ accounts should be independently checked.

11.5.5 Bills for Collection

(a) All the documents accompanying the bills should be received and entered in the Register by a responsible officer. At the time of despatch, the officer should also see that all the documents are sent along with the bills.

(b) The accounts of customers or principals should be credited only after the bills have been collected or an advice to that effect received from the branch or agent to which they were sent for collection.

(c) It should be ensured that bills sent by one branch for collection to another branch of the bank, are not taken in the bills for collection twice in the amalgamated balance sheet of the bank. For this purpose, the receiving branch should reverse the entries regarding such bills at the end of the year for closing purposes.

11.5.6 Bills Purchased

(a) At the time of purchase of the bills, an officer should verify that all the documents of title are properly assigned to the bank.

(b) Sufficient margin should be kept while purchasing or discounting a bill so as to cover any decline in the value of the security etc.

(c) If the bank is unable to collect a bill on the due date, immediate steps should be taken to recover the amount from the drawer against the security provided.
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(d) All irregular outstanding accounts should be reported to the Head Office.
(e) In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years.

11.5.7 Loans and Advances

(a) 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.
(b) All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
(c) 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.
(d) All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers.
(e) 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.
(f) 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.
(g) Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.
(h) 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.
(i) 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.
(j) All accounts should be kept within both the drawing power and the sanctioned limit at all times.
(k) 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.
(l) The operation (in each advance should be reviewed at least once every year.)

11.5.8 Telegraphic Transfers and Demand Drafts

(a) The bank should have a reliable private code known only to responsible officers of its branches, coding and decoding of telegrams should be done only by such officers.
(b) The signatures on a demand draft should be checked by an officer with the Signature Book.
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(c) All the T.Ts and D.Ds. sold by a branch should be immediately confirmed by the advices to the branches concerned.

(d) If the paying branch does not receive proper confirmation of any T.T. or D.D. from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to ascertain the reasons.

11.5.9 Inter Branch Accounts

(a) The accounts should be adjusted only on the basis of advices (and not on the strength of entries found in the statement of account) received from other branches,

(b) Prompt action should be taken preferably by central authority, if any entries (particularly debit entries) are not responded to by any branch within a reasonable time.

11.5.10 Credit Card Operations

(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 at 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.

11.5.11 Compliance with CRR and SLR requirements

1. **Cash Reserve Ratio (CRR) Requirements** - 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...
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Act, 1949, corresponding requirement for scheduled banks is contained in the Reserve Bank of India Act, 1934. The RBI, from time to time, reviews the evolving liquidity situation and accordingly decides the rate of CRR required to be maintained by scheduled commercial banks. Therefore, the auditor need to refer the master circular issued from time to time in this regard to ensure the compliance of CRR requirements.

2. **Statutory Liquidity Ratio (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 top management of the bank and to the Reserve Bank. The report of the statutory auditors in relation to compliance with SLR requirements has to cover two aspects:

(i) correctness of the compilation of DTL (Demand and Time Liabilities) position; and

(ii) maintenance of liquid assets.

**Audit approach and procedure:**

(i) Obtain an understanding of the relevant circumstances of the RBI, particularly regarding composition of items of DTL.

(ii) Require the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates.

(iii) 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 the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.

(iv) While examining the computation of DTL, specifically examine that the following items have been excluded from liabilities-

(a) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.

(b) Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.

(c) Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.

(d) Margins held and kept in sundry deposits for funded facilities.

(v) Similarly, specifically examine that the following items have been included in liabilities-
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(a) Net credit balance in branch adjustment accounts including these relating to foreign branches.

(b) Interest on deposit as at the end of the firm half year reversed in the beginning of the next half-year.

(c) **Borrowings from abroad by banks in India needs to be considered as ‘liabilities to other’ and thus, needs to be considered at gross level unlike ‘liabilities towards banking system in India’, which are permitted to be netted off against ‘assets towards banking system in India’. Thus, the adverse balances in Nostro Mirror Account needs to be considered as ‘Liabilities to other’**

(d) **The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.**

(vi) **Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches.**

(vii) **It may be noted that, even though interest accrues on a daily basis, it is recorded in the books only at periodic intervals. Thus, examine whether such interest accrued but not accounted for in books is included in the computation of DTL.**

(viii) **The auditor at the central level should apply the audit procedures listed above to the overall consolidation prepared for the bank as a whole. Where such procedure is followed, the central auditor should adequately describe the same in his report.**

While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion. **Recently, there has been introduction of Automated Data Flow (ADF) for CRR & SLR reporting and the auditors should develop necessary audit procedures around this.**

11.6 Verification of Assets and Balances

The following are the steps involved in verification of assets and balances-

I. **CASH, BANK BALANCES AND MONEY AT CALL AND SHORT NOTICE** - The Third Schedule to the Banking Regulation Act, 1949, requires the following disclosures to be made in the balance sheet regarding cash, balances with RBI, balances with other banks, and money at call and short notice.

**Cash and Balances with Reserve Bank of India**

I. Cash in hand (including foreign currency notes)

II. Balances with Reserve Bank of India

(i) in Current Account
Balances with Banks and Money at Call and Short Notice

I. In India
   (i) Balances with other banks
       (a) in Current Accounts
       (b) in Other Deposit Accounts
   (ii) Money at call and short notice
       (a) with banks
       (b) with other institutions

II. Outside India
   (i) in Current Accounts
   (ii) in Other Deposit Accounts
   (iii) Money at call and short notice

Audit Procedures:

(a) Cash - The auditor should count the balance of cash on hand. As far as possible, the auditor should visit the branch at the close of business on the last working day of the year or before the commencement of business on the next day for carrying out the physical verification of cash. If, for any reason, the auditor is unable to do so, he should carry out the physical verification of cash as close to the balance sheet date as possible. It is sometimes arranged by the branch to deposit a large portion of its cash balance with the Reserve Bank of India or the State Bank of India or any other bank on the closing day, in which case, the work of the auditor is reduced substantially.

The cash balance as physically verified should be agreed with the balance shown in the cash book and the cash balance book. When the physical verification of cash is carried out by the auditor before or after the date of the balance sheet, the auditor should work forward/backward (as the case may be) to reconcile the results of his verification with the cash balance at the balance sheet date as shown by the books.

(b) Balance with Reserve Bank of India - In a bank, only a few select branches are designated to have account with the Reserve Bank. Thus, this item would not appear in the balance sheet of every branch. The following procedures are therefore applicable only to branches having account with the Reserve Bank of India.

* Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.
* Review the reconciliation statements. He should pay special attention to the following items appearing in the reconciliation statements:
   (i) Cash transactions remaining unresponded;
(ii) Revenue items requiring adjustments/write-offs; and
(iii) Old outstanding balances remaining unexplained / unadjusted for over one year.

* Obtain a written explanation from the management as to the reasons for old outstanding transactions in bank reconciliation statements remaining unexplained / unadjusted for over one year.

(c) Balance with Banks (Other than Reserve Bank of India) - Apart from the procedures described above in examining the balances with banks other than Reserve Bank, while reviewing the reconciliation statements, the auditor should pay particular attention to the following.

(i) 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.
(ii) Examine that no cheque sent or received in clearing is outstanding.
(iii) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

The balances with banks outside India should also be verified in the manner described above. These balances should be converted into the Indian currency at the exchange rates prevailing on the balance sheet date.

(d) Money at Call and Short Notice - Money at call and short notice represents short-term investment of surplus funds in the money market. Money lent for one day is money at ‘call’ while money lent for a period of more than one day and up to fourteen days is money at ‘short notice’.

The auditor should examine whether there is a proper authorisation, general or specific, for lending of the money at call or short notice. Compliance with the instructions or guidelines laid down in this behalf by the head office or controlling office of the branch, including the limits on lendings in inter-bank call money market, should also be examined.

Call loans should be verified with the certificates of the borrowers and the call loan receipts held by the bank. The auditor should examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger. He should also examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end. It may be noted that call loans made by a bank cannot be netted-off against call loans received.

II. INVESTMENTS - The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of investments in the balance sheet as follows:

I. Investments in India in

   (i) Government securities
   (ii) Other approved securities
   (iii) Shares
   (iv) Debentures and Bonds
   (v) Subsidiaries and/or joint ventures
(vi) Others (to be specified)

II. Investments outside India in

(i) Government securities (including local authorities)

(ii) Subsidiaries and/or joint ventures abroad

(iii) Other investments (to be specified)

In addition to other disclosures regarding investments, the Notes and Instructions for Compilation of Balance Sheet, also require the following information to be disclosed in the balance sheet:

(1) gross value of investments in India and outside India;
(2) aggregate of provisions for depreciation, separately on investments in India and outside India; and
(3) net value of investments in India and outside India.

(4) movement of provisions held towards depreciation on investments including opening balance by adding provisions made during the year and after deducting write-off/write-back of excess provisions during the year.

The gross value of investments and provisions need not, however, be shown against each of the categories specified in the Schedule. The break-up of net value of investments in India and outside India (gross value of investments less provision) under each of the specified category need only be shown.

Audit Procedures: The auditor's primary objective in audit of investments is to satisfy himself as to their existence and valuation. Examination of compliance with statutory and regulatory requirements is also an important objective in audit of investments in as much as non-compliance may have a direct and material affect on the financial statements. The latter aspect assumes special significance in the case of banks where investment transactions have to be carried out within the numerous parameters laid down by the relevant legislation and directions of the RBI. The auditor should keep this in view while designing his audit procedures relating to investments.

(a) Internal Control Evaluation and Review of Investment Policy: The auditors should familiarise 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. While examining the internal controls over investments (including those on SGL forms and BRs), the auditor should particularly examine whether the same are in consonance with the guidelines of the RBI. He should also judge their efficacy.

(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). As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors.
(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 Documents:** 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. Apart from the above, the auditor should also ensure that any other covenants or conditions which restrict qualify or abridge the right of ownership and/or disposal of investments, have been complied with by the bank.

The auditor should satisfy himself that the transactions for the purchase/sale of investments are supported by due authority and documentation. The acquisition/disposal of investments should be verified with reference to the broker’s contract note, bill of costs, receipts and other similar evidence. *The auditors should also check the segregation of duties within the bank staff in terms of executing trades, settlement and monitoring of such trades, and accounting of the same (generally termed as front office, middle office and back office functions’ segregation).*

(e) **Physical Verification:** The auditor should verify the investment scrips physically at the close of business on the date of the balance sheet. In exceptional cases where it is not possible, the auditor should carry out the physical verification on a date as near to the balance sheet date as possible. In such a case, he should take into consideration any adjustments for subsequent transactions of purchase, sale, etc.

In respect of scripless 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 organisation.

In respect of BRs issued by other banks and on hand with the bank at the year-end, the auditor should examine confirmations of counterparty banks about such BRs. Where any BRs have been outstanding for an unduly long period, the auditor should obtain written explanation from the management for the reasons thereof. The auditor should examine the reconciliation of BRs issued by the bank.

If certain securities are held in the names of nominees, the auditor should examine whether there are proper transfer deeds signed by the holders and also an undertaking from them that they hold the securities on behalf of the bank.

(f) **Examination of Valuation:** Method of valuation of investments followed by a bank may, therefore, have a significant effect on its balance sheet and profit and loss account. The auditor should examine whether the method of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate.

The auditor should examine the manner of accounting for investments in the context of the guidelines of the RBI and the accounting policy followed by the bank in respect of investments. The auditor should examine the appropriateness of accounting policies followed
by the bank. In case any of the accounting policies is not appropriate, the auditor should consider the effect of adoption of such policy on the financial statements and, consequently, on his audit report. In this regard, it may be noted that Accounting Standard (AS) 13, “Accounting for Investments”, does not apply to banks.

According to RBI guidelines, in respect of shares which are unquoted or for which current quotations are not available, the market value has to be determined on the basis of the latest balance sheet of the company. This might create a problem in the case of new companies whose first annual reports are not yet available. It appears that in such a situation, it would be appropriate to value the shares at cost except where the evidence available indicates the deterioration in the value.

RBI guidelines require that individual scrips in the available-for-sale category should be marked to market at quarterly or more frequent intervals. It is further required that net depreciation in respect of each of the categories in which investments are presented in the balance sheet should be provided for while any similar net appreciation should be ignored. As regards the scrips in Held for Trading (HFT) category, the same should be marked to market at monthly or at more frequent intervals in the similar manner, except in the following cases:

(i) **Equity shares should be marked to market preferably on daily basis, but at least on a weekly basis**;

(ii) **Banks which undertake short sale transactions, the entire HFT portfolio including the short position should be marked to market on daily basis**.

The auditor should examine whether the profit or loss on sale of investments has been computed properly. **The carrying amount of investments disposed off should be determined consistently on similar basis. In case of HTM investments, Net 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’ net of taxes and Net Loss will be recognised in the Profit & Loss Account.**

The classification of investments into held-to-maturity, held-for-trading and available-for-sale categories is based on the intention with which the respective investments have been acquired by the bank. The auditor should examine whether the investments have been properly classified into the three categories at the time of acquisition based on such intention as evidenced by the decision of the competent authority such as Board of directors, ALCO or Investment Committee.

As per RBI guidelines, investments classified under held-for-trading category should be sold within 90 days of their acquisition, failing which they should be shifted to the available-for-sale-category. The auditor should accordingly ensure that no investments purchased more than 89 days before the balance sheet date have been classified under this category.

Subject to what is stated above, the auditor should examine compliance by the bank with the guidelines of the RBI relating to valuation of investments.
The auditor should examine whether income from investments is properly accounted for. This aspect assumes special importance in cases where the bank has opted for receipt of income through the electronic/on line medium.

There may be cases where the certificates of tax deduction at source (TDS) received along with the dividend/interest on investments are found missing. This increases the incidence of tax on the bank. The auditor should see that there is a proper system for recording and maintenance of TDS certificates received by the bank.

**Special-purpose Certificates Relating to Investments:** It may be noted that pursuant to RBI's circulars, issued from time to time, banks require their central auditors to issue the following certificates regarding investments of the bank (in addition to their main audit report and the long form audit report)-

(i) Certificate on reconciliation of securities by the bank (both on its own Investment Account as well as PMS clients’ account). The reconciliation is to be presented in a given format.

(ii) Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the Reserve Bank of India.

(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.

The auditor should examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. The auditor also needs to consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.

(h) **Examination of classification and shifting:** The auditor should examine whether the shifting of the investments from ‘available for sale’ to ‘held to maturity’ is duly approved by the Board of Directors of the bank. The auditor should also ensure the compliance of the RBI guidelines, issued from time to time, in this regard.

**Audit, Review and Reporting:** Banks should undertake half-yearly reviews (as of 30th September and 31st March) of their investment portfolio. These half yearly reviews should not only cover the operational aspects of the investment portfolio but also clearly indicate amendments made to the investment policy and certify the adherence to laid down internal investment policy and procedures and RBI guidelines.

The internal auditors are required to separately conduct the concurrent audit of treasury transactions and the results of their report should be placed before the CMD once every month. Banks need not forward copies of the audit report of internal auditor to RBI. However, major irregularities observed in these reports and position of compliance thereto may be incorporated in the half yearly review of the investment portfolio.

**Classification of Investments:** Banks are required to classify their entire investments portfolio into three categories-

(i) **Held-to-maturity (HTM):** This category would comprise securities acquired by the bank
with the intention to hold them up to maturity.

(ii) **Held-for-trading (HFT):** This category would comprise securities acquired by the bank with the intention of trading, i.e., to benefit from short-term price/interest rate movements.

(iii) **Available-for-sale (AFS):** This category will comprise securities, which do not qualify for being categorised in either of the above categories, i.e., those that are acquired neither for trading purpose nor for being held till maturity.

Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposal/deal slip.

**Non-Performing Investments:** A non performing investment (NPI), similar to a non-performing advance (NPA), is one where-

(i) Interest/instalment (including maturity proceeds) is due and remains unpaid for more than 90 days.

(ii) The above would apply mutatis-mutandis to preference shares where the fixed dividend is not paid.

(iii) In the case of equity shares, in the event the investment in the shares of any company is valued at ₹ 1 per company on account of the non-availability of the latest balance sheet.

(iv) If any credit facility availed by the issuer is NPA in the books of the bank, investment in any of the securities, including preference shares issued by the same issuer would also be treated as NPI and vice versa. However, if only the preference shares are classified as NPI, the investment in any of the other performing securities issued by the same issuer may not be classified as NPI and any performing credit facilities granted to that borrower need not be treated as NPA.

(v) The investments in debentures/bonds, which are deemed to be in the nature of advance would also be subjected to NPI norms as applicable to investments.

(vi) In case of conversion of non-performing loans into equity, debentures, bonds, etc., such instruments should be treated as NPI ab-initio in the same asset classification in which the relevant non-performing loans were classified and provision should be made as per the norms.

The guidelines specified above for identification of NPI will apply to state government guaranteed securities also.

Bank should make appropriate provisions for such NPIs by way of depreciation in the value of the investment. The banks should not set-off the depreciation requirement in respect of these non-performing securities against the appreciation in respect of other performing securities.

**Income Recognition:** The banks may book income in the following manner-

(i) Banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government, provided interest is serviced regularly and as such is not in arrears.
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(ii) Banks may book interest income from all other performing investments on accrual basis provided interest rates on these instruments are pre-determined.

(iii) Discount earned on discounted instruments like commercial papers, zero coupon bonds should be booked on accrual basis. The discount may either be accrued equally over the remaining period to maturity or by following the constant yield method.

(iv) Interest income from non-performing investments should be booked on realisation.

(v) Dividend on shares may be booked on accrual basis provided it is approved by the corporate body in its Annual General Meeting and the owner’s right to receive dividend is established.

(vi) Income from units of mutual funds should be booked on cash basis.

(vii) Discount on interest bearing government securities classified under HTM should be recognised on redemption of the investments and should not be amortised over the remaining period to maturity.

(viii) Profit and loss on sale of investments including on HTM category, should be shown under Profit/Loss on sale of investments.

(ix) In case of sale of investments acquired on conversion of loan, if the sale proceeds are higher than the net book value, the excess to the extent of provision will not be reversed but will be utilised to meet the shortfall / loss on account of sale of other financial assets to SC/RC.

(x) Except for profit/loss on sale/revaluation of investment, provision for investments and dividend from subsidiaries and joint ventures, all other income from investments should be shown under the head income from investment.

III. Advances - The Third Schedule to the Act requires classification of advances made by a bank from three different angles, viz., nature of advance, nature and extent of security, and place of making advance (i.e. whether in India or outside India). Accordingly, the advances are to be classified in Schedule 9 to the balance sheet as follows:

A. (i) Bills purchased and discounted
   (ii) Cash Credits, Overdrafts and Loans repayable on demand
   (iii) Term loans

B. (i) Secured by tangible assets
   (ii) Covered by bank/government guarantees
   (iii) Unsecured

C. I. Advances in India
   (i) Priority sectors
   (ii) Public sector
   (iii) Banks
   (iv) Others
II. Advances outside India
   (i) Due from banks
   (ii) Due from others
   (iii) Bills purchased and discounted
   (iv) Syndicated loans
   (v) Others

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

Criteria for Classification of Various Types of Credit Facilities: In line with the international best practices and to ensure greater transparency, the RBI has directed the banks to adopt the ‘90 days’ overdue’ norm for identification of NPAs from the year ending March 31, 2004.

Banks have been charging interest at monthly rests, from April 1, 2002. However, the banks were advised that the date of classification of an advance as NPA would not be changed on account of charging of interest at monthly rests. Banks should, therefore, continue to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 90 days from the end of the quarter.

An account should be treated as ‘out of order’ if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as ‘out of order’. Further, any amount due to the bank under any credit facility is ‘overdue’ if it is not paid on the due date fixed by the bank.

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

(a) Term Loans: A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remain overdue for a period of more than 90 days.

(b) Cash Credits and Overdrafts: A cash credit or overdraft account is treated as NPA if it remains out of order as indicated above.

(c) Bills Purchased and Discounted: Bills purchased and discounted are treated as NPA if they remain overdue and unpaid for a period of more than 90 days.

(d) Securitisation: The asset is to be treated as NPA if the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006.

(e) Agricultural Advances: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and, a loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

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

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

(f) Credit Card Accounts: RBI vide its Circular on “Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Credit Card Accounts” advised that a credit card account will be treated as non-performing asset if the minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the next statement date. The gap between two statements should not be more than a month. It is further suggested by RBI that banks should follow this uniform method of determining over-due status for credit card accounts while reporting to credit information companies and for the purpose of levying of penal charges, viz., late payment charges, etc., if any.

Classification Norms relating to NPAs

Temporary Deficiencies: In the matter of classification of accounts with temporary deficiencies, banks have to follow the following guidelines:

(a) Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock 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.

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

(c) A working capital borrowing account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower’s financial position is satisfactory.

(d) The accounts where regular/ad hoc credit limits have not been reviewed/renewed within 180 days from the due date/date of ad hoc sanction, the account should be treated as NPA.

Regularisation Near About Balance Sheet: The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA.

Asset Classification to be Borrower-wise not Facility-wise: All facilities granted to a borrower and investment made in securities issued by the borrower will have to be treated as NPA/NPI and not the particular investment/facility once any or a part of the facility/investment has become irregular.
Erosion in Value of Securities/ Frauds Committed by Borrowers: In respect of accounts where there are potential threats for 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, such accounts need not go through the stages of asset classification. In such cases, the asset should be straightaway classified as doubtful or loss asset, as appropriate. Further,

(i) Erosion in the value of securities by more than 50% of the value assessed by the bank or accepted by RBI inspection team at the time of last inspection, as the case may be, would be considered as “significant”, requiring the asset to be classified as doubtful straightaway and provided for adequately.

(ii) The realisable value of security as assessed by bank/approved valuers/RBI is less than 10% of the outstanding in the borrowal accounts, the existence of the security should be ignored and the asset should be classified as loss asset. In such cases the asset should either be written off or fully provided for.

Government Guaranteed Advances: The credit facilities backed by guarantees of central government though overdue may be treated as NPA only when the government repudiates its guarantee when invoked. This exemption from classification of Central Government guaranteed advances as NPA is not for the purpose of recognition of income. In case of State Government guaranteed loans, this exemption will not be available and such account will be NPA if interest / principal / other dues remain overdue for more than 90 days.

Advances under Consortium: Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.: Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided adequate margin is available in the accounts.

Agricultural Advances Affected by Natural Calamities: Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities. Banks may decide on their own relief measures, viz., conversion of the short term production loan into a term loan or re-schedulement of the repayment period and the sanctioning of fresh short term loan, subject to the guidelines contained in RBI’s latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. In such cases, the NPA classification would be governed by such rescheduled terms.

Advances to Staff: Interest bearing staff advances as a banker should be included as part of
advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head ‘Others’ under the schedule of Other Assets.

**Income Recognition**

**On Advances Granted:** Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognise income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realised should be reversed or provided for. Further,

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

ii. Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated 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.

**Reversal of Income:** If any advance, including bills purchased and discounted, becomes NPA 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).

**On Leased Assets:** The finance charge component of finance income [as defined in ‘AS 19 – Leases] on the leased asset which has accrued and was credited to income account before the asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.

**On Take-out Finance:** In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognise income unless realised from the borrower/taking-over institution (if the arrangement so provides).
**On Partial Recoveries in NPAs:** In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.

Interest partly realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

**Note:** For classification of advances, provisioning norms, etc., students may refer Chapter 6 of Paper 5 - Advanced Accounting, Intermediate (IPC) Study Material.

**Auditor’s Report in Case of Bank Borrowers:** The RBI vide its circular had prescribed that all borrowers having credit limit of ₹ 10 lakh and above from the banking system should get their annual accounts audited by chartered accountants. The RBI has authorised the Board of Directors of banks to fix a suitable cut off limit with reference to the borrowing entity's overall exposure on the banking system, over which audit of accounts of borrower by chartered accountants would be mandatory.

**Audit Procedures -** Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.

b. Advances represent amount due to the bank.

c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.

d. There are no unrecorded advances.

e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.

f. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining the validity of the recorded amounts;
- examining loan documentation;
reviewing the operation of the accounts;
- examining the existence, enforceability and valuation of the security;
- checking compliance with RBI norms including appropriate classification and provisioning; and
- carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant. The extent of sample checking would also depend on the auditor’s assessment of efficacy of internal controls. What constitutes a ‘large advance’ would need to be determined in the context of volume of operations of the branch. As a general rule, however, an advance may be considered to be a large advance if the year-end balance is in excess of ₹ 2 crore or 5% of the aggregate year-end advances of the branch, whichever is less.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank’s internal inspection, etc. should generally be included in the auditor’s review.

**Evaluation of Internal Controls over Advances:** The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia,* the following:

- The bank should make an advance 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 should specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment etc. It also needs to be ensured that the loans sanctioned are as per the Loan Policy of the bank and adhere to the regulatory (RBI) norms unless a specific exemption is taken in this regard.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be
test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.

- Surprise checks should be made in respect of hypothecated goods not in the physical possession of the bank.

- **Drawing Power Register should be updated every month to record the value of securities hypothecated.** These entries should be checked by an officer.

- The accounts should be kept within both the drawing power and the sanctioned limit.

- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.

- The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

**Long Form Audit Report:** 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, *inter alia*, whether the loan applications are complete and in prescribed form; procedural instructions regarding grant/ renewal/ enhancement of facilities have been complied with; sanctions are within delegated authority and disbursements are as per terms of the sanction; 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.

**Examining the Validity of Recorded Amounts:** The auditor should ascertain the status of balancing of subsidiary ledgers relating to advances. The total of balances in the subsidiary ledgers should agree with the control accounts in the General Ledger. The auditor should also tally the total of the statement of advances with the balances as per general ledger/subsidiary ledgers. He should also cross-check the balances of the advances selected for examination as listed in the statement of advances with the balances in the relevant advance accounts in the subsidiary ledgers. Banks often obtain balance confirmation statements from borrowers periodically. Such statements have a dual advantage in preventing disputes by the customer and extending the period of limitation by reference to the date of confirmation. Wherever available, such confirmations may be seen.

These days most of the banks have their ‘advances’ statements generated through the system. The auditor should ensure that the fields which system copies from last year are the same and he should take extra care in relation with the date of NPA and date of becoming doubtful asset as these facts have great bearing on the provisioning. The auditor should obtain audit trail from the bank to verify whether there are any changes or not.

**Examination of Loan Documents:** As indicated earlier, the documents relating to advances
would be affected by the legal status of the borrower and the nature of security. Thus, where the borrower is a company, loan documents would include certificate of incorporation, memorandum and articles of association, 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 180 of the Companies Act, 2013], etc. Where the borrower is a partnership firm, loan documents would include copy of partnership deed. Where 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 would also form part of loan documentation if the borrower is a company. Each bank has its own set of rules regarding the documents to be obtained from various types of borrowers and in respect of different kinds of securities. The formats of many of the documents are also prescribed. The auditor should evaluate the adequacy of the loan documents in the context of the rules framed by the bank in this regard.

Review of Operation of Account: The auditor should review the operation of the advance accounts. In doing so, an intelligent scrutiny of the operation of the account should be carried out to see that the 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.

The auditor should also 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. A written note/explanation may be obtained from the management as regards any major irregularities which may have a bearing on his report.

The auditor may also review the following to assess the recoverability of advances:

(a) Periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.
(b) Latest financial statements of borrowers.
(c) Reports on inspection of security.
(d) Auditors’ reports in the case of borrowers enjoying aggregate credit limits of ₹ 10 lakh or above for working capital from the banking system.

The auditor should satisfy himself that interest is being charged on all performing accounts regularly. He should compare the rate of interest with the agreement and the sanction and with the credit rating reports where the rate of interest is linked to credit rating. In case the interest rate is to be revised based on the changes in PLR/BPLR/Base rate of the bank, it needs to be ensured that the rate of interest to be charged from the borrower is suitably revised as and
when there are changes in PLR/BPLR/Base rate. Calculation of interest should be test-checked. The auditor should examine that interest not received on any account, which is a non-performing asset as per the guidelines of the RBI, has not been recognised as income. It may be noted that interest accrued but not due on advances does not form part of advances.

**Verification of Security against Advances:** From the view point of security, advances are to be classified in the balance sheet in the following manner:

(a) Secured by tangible assets
(b) Covered by bank/government guarantees
(c) Unsecured

An advance should be treated as secured to the extent of the value of the security on the balance sheet date. If only a part of the advance is covered by the value of the security as at the date of the balance sheet, that part only should be classified as secured; the remaining amount should be classified as unsecured.

As mentioned earlier, the Reserve Bank has specified that advances against book debts may be included under the head ‘secured by tangible assets’.

The following points are relevant for classifying the advances based on security.

(a) Government guarantees include guarantees of Central/State Governments and also advances guaranteed by Central/State Government owned corporations and financial institutions like IDBI, IFCI, ICICI, State Financial Corporations, State Industrial Development Corporations, ECGC, DICGC, etc.

(b) Advances covered by bank guarantees also include advances guaranteed against any negotiable instrument, the payment of which is guaranteed by a bank.

(c) Advances covered by bank/government guarantees should be included in unsecured advances to the extent the outstanding in these advances exceed the amount of related guarantees.

(d) While classifying the advances as secured, the primary security should be applied first and for the residual balance, if any, the value of collateral security should be taken into account. If the advance is still not fully covered, then, to the extent of bank/government guarantees available, the advance should be classified as ‘covered by bank/government guarantee’. The balance, if any, remaining after the above classification, should be classified as ‘unsecured’.

(e) There may be situations where more than one facility is granted to a single borrower and a facility is secured, apart from primary and collateral securities relating specifically to that facility, by the residual value of primary security relating to any other credit facility (or facilities) granted to the borrower. In such a case, in the event of shortfall in the value of primary security in such a credit facility, the residual value of primary security of the other facility (or facilities, as the case may be) may be applied first to the shortfall and the value of collateral securities should be applied next.

(f) In the case of common collateral security for advances granted to more than one borrower, if there is a shortfall in value of primary security in any one or more of the
borrowal accounts, the value of collateral security may be applied proportionately to the shortfall in each borrowal account.

(g) Advances covered by ECGC/DICGC guarantees should be treated as covered by guarantees to the extent of guarantee cover available. The amount already received from DICGC/ECGC and kept in sundry creditors account pending adjustment should be deducted from advances.

(h) An account which is fully secured but the margin in which is lower than that stipulated by the bank should nevertheless be treated as fully secured for the purposes of balance sheet presentation.

(i) All documentary bills under delivery-against-payment terms (i.e., covered by RR/Airway Bill/Bill of lading) for which the documents are with the bank as on the balance sheet date should be classified as ‘secured’.

(j) Documentary bills under delivery-against-acceptance terms which remain unaccepted as at the close of 31st March (i.e., for which the documents of title are with the bank on this date) should be classified as secured. All accepted bills should be classified as ‘unsecured’ unless collaterally secured.

(k) Cheques purchased including self-cheques (i.e., where the drawer and payee are one and the same) should be treated as unsecured.

(l) Advances against supply bills, unless collaterally secured, should be classified as unsecured even if they have been accepted by the drawees.

(m) ‘Security’ means tangible security properly discharged to the bank and will not include intangible securities like guarantees (including State government guarantees), comfort letters, etc.

In examining whether an advance is secured and, if so, to what extent, the auditor is concerned with determining –

(a) whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with;

(b) whether the security is in the effective control of the bank; and

(c) to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.

The auditor should examine the following aspects in respect of advances classified as ‘secured’:

(a) Documents executed are complete and in force.

(b) Where documents have not been renewed, the limitation period has not expired.

(c) Evidence is available as to the market value of the security.

(d) Evidence is available that –

   (i) hypothecated/pledged goods are the property of the borrowers and are not old/obsolete or otherwise unsaleable;
(ii) advances against book debts of borrowers are related to their current debts and not old/doubtful debts; and

(iii) Stocks hypothecated/pledged are paid stocks owned by the borrower.

(e) In the case of companies, the charge is appropriately registered with the Registrar of Companies and a certificate of registration of charge or other evidence of registration is held.

(f) Borrowers are regular in furnishing the requisite information regarding the value of security lodged with the bank.

(g) In respect of the second charge being available in respect of certain assets, the amount of the lender(s) enjoying the first charge on such asset be worked out and only the residuary value, if any, available for second charge holders, be considered.

The following paragraphs deal with the different types of securities against advances generally accepted by banks and the manner in which the auditor should verify them.

**Stock Exchange Securities and Other Securities:** The auditor should verify stock exchange securities and their market value in the same manner as in the case of investments. The auditor should examine whether the securities have been registered or assigned in favour of the bank, wherever required and verify the same with Demat Account.

It sometimes happens that a quoted security may not have frequent transactions on the stock exchange and the quotation included in the official quotations may be that of a very old transaction. In such a case, the auditor should satisfy himself as to the market value by scrutiny of balance sheet, etc., of the company concerned, particularly if the amount of advance made against such security is large.

Banks do not generally make advances against partly paid securities. If, however, any such shares are accepted by the bank as security and these are registered in the name of the bank, the auditor should examine whether the issuing company has called up any amount on such securities and, if so, whether the amount has been paid in time by the borrower/bank.

**Goods:** In respect of hypothecated goods, the auditor should check the quantity and value of goods hypothecated with reference to the statement received from the borrower. He should also examine the reasonableness of valuation. Letter of hypothecation should also be examined by the auditor. If the value of the goods is higher than the amount mentioned in the letter of hypothecation, the bank’s security is only to the extent of the latter. Auditor should also verify that the Bank has system of maintenance of proper register in this regard as also system of scrutiny of stock/book debt statement furnished by the borrower.

In respect of goods pledged with the bank, the auditor should check the statement received from the borrower regarding the quantity and value of goods pledged by him. He should test check the godown registers and the valuation of the goods. If there is any outstanding delivery order against the goods as on the balance sheet date, the same should be deducted from the total quantity in hand in ascertaining the value of the goods constituting the security. The auditor may also examine the key movement register to verify the movement of goods inwards and/or outwards.

Sometimes, goods are in the possession of third parties, such as clearing and forwarding
agents, transporters, brokers, warehouse-keepers, etc. If these parties have given an undertaking to the bank that they will hand over the goods or sale proceeds thereof to the bank only, i.e., they have 'attorned' to the bank the advances made against such goods should be considered as secured. In such cases, certificates should be obtained by the bank from such third parties regarding quantities on hand on balance sheet date. The valuation of such goods should be checked by the auditor.

In case the borrower is a company, the auditor should examine the certificate of registration of charge on the goods hypothecated with the Registrar of Companies. It may be mentioned that in case of pledge of goods, registration of charge is not necessary.

**Gold Ornaments and Bullion:** The auditor should inspect and weigh (on a test basis) the ornaments on the closing date. He should also see the assayer’s certificate regarding the net gold content of the ornaments and their valuation. Valuation should also be checked with reference to the current market price of gold.

In respect of gold and silver bars, the auditor should inspect the bars on a test basis and see that the mint seals are intact. The weights mentioned on the bars may generally be accepted as correct.

**Life Insurance Policies:** 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. The auditor should also examine whether premium has been paid on the policies and whether they are in force. Certificate regarding surrender value obtained from the insurer should be examined. The auditor should particularly see that if such surrender value is subject to payment of certain *premia*, the amount of such *premia* has been deducted from the surrender value.

**Bank’s Own Deposit Certificates:** The auditor should inspect such certificates and examine whether they have been properly discharged and whether the lien of the bank is noted on the face of the certificates as well as in the relevant register of the bank.

**Hire-purchase Documents:** These advances may be classified as secured against the hypothecation of goods. Where there is no hypothecation, the advance will be classified as unsecured.

**Plantations:** These advances are classified as secured against the crop and/or the fixed assets of the plantation. The auditor should examine the agreement and the title deeds. Regarding the estimate of the crop, he may examine the record of the garden for the last few years. He should also ascertain whether the crop is properly insured against natural calamities and other disasters such as hail, etc.

Auditor should keep in mind that where moratorium is available for payment of interest in such plantation projects, the payment of interests becomes due only after the moratorium or gestation period is over and in such a case the account will become NPA in case interest is not recovered after the due date of such interest after moratorium period, if specifically mentioned in the sanction letter.

**Immovable Property:** The auditor should inspect the title deed, the solicitor’s opinion taken by the bank in respect thereof, and the mortgage deed. For valuation, he may rely upon the architect’s or valuer’s report (which should be taken at least once in three years) after carrying
out appropriate audit procedures to satisfy himself about the adequacy of the work of the architect/valuer for his purpose. He should also examine the insurance policies.

In some cases, banks make advances against immovable properties where the title deeds are not in the name of the borrower. For example, an advance may be given against the security of a flat in a co-operative group housing society, the title deeds of which may not be in the name of the borrower. In such cases, the auditor should examine the evidence regarding the right or interest of the borrower in the property mortgaged, e.g., power of attorney, share certificate of co-operative group housing society, ‘no objection certificate’ from the society/lessor (in the case of leasehold properties) for offering the property as security, etc.

Reliance on / review of other reports: The auditor should take into account the adverse comments, if any, on advances appearing in the following:

- Previous audit reports.
- Latest internal inspection reports of bank officials.
- Reserve Bank’s latest inspection report.
- Concurrent / Internal audit report.
- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager’s charge-handing-over report when incumbent is changed.

The above reports should be reviewed in detail. The Statutory Central Auditors must review the Annual Financial Inspection report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

Third Party Guarantees: The auditor should examine the guarantee bonds and the demand promissory notes in order to verify the third party liability. He should satisfy himself that the guarantee is in force as at the date of the balance sheet. 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. 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. The guarantee forms used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies.

Verification of Bills Purchased and Discounted: The auditor should familiarise himself with the guidelines issued by the RBI and the policies framed by the bank itself regarding the discounting and rediscounting of bills. The auditor should ascertain that the policy framed by the bank conforms to the requirements laid down by the RBI.

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. This category will include bills covering export of goods, bills discounted by foreign branches of the bank and payable in their respective countries, etc.

Banks purchase or discount bills of exchange drawn or endorsed by their customers. The bank credits the amount of the bill to its customer after deducting the discount. The total amount of such bills is shown as an asset in the balance sheet.

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.

Bills purchased and discounted by the bank are generally drawn on outstation parties and are, therefore, sent by the bank to its branches or agents for collection immediately after their receipt. They are generally not in the possession of the bank on the closing date. The auditor therefore has to rely upon the Register of Bills Purchased and Discounted and the party-wise Register of Bills maintained by the bank. The auditor should examine these registers and satisfy himself that:

(a) all the outstanding bills have been taken in the balance sheet;
(b) all the details, including the nature of the bills and documents, are mentioned in the register and that the bills have been correctly classified;
(c) 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; and
(d) the bills are not overdue. If there are any overdue bills, the auditors should ascertain the reasons for the delay and the action taken by the bank.

The auditor should examine whether registers of bills purchased and discounted are properly maintained and the transactions are recorded therein correctly. He should examine whether the bills and the documents accompanying the bills are properly endorsed and assigned in favour of the bank. In checking the bills, it should be ensured that the bills are held along with the documents of title. In the case of documentary bills, it should be ensured that the related RR/RRs/Trs are held along with the invoices/hundies/bills and that these have not been parted with. Wherever such RR/Trs are not held on record, the fact should be duly considered by the auditor. The auditor should also examine bills collected subsequent to the year-end to obtain assurance regarding completeness and validity of the recorded bill amounts.

**Other Aspects:** Sometimes, a customer is sanctioned a cash credit limit at one branch but is authorised to utilise such overall limit at a number of other branches also, for each of which a sub-limit is fixed. In such a case, the determination of status of the account as NPA or otherwise should be determined at the limit-sanctioning branch with reference to the overall sanctioned limit/drawing power, and not by each of the other branches where a sub-limit has been fixed. The auditor should examine that any advances made by a banking company otherwise than in the course of banking business, such as, prepaid expenses, advance for
purchase of assets, etc., is not included under the head ‘advances’ but is included under ‘other assets’.

The amounts of advances in India and those outside India are to be shown separately in the balance sheet. The auditor should examine whether any loan has been granted in violation of the statutory limitations contained in section 20 of the Banking Regulations Act, 1949. If any such loan has been granted the report will have to be drafted with suitable qualifications, as the transaction would be ultra vires.

It may also be examined whether the bank has a system of ensuring the end use of the funds granted as compared with the purpose of sanction. The reports submitted by the inspectors/officers in this regard should be reviewed to form opinion on the quality of the asset and also to consider reporting any matter in the LFAR.

Adverse features in a borrower’s account are required to be reported in LFAR and hence during the course of verification all material information should be noted and documented in appropriate format. Following is an illustrative but not an exhaustive format:

1. Name of the Borrower.
2. Constitution.
3. Sanctioned limits as on Balance Sheet date.
4. Any change in limit during the year.
5. Terms of sanction.
6. Details of fulfilment of terms of sanction.
7. Details of Loan documents and observations on the same.
8. Balance outstanding as at balance sheet date.
9. Classification as per bank.
10. Whether classification requires a change.
11. If so the reasons for the differing view and the impact of the same.
12. Whether necessary changes made in Memorandum of Changes.
14. Deficiencies noted in the account.
15. Availability of security.
16. Timely submission of stock statement and other statements.

**Verification of Provision for Non-performing assets:** An important aspect of audit of advances relates to their classification and provisioning. This implies that a proper provision should be made in respect of advances where the recovery is doubtful. As mentioned earlier, the Reserve Bank has prescribed objective norms for determining the quantum of provisions required in respect of advances. The auditors must take / download the latest Master Circular of RBI to familiarise himself fully with the norms prescribed by RBI in this regard. The circulars
issued by RBI after the date of issue of Master Circular and till the date of audit should also be taken / downloaded and reviewed by the auditors for its adherence. However, these norms should be construed as laying down the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, such higher provision should be made. In this regard, the provisions of section 15 of the Banking Regulation Act, 1949 may be noted. This section, which applies to banking companies, nationalised banks, State Bank of India, its subsidiaries, and regional rural banks, requires the bank concerned to make adequate provision for bad debts to the satisfaction of its auditor before paying any dividends on its shares.

The accounting entry for provision in respect of debts that are doubtful of recovery is usually made at the head office level and is not recorded in the books at the branch level. The amount of provision to be made at the head office level is based largely on the classification of various advances into standard, sub-standard, doubtful and loss categories. The auditor should carefully examine whether the classification made by the branch is appropriate. In doing so, he should particularly examine the classification of advances where there are threats to recovery. The auditor should also examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.

As per the Reserve Bank guidelines, if an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA. Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.

It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date. The date of NPA is of significant importance to determine the classification and hence specific care be taken in this regard.

**Drawing Power Calculation**: Working capital borrowal account, drawing power calculated from stock statement older than 3 months has to be considered as “irregular” (overdue). If such “irregular” account continues for 90 days, account has to be classified as NPA, even though the account is otherwise operated regularly.

The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinised in detail.

The audited Annual Report submitted by the borrower should be scrutinised properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.
It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

The stock audit should be carried out by the bank for all accounts having funded exposure of more than ₹ 5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be ensured that mobilization advance being received by the contractors is reduced while calculating drawing power.

Limits not reviewed: Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of adhoc sanction, have to be considered as NPA. Auditors should also ensure that the ad hoc/short reviews are not done on repetitive basis. In such cases, auditor can consider the classification of account based on other parameters and functioning of the account.

Government Guaranteed Advances: If 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 realised. 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. 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.

Agricultural Advances: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season. For the purpose of these guidelines, “long duration” crops would be crops with crop season longer than one year and crops, which are not “long duration” crops, would be treated as “short duration” crops. The crop season for each crop, which means the period up to harvesting of the crops raised would be as determined by the State Level Bankers’ Committee in each State. Depending upon the duration of crops raised by an agriculturist, the above NPA norms would also be made applicable to agricultural term loans availed of by him. The above norms should be made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector. In respect of agricultural loans, other than those specified in the circular, identification of NPAs would be done on the same basis as non-agricultural advances, which, at present, is the 90 days delinquency norm.
Provisioning Towards Standard Assets: The auditor should check the latest RBI Circulars in this regard. The provisions need to be checked in detail with the statement of advances. The provisions bifurcation of standard advances under relevant category for proper calculation of provision should be checked and certified at branches level. The definition of respective items specified should be adhered as defined by RBI.

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

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

Audit Procedure for Accounts falling under CDR (Corporate Debt Restructuring) Programme: Following audit procedures are to be carried out to assess / gain an understanding about the borrower account-

(a) Review the present classification of the account under IRAC norms adopted by the bank and corresponding provision made in the books of accounts, if any. If the account is already treated as NPA in the books of the bank, the same cannot be upgraded only because of the CDR package.

(b) Review the Debtor- Creditor Agreement (DCA) and Inter Creditor Agreement (ICA) with respect to availability of such agreements and necessary provisions in the agreement for reference to CDR cell in case of necessity, penal clauses, stand-still clause, to abide by the various elements of CDR system etc., (DCA may be entered into at the time of original sanction of loan or at the time of reference to CDR).

(c) Auditor has to ascertain the terms of rehabilitation along with the sacrifices, if any, assumed in the rehabilitation program to verify whether such sacrifices have been accounted in the books of accounts of the lender. Ascertain whether any additional financing / conversion of loan into equity have been envisaged in the rehabilitation / restructuring program.
Auditor should also ascertain whether account has been referred to BIFR, as such cases are not eligible for restructuring under CDR system. Large value BIFR cases may be eligible for restructuring under CDR if specifically recommended by CDR core group. Auditor has to verify the necessary approvals / recommendations by CDR core group if auditor comes across any BIFR cases.

Auditor has to ensure that accounts wherein recovery suits have been filed, the initiative to resolve under CDR system is taken by at least by 75% of the creditors by value and 60% in number provided the account meets the basic criteria for becoming eligible under CDR mechanism.

**Treatment of accounts restructured under CDR program: Classification and Provisioning:** The criteria for classification of accounts will be on the basis of record of recovery as per the existing prudential norms. The asset classification will be as per the lender bank’s record of recovery and will be bank specific.

The auditor should ensure that the lender has applied the usual asset classification norms pending outcome of the account with the CDR Cell. The asset classification status should be restored to the position, which existed at the time of reference to the cell if the restructuring under the CDR system takes place.

The auditor should also ensure that in case a standard asset has been restructured second or more time, it has been downgraded to “sub-standard” asset.

The auditor should also ensure that proper disclosure in the Notes to Accounts in respect of CDR of SME undertaken by the bank during the year, as prescribed in the RBI’s circular, has been made.

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

The auditor should also examine that:

(i) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.

(ii) the assets have been sold/purchased ‘without recourse’ only.

(iii) subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.

(iv) the NPA has been sold at cash basis only.

(v) the bank has not purchased an NPA which it had originally sold.

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

(i) on the sale of the NPA, the same has been removed from the books of the account.

(ii) the short fall in the net book value has been charged to the profit and loss account.
where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/loss on account of sale of other non-performing financial assets.

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

(i) the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank.

(ii) any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.

(iii) for the purpose of capital adequacy, banks have assigned 100% risk weights to the NPAs purchased from other banks.

IV. Fixed Assets - The Third Schedule to the Banking Regulation Act, 1949 requires fixed assets to be classified into two categories in the balance sheet, viz., Premises and Other Fixed Assets. Though not specifically mentioned under the Banking Regulation Act, 1949, the assets taken on lease and intangible assets should be shown separately for proper classification and disclosure and also to comply with the requirements of the Accounting Standards (ASs).

Audit Procedures: In carrying out the audit of fixed assets, the auditor is concerned, primarily, with obtaining evidence about their existence and valuation. For this purpose, the auditor should review the system of internal controls relating to fixed assets, particularly the following:

- Control over expenditures incurred on fixed assets acquired or self constructed;

- Accountability and utilisation controls; and

- Information controls for ensuring availability of reliable information about fixed assets.

The branch auditor should ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. Similarly, he should ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. The procedures described in the following paragraphs would be relevant only to the extent the accounts and documents of title, etc., relating to fixed assets are maintained at the branch. Where the acquisition, disposal, etc., of fixed assets take place at branches/other offices, but accounting of fixed assets is done at the head office, the branch auditor should examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.

Premises: The auditor should verify the opening balance of premises with reference to schedule of fixed assets, ledger or fixed assets register. Acquisition of new premises should be verified with reference to authorisation, title deeds, record of payment, etc. Self-constructed fixed assets should be verified with reference to authorisation and documents such as, contractors’ bills, work order records and record of payments. The auditor should also examine whether the balances as per the fixed assets register reconcile with those as per the
ledger and the final statements.

In the case of leasehold premises, capitalisation and amortisation of lease premium, if any, should be examined. Any improvements to leasehold premises should be amortised over their balance residual life.

In case the title deeds are held at the head office or some other location, the branch auditor should obtain a written representation to this effect from the branch management and should bring this fact to the notice of the central statutory auditor through a suitable mention in his report. This fact should also be brought in the Long Form Audit Report (LFAR).

Where premises are under construction, it should be seen that they are shown under a separate heading, e.g., ‘premises under construction’. Advances to contractors may be shown as a separate item under the head ‘fixed assets’ or under the head ‘other assets’. It should be ensured that where the branch has obtained the licence to commence business and is ready for use then the same is not shown as “premises under construction”. In such cases even if all the bills/documents from the contractors/suppliers are not received, at the year end, an estimate of the expenditure thereon should be made and capitalised on a provisional basis.

Where the premises (or any other fixed assets) are re-valued, the auditor should examine the appropriateness of the basis of revaluation. The auditor should also examine whether the treatment of resultant revaluation surplus or deficit is in accordance with relevant Accounting Standard.

The auditor should also check the impairment, if any, by applying the principles laid down in relevant Accounting Standard.

The auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, howsoever acquired (i.e., whether acquired by way of satisfaction of claims or otherwise), for a period exceeding seven years from the date of acquisition, except such as is required for its own use. The auditor should specifically examine that no immovable properties other than those required for the own use of the bank have been included in fixed assets (own use would cover use by employees of the bank, e.g., residential premises provided to employees). The branch auditor should also obtain a written representation to the above effect from the branch management.

**Other Fixed Assets:** The procedures discussed above regarding premises also apply, to the extent relevant, to verification of other fixed assets. In respect of moveable fixed assets, the auditor should pay particular attention to the system of recording the movements as well as other controls over such fixed assets, e.g., their physical verification at periodic intervals by the branch management and/or by inspection/ internal/concurrent audit team. He should also examine whether discrepancies have been properly dealt with in the books of account and adequate provision in respect of any damaged assets has been made.

In recent years, banks have incurred substantial expenditure on computer hardware and software. Computer software that is essential for the functioning of the hardware (e.g., operating system) can be considered an integral part of the related hardware. The expenditure incurred on acquisition and installation of the hardware (as also on any systems software considered to be an integral part of the related hardware) should be capitalised in accordance
with the principles laid down in relevant Accounting Standard and depreciated over the remaining useful life of the hardware. Hardware and software are susceptible to faster rate of technical obsolescence, hence the auditor must take into consideration this fact while verifying the provision for depreciation on these assets. The same, however, should not be depreciated for a period of more than three years.

Application software is not an integral part of the related hardware and is treated as an intangible asset. Accordingly, the same should be accounted for as per Accounting Standard (AS 26), "Intangible Assets". The treatment of expenditure on applications software, whether acquired from outside or developed in-house, would also be similar. However, in estimating the useful life of applications software, the rapid pace of changes in software as also the need for periodic modification/ upgradation of software to cater to changes in nature of transactions, information needs etc. need special consideration. As far as expenditure during the stage of in-house development of software is concerned, the same needs to be accounted for in accordance with AS 26, "Intangible Assets", according to which expenditure incurred during the research phase should not be capitalised as part of cost of intangibles. While capitalising the development phase expenditure, due consideration should be given to Paragraph 44 of the said Standard. While conducting the audit of intangible assets, the auditor should also consider the guidelines given by RBI by way of Circulars.

Many a time, fixed assets like furniture, office equipments, etc. are transferred from one branch to another. The auditor should examine whether accumulated depreciation in respect of such assets is also transferred. It may be noted that the consolidated accounts of the bank would not be affected by such transfers.

It should be examined whether fixed assets have been properly classified. Fixed assets of similar nature only should be grouped together. For example, items like safe deposit vaults should not be clubbed together with the office equipments or the theft alarm system of the bank.

In respect of fixed assets sold during the year, a copy of the sale deed, if any, and receipt of the sale value should be examined by the auditor. In such a case, it should also be seen that the original cost and accumulated depreciation on the assets sold have been correctly adjusted. Profit earned or loss incurred on such sales should also be checked.

The auditor should examine whether any expenditure incurred on a fixed asset after it has been brought to its working condition for its intended use, has been dealt with properly.

The auditor at head office level should examine if the consolidated fixed assets schedule matches in all respect and all the transfers ins/outs, are tallied. A broad check on the depreciation amount vis-a-vis the gross block of assets be reviewed with special emphasis on the computer hardware/software.

**Leased Assets:** RBI's Circular No. DBOD No.FSC.BC.70/24.01.001/99 dated July 17, 1999 deals with accounting and provisioning norms to be followed by banks undertaking leasing activity. The auditor, in respect of leased assets, should also have regard to the requirements of AS 19, “Leases”.

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Impairment of Assets: AS 28 prescribe the procedures that an enterprise should apply to ensure that its assets are carried at not more than their recoverable amount. An asset is treated as carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognise an impairment loss. This Standard also prescribes when an enterprise should reverse an impairment loss and it prescribes certain disclosures for impaired assets. This Standard requires that an enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. The impairment loss if recognised shall be debited in the profit and loss account provided no revaluation reserve exists at that date in relation to the asset, and if it exists, the loss should first be debited to revaluation reserve. After debiting the revaluation reserve, if still there is impairment loss then the same should be debited to profit and loss account. RBI’s circular on compliance with Accounting Standards, issued in April 2004 states as follows in respect of AS 28:

- The Standard would not apply to investments, inventories and financial assets such as loans and advances and may generally be applicable to banks in so far as it relates to fixed assets.
- Banks may also take into account the following specific factors while complying with the Standard:
  - Paragraphs 7 and 8 of the Standard have clearly listed the triggers which may indicate impairment of the value assets. Hence, banks may be guided by these in determining the circumstances when the Standard is applicable to banks and how frequently the assets covered by the Standard need to be reviewed to measure impairment.
  - In addition to the assets of banks which are specifically identified above, viz., financial assets, inventories, investment, loans and advances etc to which the Standard does not apply, the Standard would apply to financial lease assets and non banking assets acquired in settlement of claims only when the indications of impairment of the entity are evident.

V. Other Assets - The branch auditor may carry out the audit of various items appearing under the head ‘other assets’ in the following manner:

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

Interest Accrued: The main components of this item are interest accrued but not due on investments and advances and interest due but not collected on investments. As banks
normally debit the borrower’s account with interest due on the balance sheet date, there would not usually be any amount of interest accrued but not due on advances as banks normally debit the borrowers account with interest due on the balance sheet date, there would not usually be any amount of interest accrued but not due on advances. On the other hand interest on government securities, debentures, bonds, etc. which accrues from day to day should be calculated and brought into account, in so far as it has accrued on the date of the balance sheet. The auditor should examine whether the interest has been accrued on the entire loans and advances portfolio of the bank. Special consideration should be given to the overdue bills purchased/discounted.

The auditor should ensure that only such interest as can be realised in the ordinary course of business should be shown under this head. This is based on the principle, recognised in AS 9, that revenue cannot be recognised if there is a significant uncertainty about its collectability. Dividends recognised as income but not received may be included in the residuary sub-head of ‘others’. Dividends and interest on investments would be recognised in the books of the branch only if it is handling the work relating to investments or receipt of income on investments.

**Tax Paid in Advance/Tax Deducted at Source:** Generally, this item is dealt with at the head office level only and would, therefore, not appear in the balance sheet of a branch, except that tax deducted at source on fixed deposits and other products/services is handled at the branch level. The procedures to be followed by the branch auditor for verification of tax deducted at source by the branch would be similar to those in an audit of other types of entities. The branch auditor needs to ensure that the certificates for such tax deducted at source is collected by the branch and the original copy is sent to the Head Office along with the transfer of such Tax Deducted at Source (TDS) amount to Head Office on periodic basis as defined.

At Head Office level, the availability of all the TDS Certificates, submission of the same with Income Tax Department/claim of the same in Income Tax returns filed should be checked to ensure the justification of the claim towards such certificates.

**Stationery and Stamps:** Internal controls over stationery of security items (like term deposit receipts, drafts, pay orders, cheque books, traveller’s cheques, gift cheques, etc.) assume special significance in the case of banks as their loss or misuse could eventually lead to a misappropriation of the most valuable physical asset of a bank, viz., cash. The branch auditor should study and evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of his audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of the relevant internal controls in his LFAR.

The item “Stationery and Stamps” should include only exceptional items of expenditure on stationery like, bulk purchase of security paper, loose leaf or other ledgers, etc., which are shown as quasi-asset to be written off over a period of time. In other words, the normal expenditure on stationery may be treated as an expense in the profit and loss account, while unusually heavy expenditure may be treated as an asset to be written off based on issue/consumption. At the branch level, the expenditure on latter category may not appear since a considerable part of the stationery is supplied to branches by the head office.

The auditor should physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be inquired into as it could expose
the bank to a potential loss from misuse. The auditor should examine whether the cost of stationery and stamps consumed during the year has been properly charged to the profit and loss account for the year in the context of the accounting policy/instructions from the head office regarding treatment of cost of stationery and stamps.

**Non-Banking Assets Acquired in Satisfaction of Claims:** Under this heading, will be included, those immovable properties/tangible assets, which the bank has acquired in satisfaction of debts due or its other claims and are being held with the intention of being disposed of.

While examining this item, the auditor should specifically keep in mind the provisions of section 9 of the Banking Regulation Act, 1949, which prohibit a banking company from holding any immovable property, however, acquired (i.e., whether acquired by way of satisfaction of claims or otherwise), except such as is required for its own use, for any period exceeding seven years from the date of acquisition thereof. During this period, the bank may deal or trade in any such property for the purpose of facilitating the disposal thereof. The RBI has the power to extend the aforesaid period in a particular case up to another five years. (It may be noted that the aforesaid section is applicable to banking companies only and not to other types of banks like nationalised banks.)

The auditor should verify such assets with reference to the relevant documentary evidence, e.g., terms of settlement with the party, order of the Court or the award of arbitration, etc. He should satisfy himself that the ownership of the property has legally vested in the bank. If there is any dispute or other claim about the property, the auditor should examine whether the recording of the asset is appropriate or not. In case the dispute arises subsequently, the auditor should examine whether a provision for liability or disclosure of a contingent liability is appropriate, keeping in view the requirements of AS 29 “Provisions, Contingent Liabilities and Contingent Assets”.

**Others:** This is the residual heading, which will include items not specifically covered under other sub-heads, e.g., claims which have not been received, debit items representing additions to assets or reductions in liabilities which have not been adjusted for technical reasons or want of particulars, etc., receivables on account of government business, prepaid expenses, Accrued income other than interest (e.g., dividend declared but not received) may also be included under this head. The audit procedures relating to some of the major items included under this head are discussed below-

**Non-Interest Bearing Staff Advances:** The auditor should examine non-interest bearing staff advances with reference to the relevant documentation and the policy in this regard which is framed by the bank. The availability, enforceability and valuation of security, if any, should also be examined. It needs to be ensured that the same relates to employees on the roll of the bank on the date of the preparation of financial statements.

**Security Deposits:** Security deposits with various authorities (e.g., on account of telephone, electricity, etc.,) and with others (e.g., deposits in respect of premises taken on rent) should be examined with reference to documents containing relevant terms and conditions, and receipts obtained from the parties concerned. It needs to be ensured that the deposit amount has not become due as per the terms and conditions. If it is so, then the recoverability of the same...
needs to be looked into in detail and appropriate provision be made against the amount which is doubtful to recover.

**Suspense Account:** 'Suspense' account is another item included under 'other assets'. Ideally, where accounts are maintained properly and on a timely basis, the suspense account may not arise. However, in a practical situation, suspense account is often used to temporarily record certain items such as the following:

(i) amounts temporarily recorded under this head till determination of the precise nature thereof or pending transfer thereof to the appropriate head of account;

(ii) debit balances arising from payment of interest warrants/ dividend warrants pending reconciliation of amounts deposited by the company concerned with the bank and the payment made by various branches on this account;

(iii) amounts of losses on account of frauds awaiting adjustment.

The auditor should pay special attention to any unusual items in suspense account. He should obtain from the management details of old outstanding entries in suspense account along with reasons for delay in adjusting the entries. Where the outstanding balances comprised in suspense account require a provision/write-off, the auditor should examine whether the necessary provision has been made/write-off.

**Prepaid Expenses:** The auditor should verify prepaid expenses in the same manner as in the case of other entities. Thus, the auditor should examine whether the basis of allocation of expenditure to different periods is reasonable. He should particularly examine whether the allocation of discounting and rediscounting charges paid by the bank to different accounting periods is in consonance with the accounting policy followed for the bank as a whole.

**Miscellaneous Debit Balances on Government Account:** Miscellaneous debit balances on government account in respect of pension, public provident funds, compulsory deposit scheme payments, etc., for which the branch obtains reimbursement from the government through a designated branch, are also included under the head 'others'. The auditor should review the ageing statements pertaining to these items. He should particularly examine the recoverability of old outstanding items. The auditor should also examine whether claims for reimbursement have been lodged by the branch in accordance with the relevant terms and conditions. The net balances of the amount recoverable at the Head Office level should also be taken along with the age-wise analysis of the same. In case of old outstanding balances without any confirmation or proper justification of the same, should be provided for in the accounts.

The residual item of “Others” in Other Assets generally constitutes a significant amount in the Balance Sheet of the bank. The Head Office auditors should obtain the head wise details of the same along with the previous year figures. The age-wise details of the major outstanding should also be obtained, wherever, feasible. Further, the major variance as compared to the previous year figures should also be enquired into and reasons for the same should be recorded and reviewed. In case any amount seems doubtful of recovery, appropriate provisions against the same should be made.
VI. Capital - The following particulars have to be given in respect of share capital in the balance sheet.

(a) For Banks Incorporated in India

- Authorised Capital (shares of ₹ each)
- Issued Capital (-do-)
- Subscribed Capital (-do-)
- Called-up Capital (-do-)

Less: Calls unpaid
Add: Forfeited shares

(In case of Nationalised Banks capital owned by Central Government as on the date of balance sheet including contribution from Government, if any, for participating in World Bank Projects should be shown separately.)

(b) For Banks Incorporated Outside India

(i) Capital (the amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head).

(ii) Amount of deposit kept with the RBI under section 11(2) of the Banking Regulation Act, 1949.

The auditor should verify the opening balance of capital with reference to the audited balance sheet of the previous year. In case there has been an increase in capital during the year, the auditor should examine the relevant documents supporting the increase. For example, in case of an increase in the authorised capital of a banking company, the auditor should examine the special resolution of shareholders and the memorandum of association. An increase in subscribed and paid-up capital of a banking company, on the other hand, should be verified with reference to prospectus/other offer document, reports received from registrars to the issue, bank statement, etc.

11.7 Capital Adequacy

The term 'capital adequacy' is used to describe the adequacy of capital resources of a bank in relation to the risks associated with its operations.

Adequacy of capital of banks has been the subject matter of consideration by banking authorities around the world for several decades. For example, in 1975, the Bank of England published the conclusions of a Joint Working Party which had been formed by the Bank along with several clearing banks to examine the nature of capital and of liquidity of banks and to develop principles for examining their adequacy. The paper outlined two ratios for assessing the adequacy of capital: 'free resources ratio' and 'risk asset ratio'. The free resources ratio related current liabilities to capital resources excluding the part of capital devoted to financing infrastructure and other non-banking assets. The risk asset ratio related the risk of losses inherent in the assets of the business of banks to the capital available to absorb such losses. The paper argued that the risk asset ratio was more useful.
The risk asset measure has since received wide international acceptance as the basis for measuring the capital adequacy of banks. An international agreement on a common risk-based capital framework and definition of bank capital was framed by the Committee on Banking Regulations and Supervisory Practices of the G-10 Nations (popularly known as the Basel Committee) and was formally adopted in 1988. It was also adopted by all the twenty-five countries that were either full members of the Organisation for Economic Co-operation and Development or had special lending arrangements under the International Monetary Fund’s general borrowing procedures.

The framework attempted to relate a bank’s capital needs to its risk profile. Besides serving to strengthen the soundness and stability of the banking system, it also sought to give banks an incentive to hold lower-risk assets, incorporate off-balance sheet exposures explicitly into capital assessments, and achieve greater uniformity in application of capital standards to banks across different countries. The prescribed minimum capital standards for risk-based capital were to apply to banks on a transitional basis beginning at the year-end 1990 and were to be fully in place by end 1992.

**Capital Adequacy Measures in India:** In India, the statutes governing various types of banks lay down the minimum capital requirements for them. Besides, there are also requirements for maintenance of statutory reserves. Considering the variations in minimum capital requirements applicable to different types of banks and taking into account the approach adopted by Basel Committee, the Reserve Bank prescribed, in year 1992, a uniform methodology for determining the capital adequacy of scheduled commercial banks (other than regional rural banks). The Master Circular on “Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF)”, provides the guidelines to be followed by banks for capital adequacy. Some of the important aspects of the circular are covered below.

The basic approach of capital adequacy framework is that a bank should have sufficient capital to provide a stable resource to absorb any losses arising from the risks in its business. Capital is divided into tiers according to the characteristics/qualities of each qualifying instrument. For supervisory purposes capital is split into two categories: Tier I and Tier II, representing different instruments’ quality as capital.

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

**Components of Capital:** The Master Circular on Capital Adequacy discusses the Capital Funds in two categories – capital funds for Indian banks and capital funds of foreign banks operating in India. The following table shows the components of the Capital Funds for Indian vis a vis foreign banks operating in India.
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<th>Tier Capital</th>
<th>Indian Banks</th>
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<td>Interest free funds from Head Office(^2)</td>
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<tr>
<td></td>
<td>Statutory reserves</td>
<td>Statutory reserves kept in Indian books</td>
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<td></td>
<td>Other disclosed free reserves, if any</td>
<td>Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India</td>
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\(^2\) Kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

* The annexure to the Master Circular on Prudential Norms on Capital Adequacy- Basel I Framework provides the guidelines for Perpetual non-cumulative preference shares eligible for inclusion as Tier I capital.
In case of foreign banks operating in India, RBI’s Master Circular on Capital Adequacy also lays down certain additional provisions in respect of capital to be followed by such banks.

**Undisclosed Reserves:** They can be included in capital, if they represent accumulations of post-tax profits and are not encumbered by any known liability and should not be routinely used for absorbing normal loss or operating losses.

**Re-valuation Reserves:** It would be prudent to consider re-valuation reserves at a discount of 55 percent while determining their value for inclusion in Tier II capital. Such reserves will have to be reflected on the face of the Balance Sheet as re-valuation reserves.

**General Provisions and Loss Reserves:** Such reserves can be included in Tier II capital if they are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier II capital. General provisions/loss reserves will be admitted up to a maximum of 1.25 percent of total risk weighted assets. ‘Floating Provisions’ held by the banks, which is general in nature and not made against any identified assets, may be treated as a part of Tier II capital within the overall ceiling of 1.25 percent of total risk weighted assets, if such provisions are not netted off from gross NPAs to arrive at disclosure of net NPAs.

**Hybrid Debt Capital Instruments:** Those instruments which have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier II capital. At present following instruments have been recognised and placed under this category.

1. **Perpetual Cumulative Preference Shares (PCPS)/ Redeemable Non-Cumulative Preference Shares (RNCPS)/Redeemable Cumulative Preference shares (RCPS) as part of upper Tier II capital.**
2. **Debt capital instruments eligible for inclusion as Upper Tier II capital.**

**Subordinated Debt:** To be eligible for inclusion in Tier II capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses, and should not be redeemable at the initiative of the holder or without the consent of the RBI. They often carry a fixed maturity, and as they approach maturity, they should be subjected to progressive discount, for inclusion in Tier II capital. Instruments with an initial maturity of less than 5 years or with a remaining maturity of one year should not be included as part of Tier II capital.

**Investment Reserve Account:** In the event of provisions created on account of depreciation in the ‘Available for Sale’ or ‘Held for Trading’ categories being found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment Reserve Account in Schedule 2 –“Reserves & Surplus” under the head “Revenue and other Reserves” and would be eligible for inclusion under Tier II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.
Banks are allowed to include the ‘General Provisions on Standard Assets’ and ‘Provisions held for Country Exposures’ in Tier II capital. However, the provisions on ‘standard assets’ together with other ‘general provisions/loss reserves’ and ‘provisions held for country exposures’ will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

**Capital Risk Adequacy Ratio (CRAR)**

The CRAR is computed as follows:

\[
\frac{\text{Capital Funds}}{\text{Risk weighted assets and off-balance sheet items}} \times 100
\]

The RBI requires banks to maintain a minimum CRAR of 9 per cent on an ongoing basis. The Master Circular on Capital Adequacy contains detailed guidelines on calculation of risk weighted assets and off-balance sheet items and CRAR.

**VII. Reserves and Surplus** - The following are required to be disclosed in the balance sheet under the head ‘Reserves and Surplus’.

I. Statutory Reserves

II. Capital Reserves

III. Share Premium

IV. Revenue and Other Reserves including investment Fluctuation Reserve

(In respect of items I – IV above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item)

V. Balance in Profit and Loss Account

**Statutory Reserves:** Under sub-section (1) of section 17 of the Banking Regulation Act, 1949 every banking company incorporated in India has to transfer 20% of its profits to its reserve fund each year before declaring dividends. The transfer to reserve as above and any other reserve created in pursuance of any section of the Act has also to be disclosed under the aforesaid head. Sec 17(2) of Act provides that where a banking company appropriates any sum or sums from the reserve fund or the share premium account, it shall, within twenty-one days from the date of such appropriation, report the fact to the RBI, explaining the circumstances relating to such appropriation.

All scheduled commercial banks, including foreign banks operating in India, (except RRBs/LABs) have been instructed to transfer not less than 25% of the ‘net profit’ (before appropriations) to the Reserve Fund with effect from the year ending 31st March, 2001. Such transfer to reserves may be made “after adjustment / provision towards bonus to staff”.

**Capital Reserves:** The expression ‘capital reserves’ does not include any amount regarded as free for distribution through the profit and loss account. According to the Notes and Instructions for Compilation of Balance Sheet, issued by the RBI, surplus on re-valuation or sale of fixed assets is to be treated as capital reserve.

**Securities Premium Account:** According to section 52 of the Companies Act, 2013, where a company issues shares at a premium, the amount of premium should be transferred to a
separate account to be called the ‘securities premium account’. The provisions of the Companies Act, 2013 regarding reduction of capital also apply to securities premium account. However, as per section 52, the securities premium may be applied for the following purposes:

(a) issuing fully paid bonus securities;
(b) writing off the preliminary expenses;
(c) writing off the expenses of, or the commission paid or discount allowed on, any issue of securities or debentures;
(d) providing for the premium payable on the redemption of any redeemable preference securities or debentures; or
(e) for the purchase of its own shares or of other securities under section 68 of the Companies Act, 2013.

A banking company has to report to the RBI any appropriations made from the securities premium account. Such an appropriation can be only for the purposes described above or in accordance with the provisions governing reduction of share capital by a company.

Revenue and Other Reserves: According to the Notes and Instructions for Compilation of Balance Sheet and Profit and Loss Account, issued by the RBI, the expression ‘Revenue Reserve’ shall mean any reserve other than capital reserve.

All reserves, other than those separately classified (viz., statutory reserves, capital reserves and share premium) will be shown under this head. The expression ‘reserve’ shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability. In terms of RBI guidelines, the ‘Investment Reserve Account’ representing write back of excess provision on investments has to be treated as revenue reserve.

Balance of Profit: This item includes balance of profit after appropriations. According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, in case of loss, the balance may be shown as a deduction. Though it is not mentioned whether the loss is to be deducted from the aggregate of ‘reserves’ or from ‘revenue and other reserves’ only, it is obvious on a consideration of legal requirements and sound accounting principles that the loss should be deducted only from revenue reserves.

Further, as prescribed by RBI’s circular, the banks need to obtain prior approval of the Reserve Bank of India before any appropriation is made from the statutory reserve or any other reserve.

The said circular also requires that:

(i) all expenses including provisions and write offs recognised in a period, whether mandatory or prudential, should be reflected in the Profit and Loss Account for the period as an ‘above the line’ item (i.e., before arriving at the net profit);
(ii) wherever draw down from reserves takes place with the prior approval of Reserve Bank, it should be effected only “below the line”, (i.e., after arriving at the profit/loss for the period); and
(iii) suitable disclosures should be made of such draw down of reserves in the ‘Notes on Accounts’ to the Balance Sheet.

**Audit Procedures:** The auditor should verify the opening balances of various reserves with reference to the audited balance sheet of the previous year. Additions to or deductions from reserves should also be verified in the usual manner, e.g., with reference to board resolution. In the case of statutory reserves and share premium, compliance with legal requirements should also be examined. Thus, the auditor should specifically examine whether the requirements of the governing legislation regarding transfer of the prescribed percentage of profits to reserve fund have been complied with. In case the bank has been granted exemption from such transfer, the auditor should examine the relevant documents granting such exemption. Similarly, it should be examined whether the appropriations from share premium account conform to the relevant legal requirements.

**VIII. Deposits** - Deposits are required to be classified in the balance sheet under the following heads.

A. I. **Demand Deposits**
   (i) From Banks
   (ii) From Others

II. **Savings Bank Deposits**

III. **Term Deposits**
   (i) From Banks
   (ii) From Others

B. I. **Deposits of branches in India**

II. **Deposits of branches outside India**

**Audit Procedures:** In carrying out audit of deposits and liabilities, the auditor is primarily concerned with obtaining reasonable assurance that all known liabilities are recorded and stated at appropriate amounts.

The auditor may verify various types of deposits in the following manner:

**Current Accounts:** The auditor should verify the balances in individual accounts on a sampling basis. He should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

Some banks have a procedure for obtaining confirmation of balances periodically. The auditor should examine whether the procedure laid down in this behalf has been followed consistently throughout the year. He should also examine, on a sampling basis, the confirmations received.

The auditor should ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head ‘advances’.

Inoperative accounts are a common area of frauds in banks. While examining current accounts, the auditor should specifically cover in his sample some of the inoperative accounts.
revived during the year. The auditor should also ascertain whether inoperative accounts are ‘revived’ only with proper authority. For this purpose, the auditor should identify cases where there has been a significant reduction in balances compared to the previous year and examine the authorisation for withdrawals.

**Savings Bank Deposits:** The auditor should verify the balances in individual accounts on a sampling basis. He should also examine whether the balances as per subsidiary ledgers tally with the related control accounts in the General Ledger. In case of any differences, the auditor should examine the reconciliation prepared by the branch in this regard.

The auditor should also check the calculations of interest on a test check basis. In case of branch under Core Banking Solution (CBS) the product sheet for calculation of interest on saving bank account can be obtained in selected sample and can verify the calculation. In case of manual branches the calculation can be verified as per the work sheets.

As in the case of current accounts, the auditor should pay special attention to inoperative savings bank accounts.

**Term Deposits:** While evaluating the internal controls over term deposits, the auditor should specifically examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. The auditor should also satisfy himself that there is a proper control over the unused forms of deposit receipts and cash certificates to prevent their misuse.

As stated earlier, the rate of interest on Certificates of Deposits (CDs) is negotiable with the depositor. This area is quite sensitive. The auditor should bear this fact in mind while examining the efficacy of prescribed internal controls with regard to rates of interest on CDs.

The auditor should verify the deposits with reference to the relevant registers. The auditor should also examine, on a sampling basis, the registers with the counter-foils of the receipts issued and with the discharged receipts returned to the bank. The reconciliation of subsidiary records for various types of term deposits with the related control accounts in the General Ledger should be examined. The auditor should also examine whether provision has been made for interest accrued on the deposits up to the date of the balance sheet. Auditor should ensure that proper provision for interest payable on deposits is made.

In some cases, banks employ some persons as ‘collectors’ to collect the deposits from depositors, e.g., in case of recurring deposits. In such cases, the auditor should specifically examine the efficacy of the internal control procedures for reconciling the records of the bank with those of the collectors.

Term deposits from banks are usually (though not necessarily) in round figures. Any odd balances should, therefore, put the auditor to enquiry.

**Deposits Designated in Foreign Currencies:** In the case of deposits designated in a foreign currency, e.g., foreign currency non-resident deposits, the auditor should examine whether they have been converted into Indian rupees at the rate notified in this behalf by the head office. The auditor should also examine whether any resultant increase or decrease has been taken to the profit and loss account. It may also be seen that interest on deposits has been paid on the basis of 360 days in a year. Further, in case of conversion of FCNR (B) deposits
into NRE deposits or vice versa before maturity has been subjected to the provisions relating to premature withdrawal.

**Interest Accrued But Not Due:** The auditor should examine that interest accrued but not due on deposits is not included under the relevant deposits but is shown under the head ‘other liabilities and provisions’.

**Overall Reconciliation:** The procedures of banks usually provide for periodic correlation of outstanding deposits with the cost of deposits. The auditor should ascertain from the management whether such an exercise has been carried out and if so, he should review the same. The auditor should examine that interest accrued but not due has also been considered for this purpose.

**Window-dressing:** There are several ways in which the deposits of a bank may be inflated for purposes of balance sheet presentation. For example, some of the constituents may be allowed overdraft on or around the date of the balance sheet, the overdrawn amounts may be placed as deposits with the bank, and further advances may be given on the security of the deposit receipts, thus inflating deposits as well as advances. The transactions may be reversed immediately after the close of the year. Where the auditor comes across transactions, which indicate the possibility of window-dressing, he may report the same in his long form audit report. In appropriate cases, the auditor should consider making a suitable qualification in his main audit report also.

**Know Your Customers Norms:** RBI has issued instructions to all banks to implement without fail certain procedural norms on KYC. Failure would attract levy of penalty and if penalty has been levied the same is to be disclosed in the notes to accounts. In view of the nature of the directive the audit procedure may be suitably adopted to enquire the system of implementation and review of other reports in respect of this area. The auditor should examine that an adequate there exists proper procedure in place to ensure that framework relating to ‘Know Your Customer’ and Anti-Money Laundering measures is formulated and put in place by the bank.

**IX. Borrowing** - Borrowings of a bank are required to be shown in balance sheet as follows.

I. **Borrowings in India**
   (i) Reserve Bank of India
   (ii) Other Banks
   (iii) Other Institutions and Agencies

II. **Borrowings outside India**

The total amount of secured borrowings included under the above heads is to be shown by way of a note to the relevant schedule. Secured borrowings for this purpose include borrowings/refinance in India as well as outside India. It may be noted that the inter-office transactions are not borrowings and therefore, should not be presented as such.
Audit Procedures

Borrowings from RBI, other banks/financial institutions, etc. should be verified by the auditor with reference to confirmation certificates and other supporting documents such as agreements, correspondence, etc. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence that the auditor requires to respond to significant risks of material misstatement. The auditor is required to comply with the requirements of SA 505 “External Confirmations” which contains guidance on designing and performing external confirmation procedures to obtain relevant and reliable audit evidence.

The auditor should also examine whether a clear distinction has been made between ‘rediscount’ and ‘refinance’ for disclosure of the amount under the above head since rediscount does not figure under this head.

The auditor should examine whether borrowings of money at call and short notice are properly authorised. The rate of interest paid/payable on, as well as duration of such borrowings should also be examined by the auditor.

The auditor should similarly examine the relevant correspondence or other documents to ensure that the branch has been authorised by the head office to borrow/retain other borrowings and that the terms on which borrowings have been made are in accordance with the authorisation.

The auditor should examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

X. Other Liabilities and Provisions - The Third Schedule to the Banking Regulation Act, 1949, requires disclosure of the following items under the head ‘Other Liabilities and Provisions’.

(a) Bills payable
(b) Inter-office adjustments (net)
(c) Interest accrued
(d) Others (including provisions)

Audit Procedures: The auditor may verify the various items under the head ‘other liabilities and provisions’ in the following manner.

Bills Payable: The auditor should evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following-

(a) Drafts, mail transfers, traveller’s cheques, etc. should be made out in standard printed forms.
(b) Unused forms relating to drafts, traveller’s cheques, etc. should be kept under the custody of a responsible officer.
(c) The bank should have a reliable private code known only to the responsible officers of its branches coding and decoding of the telegrams should be done only by such officers.
(d) The signatures on a demand draft should be checked by an officer with the specimen
signature book.

(e) All the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advices to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch.

(f) If the paying branch does not receive proper confirmation of any telegraphic transfers or demand draft from the issuing branch, it should take immediate steps to ascertain the reasons.

(g) In case an instrument prepared on a security paper, e.g., draft, has to be cancelled (say, due to error in preparation), it should be ensured that the manner of cancellation is such that the instrument cannot be misused. (For example, in the case of drafts, banks generally cut the distinctive serial number printed on the form and paste it in the book in which drafts issued are entered.) Cases of frequent cancellation and re-issuance of drafts, pay orders, etc. should be carefully looked into by a responsible official.

Based on his evaluation of the efficacy of the relevant internal controls, the auditor should examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding debits in respect of drafts or other similar instruments paid without advice should be ascertained. Correspondence with other branches after the year-end (e.g., responding advices received from other branches, advices received from other branches in respect of drafts issued by the branch and paid by the other branches without advice) should also be examined specially in so far as large value items outstanding on the balance sheet date are concerned.

Others (Including Provisions): It may be noted that the figure of advances and investments in the balance sheet of a bank excludes provisions in respect thereof made to the satisfaction of auditors. The auditor should examine other provisions and other items of liabilities in the same manner as in the case of other entities.

Inter-office Adjustments - The balance in inter-office adjustments account, if in credit, is to be shown under this head.

Interest Accrued - Interest accrued but not due on deposits and borrowings is to be shown under this head. The auditor should examine this item with reference to terms of the various types of deposits and borrowings. It should be specifically examined that such interest has not been clubbed with the figures of deposits and borrowings shown under the head ‘Deposits and Borrowings’.

Others (including provisions) - According to the Notes and Instructions for compilation of balance sheet and profit and loss account, issued by the RBI, the following items are to be included under this head:

(a) Net provision for income tax and other taxes like interest tax, less advance payment and tax deducted at source.

(b) Surplus/provisions in bad and doubtful debts provision account (such surplus is in the nature of a reserve).

(c) Surplus/provisions for depreciation in securities (such surplus is in the nature of a
(d) Contingency funds, which are actually in the nature of reserves but are not disclosed as such.

(e) Proposed dividend/transfer to Government.

(f) Other liabilities, which are not disclosed under any of the major heads such as unclaimed dividend, provisions and funds kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance, etc.

(g) Certain types of deposits like staff security deposits, margin deposits, etc., which are repayable only subject to compliance with certain conditions. (The interest on such deposits would also be included under this head).

(h) Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years.

Besides the above items, the following are other important items usually included under this head:

(a) Collections in respect of suit-filed accounts. These are not adjusted against advances till final settlement. (However, for the purpose of provisioning against non-performing advances, such credit balances are taken into account for ascertaining net outstandings).

(b) Collection of income-tax on behalf of the Government.

(c) Collection from DICGC. These are carried till final realisation/write-off of the concerned advance account.

(d) Provisions for frauds. These are ultimately adjusted by way of a write-off.

(e) Insurance claims received in respect of frauds. These are retained separately till final write-off in respect of fraud.

(f) Provision for gratuity, pension and other staff benefits.

(g) Provision for bank’s share in the expenses of the Banking Services Recruitment Board.

(h) Provision for audit fees.

(i) Unamortized interest income on the bills purchased/discounted.

It may be noted that many of the items to be disclosed under this head are accounted for at the head office level and would not therefore form part of balance sheet of a branch.

XI. Contingent Liabilities - 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

Audit Procedures

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:

(a) 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.

(b) 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.

(c) 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.

(d) 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.

(e) 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.

(f) 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.

(g) Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities.

(h) Obtain representation from the management that:
   (i) all contingent liabilities have been disclosed;
   (ii) 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;
(iii) 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;

(iv) 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

(v) 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.

(i) 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.

(j) 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.

The specific procedures to be employed by the auditor to verify various items of contingent liabilities are discussed in the following paragraphs. It may be noted that many of the items discussed in the following paragraphs, may be designated in foreign currencies.

**Claims Against the Bank Not Acknowledged as Debts:** The auditor should examine the relevant evidence, e.g., correspondence with lawyers/others, claimants, workers/officers, and workmen’s/officers’ unions. The auditor should also review the minutes of meetings of board of directors/committees of board of directors, contracts, agreements and arrangements, list of pending legal cases, and correspondence relating to taxes, and 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 the year. A review of subsequent events would also provide evidence about completeness and valuation of claims.

**Liability on Account of Outstanding Forward Exchange Contracts:** The auditor may verify the outstanding forward exchange contracts with the register maintained by the branch and with the broker’s advice notes. In particular, the net “position” of the branch in relation to each foreign currency should be examined to see that the position is generally squared and not uncovered by a substantial amount. The net “position” as reported in the financial statements may be verified with reference to the foreign exchange position report prepared by the back office.

* In terms of the Circular No. A.P. (Dir. Series) 60 dated January 31, 2004, any trade credit extended for a period of three years and above comes under the category of external commercial borrowings.
Guarantees Given on Behalf of Constituents: The auditor should ascertain whether there are adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions, whether adherence to limits sanctioned for guarantees is ensured, whether margins are taken from customers before issuance of guarantees as per the prescribed procedures, etc.

The auditor should ascertain whether there are adequate controls over unused guarantee forms, e.g., whether these are kept under the custody of a responsible official, whether a proper record is kept of forms issued, whether stock of forms are periodically verified and reconciled with the book records, etc.

The auditor should examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not.

The auditor should check the relevant guarantee registers with the list of outstanding guarantees to obtain assurance that all outstanding guarantees are included in the amount disclosed in this behalf. The auditor should also examine that expired guarantees are not included in this head. He should verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. He should also verify the securities held as margin. If a claim has arisen, the auditor should consider whether a provision is required in terms of the requirements of AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

The auditor should obtain a written confirmation from the management that all obligations in respect of guarantees have been duly recorded and that there are no guarantees issued upto the year-end which are yet to be recorded.

Acceptances, Endorsements and Other Obligations: The auditor should evaluate the adequacy of internal controls over issuance of letters of credit and over custody of unused LC forms in the same manner as in the case of guarantees.

The auditor should verify the balance of letters of credit from the register maintained by the bank. The register indicates the amount of the letters of credits and payments made under them. The auditor may examine the guarantees of the customers and copies of the letters of credit issued. The security obtained for issuing letters of credit should also be verified.

Other Acceptances and Endorsements: The auditor should study the arrangements made by the bank with its customers. He should test check the amounts of the bills with the register maintained by the bank for such bills. The auditor should also examine whether such bills are marked off in the register on payment at the time of maturity.

In respect of letters of comfort, the auditor should examine whether the bank has incurred a potential financial obligation under such a letter. If a comfort letter does not cast any such obligation on the bank, no contingent liability need to be disclosed on this account.

Common Procedures: The auditor should obtain a written confirmation from the management that all obligations assumed by way of acceptances, endorsements and letters of credit have been duly recorded and there are no such obligations assumed upto the year-end, which are yet to be recorded.
The auditor should ascertain whether a contingent obligation assumed by a bank either by way of acceptance, endorsement etc. has resulted in an actual obligation owing to any act or default on the part of its constituent. In such a case, a provision would have to be made in the accounts for the bank’s obligation. The amount of the provision should be determined taking into account the probable recovery from the customer.

**Other Items for which the Bank is Contingently Liable:** The auditor should examine whether commitments under all outstanding underwriting contracts have been disclosed as contingent liabilities. For this purpose, the auditor should examine the terms and conditions of the relevant contracts.

Rediscounting is generally done with the RBI, Industrial Development Bank of India or other financial institutions or, in the case of foreign bills, with foreign banks. If the drawer dishonours the bill, the rediscounting bank has a right to proceed against the bank as an endorser of the bill. The auditor may check this item from the register of bills rediscounted maintained by the branch. He should satisfy himself that all the bills are properly marked off on payment at the time of maturity.

In respect of disputed tax demands, the auditor should examine whether there is a positive evidence or action on the part of the bank to show that it has not accepted the demand for payment of tax or duty. Where an application for rectification of mistake has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure as per provisions of AS 29, “Provisions, Contingent Liabilities and Contingent Assets”. In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity’s lawyers, and obtain appropriate management representations.

Disputed tax liabilities in respect of income-tax and similar central taxes would not form part of balance sheet of a branch as these items are dealt with at the head office level. However, the principles enunciated above should be followed in dealing with taxes and duties (such as, local taxes) dealt with at the branch level.

The auditor should also look into the manner of disclosure of interest rate swaps in the financial statements of the bank. The interest rate swaps would be treated as real or contingent liability depending upon the facts and circumstances of each case in accordance with the provisions of the Accounting Standard (AS) 29.

The auditor as in the case of other entities may verify other items under this head.

**Bills for Collection:** The auditor should ensure that the bills drawn on other branches of the bank are not included in bills for collection.

Inward bills are generally available with the bank on the closing day and the auditor may inspect them at that time. The bank dispatches outward bills for collection soon after they are received. They are, therefore, not likely to be in hand at the date of the balance sheet. The auditor may verify them with reference to the register maintained for outward bills for collection.
The auditor should also examine collections made subsequent to the date of the balance sheet to obtain further evidence about the existence and completeness of bills for collection.

In regard to bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection.

The commission of the branch becomes due only when the bill has been collected. The auditor should, accordingly, examine that there exists adequate internal control system that debits the customer's account with the amount of bank's commission as soon as a bill collected is credited to the customer's account. The auditor should also examine that no income has been accrued in the accounts in respect of bills outstanding on the balance sheet date.

Co-acceptance of Bills: The auditor should ensure that the bank has instituted an adequate internal control system to comply with the safeguards as set out by the RBI's Master Circular on Guarantees and Co-acceptances.

Liability on Partly Paid Investments - If the bank holds any partly paid shares, debentures, etc., the auditor should examine whether the uncalled amounts thereof are shown as contingent liability in the balance sheet.

Liability on Account of Outstanding Forward Exchange Contracts - All branches which undertake foreign exchange business (i.e., those which are authorised foreign exchange dealers) usually enter into forward exchange contracts. The amount of forward exchange contracts, which are outstanding on the balance sheet date, is to be shown under this head.

11.8 Concurrent Audit

Concurrent audit, as the name suggests, is an audit or verification of transactions or activities of an organisation concurrently as the transaction/activity takes place. It is not a pre-audit. The concept in this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place. It is akin to internal audit which is a concept recognised under the Companies Act. In view of the complexities of economic activities it is now well recognised that there must by a system of someone, other than the person involved in the operations, verifying the authenticity of the transaction/activity on a regular basis so that any deviation from the laid down procedures can be noticed in the shortest possible time and remedial action can be taken.

The concept of concurrent audit in the public as well as the private sector banks has gained acceptance in recent years. In some banks this task has been entrusted to the internal inspection staff who are not engaged in operational activities. In other banks, this work is allotted to outside professional firms of chartered accountants. The Reserve Bank of India (RBI) has issued certain guidelines for the conduct of this audit.

These guidelines are mandatory and all banks are required to cover 50 percent of total deposits and 50 per cent of total advances under this audit. This will mean that all banks will have to put their large branches under this audit.
11.8.1 Scope of Concurrent Audit - The guidelines issued by the RBI cover all the important areas of activities of the branch which is under concurrent audit. Most banks have prepared an Audit Manual for this purpose. Broadly stated, the following areas are covered by these guidelines:

(i) Daily cash transactions with particular reference to any abnormal receipts and payments. This will include currency chest transactions, major expenses incurred by cash payments and high value cash receipts and disbursements.

(ii) Purchase and sale of shares, securities, etc. physical verification of investments and verification of rates at which transactions are entered into. Similarly, examination of capital expenditure on purchase of capital assets as well as sales of such assets. This will include verification of relevant documents and authorisation.

(iii) Verification of procedure and documentation for opening new current, savings, term deposit accounts, etc. If there are any unusual operations in these new accounts the same should be examined thoroughly and unusual-features should be reported.

(iv) Verification of Advances-Overdrafts, TOD, CC Accounts, Term Loans, Bills Purchase, L.C., Guarantees, Overdues, devolvement, and L.C./Guarantee, etc. For this verification special attention is required to be given to (a) procedure for sanction and renewal of limits and proper authorisation (b) disbursement of funds within limits and according to terms of sanction (c) recovery of funds (d) verification of godown, stock, securities, etc. (e) documentation including renewal of documents, registration of charges, mortgages, etc. (f) classification of advances (g) study of financial health of customers by observation about conduct of accounts, regular compliance by submission of financial information, stock statements, etc. and study of audited annual accounts of corporate as well as non-corporate customers, (h) timely signals for accounts likely to become doubtful (I) timely legal action for recovery (j) verification of interest and other service charges levied as per terms of sanction (k) credit rating of borrower and (l) compliance with special conditions contained in the terms of sanction.

(v) Foreign Exchange transactions – if the branch is authorised to handle foreign exchange transactions these transactions have to be verified in detail in accordance with RBI guidelines. All aspects of Import/Export transactions, Foreign Bills transactions, Foreign L.C./Guarantees, FCNR/NRI deposits, Nostro/Vostro accounts, compliance with RBI guidelines and reporting will have to be examined.

(vi) House keeping – This is another sensitive area. This will include verification of balancing of all ledgers and registers, inter-branch reconciliation, bank reconciliation, test calculations and verification of interest, discount, commission and exchange income, vouchers for expenses, transactions with staff members, reconciliation of clearing differences, reconciliation of suspense and other sensitive accounts, debit balances in savings accounts and Temporary Overdrafts.

(vii) Special effort to detect revenue leakage should be made.

(viii) Special attention to be paid to all fraud prone areas. The attempt should be to ensure that effective measures are taken to prevent frauds. Inspite of these measures, if some
manipulation is done by any staff or outside party, the auditor should be able to detect the same as early as possible so that further damage is prevented and timely action is taken.

(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 from salaries, rent, interest, professional fees, etc. are followed and tax deducted is deposited with Government in time.

(xii) Verification of statements, H.O. Returns, statutory returns, calculation of capital adequacy ratio, and compliance with requirements of government business (collection of tax and disbursements).

(xiii) Study of RBI and internal inspection reports, statutory auditor's report, LFAR relating to branch, etc. and compliance thereto.

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

11.8.2 Concurrent audit system in commercial banks -

1. It hardly needs to be stressed that the concurrent audit system is to be regarded as part of a bank’s early-warning system to ensure timely detection of irregularities and lapses which helps in preventing fraudulent transactions at branches. It is, therefore, necessary for the bank’s management to bestow serious attention to the implementation of various aspects of the system such as selection of branches/coverage of business operations, appointment of auditors, appropriate reporting procedures, follow-up/rectification processes and utilisation of the feedback from the system for appropriate and quick management decisions.

2. The bank should once in a year review the effectiveness of the system and take necessary measures to correct the lacunae in the implementation of the programme.

(A) 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 ongoing basis that
the different divisions function within laid-down parameters and procedures.

(B) Coverage of business/branches

(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.

(C) Types of activities to be covered

(1) 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.

(2) 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.

(3) 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).

(4) In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving small amounts.

(5) While the detailed scope of the concurrent audit may be determined and approved by the ACB.

(D) Appointment of Auditors and accountability

(i) The option to consider whether concurrent audit should be done by bank’s own staff or external auditors is left to the discretion of individual banks.

(ii) In case the bank has engaged its own officials, they should be experienced, well trained and sufficiently senior. The staff engaged on concurrent audit must be independent of the branch where concurrent audit is conducted.

(iii) Appointment of an external audit firm may be initially for one year and extended up to three years - after which an auditor could be shifted to another branch subject to satisfactory performance.

(iv) If external firms are appointed and any serious acts of omissions or commissions are noticed in their working their appointments may be cancelled and the fact may be reported to RBI & ICAI.

(E) Facilities for effective Concurrent Audit: It has been represented that Concurrent Audit is not often effective because adequate facilities in terms of space, availability of records, etc are not available. To improve the effectiveness of concurrent audit it is suggested that -

(i) banks arrange for an initial and periodical familiarisation process both for the bank’s own staff when entrusted with the concurrent audit and for the external auditors appointed for the purpose;

(ii) all relevant internal guidelines/circulars/important references as well as relevant circulars issued by RBI/SEBI and other regulating bodies should be made available to the concurrent auditors on an on - going basis;

(iii) where adequate space is not available, concurrent auditors can commence work immediately after the close of banking hours.

(F) Remuneration - Terms of appointment of the external firms of Chartered Accountants for the concurrent audit and their remuneration may be fixed by banks at their discretion. Broad guidelines should be framed by ACB for these purposes. Suitable packages should be fixed by each bank’s management in consultation with its ACB, keeping in view various factors such as coverage of areas, quality of work expected, number of people required for the job, number of hours to be spent on the job, etc.
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(G) Reporting Systems

(i) Concurrent auditors should be attached to the branches and not the zonal offices.

(ii) Minor irregularities pointed out by the concurrent auditors are to be rectified on the spot. Serious irregularities should be straightaway reported to the controlling offices/Head Offices for immediate action.

(iii) There should be zone-wise reporting of the findings of the concurrent audit to ACB and an annual appraisal/report of the audit system should be placed before the ACB.

(iv) Whenever fraudulent transactions are detected, they should immediately be reported to Inspection & Audit Department (Head Office) as also the Chief Vigilance Officer as well as Branch Managers concerned (unless the branch manager is involved).

(v) There should be proper reporting of the findings of the concurrent auditors. For this purpose, each bank should prepare a structured format. The major deficiencies/aberrations noticed during audit should be highlighted in a special note and given immediately to the bank’s branch/controlling offices. A quarterly review containing important features brought out during the concurrent audits should be placed before the ACB.

(vi) Follow-up action on the concurrent audit reports should be given high priority by the controlling office/Inspection and Audit Department and rectification of the features done without any loss of time.

(vii) A Special Cell in the Inspection and Audit Department may be created in each bank to:
   (1) review the selection of auditors;
   (2) initiate and operate a system for the appraisal of the performance on concurrent auditors;
   (3) ensure that the work of concurrent auditors is properly documented;
   (4) be responsible for the follow-up on audit reports and the presentation of the quarterly review to the ACB.

Suggested items of coverage are given below:

(A) Cash

(i) Daily cash transactions with particular reference to any abnormal receipts and payments.

(ii) Proper accounting of inward and outward cash remittances.

(iii) Proper accounting of currency chest transactions, its prompt reporting to the RBI.

(iv) Expenses incurred by cash payment involving sizeable amount.

(B) Investments

(i) Ensure that in respect of purchase and sale of securities the branch has acted within its delegated power having regard to its Head Office instructions.

(ii) Ensure that the securities held in the books of the branch are physically held by it.

(iii) Ensure that the branch is complying with the RBI/Head Office guidelines regarding BRs,
SGL forms, delivery of scrips, documentation and accounting.

(iv) Ensure that the sale or purchase transactions are done at rates beneficial to the bank.

(C) Deposits

(i) Check the transactions about deposits received and repaid.

(ii) Percentage check of interest paid on deposits may be made including calculation of interest on large deposits.

(iii) Check new accounts opened particularly current accounts. Operations in new current/SB accounts may be verified in the initial periods to see whether there are any unusual operations.

(D) Advances

(i) Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and at the appropriate level).

(ii) Verify whether the sanctions are in accordance with delegated authority.

(iii) Ensure that securities and documents have been received and properly charged/registered.

(iv) Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, renewal of limits, etc.

(v) Verify whether there is any mis utilisation of the loans and whether there are instances indicative of diversion of funds.

(vi) Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.

(vii) Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.

(viii) Ensure proper follow-up of overdue bills of exchange.

(ix) Verify whether the classification of advances has been done as per RBI guidelines.

(x) Verify whether the submission of claims to DICGC and ECGC is in time.

(xi) Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been got confirmed or ratified at the required level.

(xii) Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

(E) Foreign Exchange transactions

(i) Check foreign bills negotiated under letters of credit.

(ii) Check FCNR and other non-resident accounts whether the debits and credits are permissible under rules.
(iii) Check whether inward/outward remittance have been properly accounted for.

(iv) Examine extension and cancellation of forward contracts for purchase and sale of foreign currency. Ensure that they are duly authorised and necessary charges have been recovered.

(v) Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank.

(vi) Ensure that the overbought/oversold position maintained in different currencies is reasonable taking into account the foreign exchange operations.

(vii) Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations.

(viii) Ensure verification/reconciliation of Nostro and Vostro account transactions/balances.

(F) Housekeeping

(i) Ensure that the maintenance and balancing of accounts, ledgers and registers including clean cash is proper.

(ii) Early reconciliation of entries outstanding in the inter-branch and inter-bank accounts, Suspense Account, Sundry Deposits Account, DDRR Account, Drafts Account, etc.

     Ensure early adjustment of large value entries.

(iii) Carry out a percentage check of calculations of interest, discount, commission and exchange.

(iv) Check whether debits in income account have been permitted by the competent authorities.

(v) Check the transactions of staff accounts.

(vi) In case of difference in clearing there is a tendency to book it in an intermediary suspense account instead of locating the difference. Examine the day book to verify as to how the differences in clearing have been adjusted. Such instances should be reported to Head Office in case the difference persists.

(vii) Detection & prevention of revenue leakages through close examination of income and expenditure persists.

(viii) Check cheques returned/bills returned register and look into reasons for return of those instruments.

(ix) Checking of inward and outward remittances (DDs, MTs & TTs).

(G) Other items

(i) In case the branch has been entrusted with government business, ensure that the transactions are done in accordance with the instructions issued by Government, RBI & HQ.

(ii) Ensure that the branch gives proper compliance to the internal inspection/audit reports.

(iii) Ensure that customers' complaints are dealt with promptly.
(iv) Verification of statements, returns, statutory returns. The aforesaid list is illustrative and not Exhaustive.

11.8.3 Reporting by Concurrent Auditors - Timely reporting is the essence of the concurrent audit. Therefore, depending on the size of the operations in a branch the bank decides to get the audit conducted on a daily basis, monthly basis or quarterly basis. In any of these assignments, the auditor has to cover the entire area of operations. In the case of daily or monthly, audit, the audit report of the work done for a particular work is required to be submitted by the auditor by the 10\textsuperscript{th} of the next month. In the case of quarterly audit the report is to be given by the 10\textsuperscript{th} of the month after the end of the quarter. In the case of any serious irregularity noticed by the auditor while conducting the audit he has to give a flash report immediately so that the bank can take remedial action without any delay. Where monthly reports are given, the auditor is required to give an executive summary of audit report at the end of each quarter. The auditor has to adhere to this discipline of timely reporting.

A member of the accounting profession has to use his specialised knowledge, skill and experience while drafting his audit report. 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. All issues pointed out in earlier reports which have not been complied with should be briefly stated in this last part. Items where no irregularities are found need not be stated in the report. Areas covered by the audit for the period covered by the report may be stated in the preamble. The rest of the reporting should be by exception so that only those items which require attention by the bank management are stated in the report.

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. This will enable him to take into consideration the opposite viewpoint and clarify his doubts. In the case of a bank where there is a four-tier system, that is, Branch, Regional Office, Zonal Office and Central Office, the detailed monthly/quarterly report is to be given to branch manager and regional manager. Quarterly executive summary is to be given to all the four authorities.

It is also essential for the bank management to take effective steps to study these reports and take remedial action so as to improve the working of the branches. Since this type of audit is conducted at the large branches only, the bank management should view the common irregularities pointed out by the auditors as illustrative and ensure that such irregularities do not take place in other branches which are not under concurrent audit. It is also essential that periodical meetings are held by the regional managers with the concurrent auditors. This will enable them to know the views of the auditors on certain important issues covering their audit assignments.

11.8.4 Audit Committee - In pursuance of RBI circular September 26, 1995, a bank is required to constitute an Audit Committee of its Board. The membership of the audit committee is restricted to the Executive Director, nominees of the Central Government and the RBI, Chartered Accountant director and one of the non-official directors.

One of the functions of this committee is to provide direction and also oversee the operations
of the total audit function in the bank. The committee also has to review the internal inspection/audit function in the bank, with special emphasis on the system, its quality and effectiveness in terms of follow up. The committee has to review the system of appointment and remuneration of concurrent auditors.

The Audit Committee is, therefore, connected with the functioning of the system of concurrent audit. The method of appointment of auditors, their remuneration and the quality of their work is to be reviewed by the Audit Committee. It is in this context that periodical meetings by the members of the audit committee with the concurrent auditors and statutory auditors help the audit committee to oversee the operations of the total audit function in the bank.

Considering the coverage of this audit assignment and the specialised nature of work there is also a need for training to be imparted to the staff of the auditors. This training has to be given in specialised fields such as foreign exchange, computerisation, areas of income leakage, fraud prone areas, determination of credit rating and other similar specialised areas. The bank can organise such training programmes at various places so that it can ensure the quality of audit.