



AUDIT OF BANKS

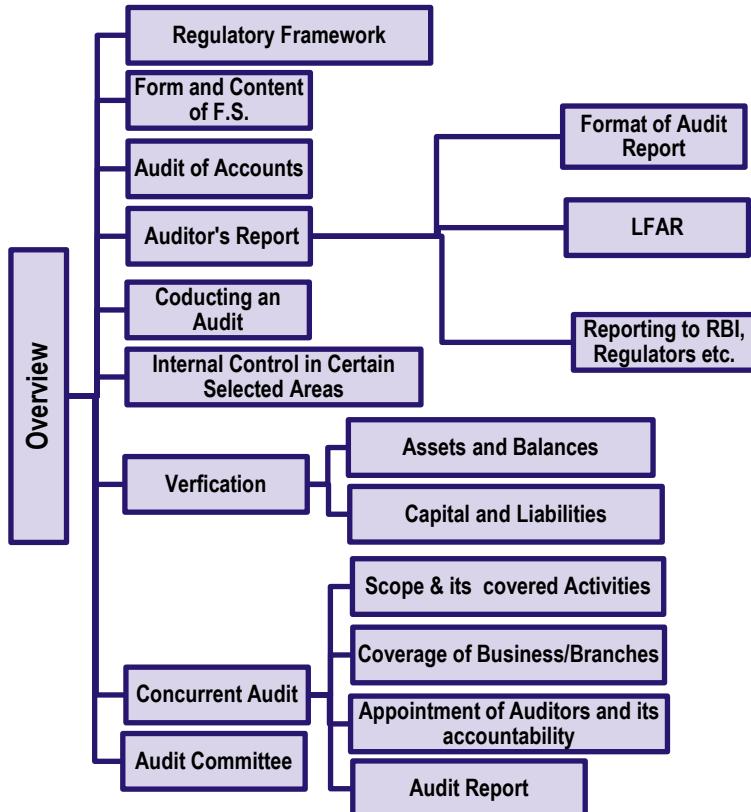


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Gain the knowledge of legal framework, form and content of financial statements of the banks.
- Know the feature of audit of accounts and auditor's report.
- Recognize CRR, SLR and Capital Adequacy etc.
- Understand the prescribed procedure to be followed while doing verification of assets and liabilities of the bank.
- Acquire the knowledge of Concurrent Audit and types of activities to be covered in it.
- Know the role of audit committee in audit of banks.

CHAPTER OVERVIEW



1. INTRODUCTION



The banking industry is the pivot of any economy and its financial system. Banks are one of the foremost agents of financial intermediation in an economy like India and, therefore, development of a strong and resilient banking system is of utmost importance. The banking institutions in the country are working in a competitive environment and their regulatory framework is aligned with the international best practices. Thus, financial deepening has taken place in India and continues to be in progress with a focus on orderly conditions in financial markets while sustaining the growth momentum.

Banks have certain characteristics distinguishing them from most other commercial enterprises.



- ☒ Custody of large volumes of monetary items, including cash and negotiable instruments, whose physical security has to be ensured. This applies to storage and the transfer of monetary items, making banks vulnerable to misappropriation and fraud, necessitating establishment of formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.
- ☒ Engagement in a large volume and variety of transactions in terms of number and value which necessarily requires complex accounting and internal control systems and widespread use of Information Technology (IT).
- ☒ Operation through a wide network of geographically dispersed branches and departments necessitating a greater decentralization of authority and dispersal of accounting and control functions, with consequent difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.
- ☒ Assumption of significant commitments without any transfer of funds. These items, called 'off-balance sheet' items, may at times not involve accounting entries and the failure to record such items may be difficult to detect.
- ☒ Engagement in transactions that are initiated at one location, recorded at a different location and managed at yet another location.
- ☒ Direct Initiation and completion of transactions by the customer without any intervention by the bank's employees. For example, over the Internet or mobile or through automatic teller machines (ATMs).
- ☒ Integration and linkages of national and international settlement systems could pose a systemic risk to the countries in which they operate.
- ☒ Regulatory requirements by governmental authorities often influence accounting and auditing practices in the banking sector.

Special audit considerations arise in the audit of banks because of:

- the particular nature of risks associated with the transactions undertaken;
- the scale of banking operations and the resultant significant exposures which can arise within short period of time;
- the extensive dependence on IT to process transactions;
- the effect of the statutory and regulatory requirements;
- the continuing development of new products and services and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices.



Evolution of technology and providing services through Net Banking and Mobiles has exposed banks to huge operational and financial risk.

The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for Branch Auditor and SCAs (Statutory Central Auditors) to have detailed knowledge of the products offered and risks associated with them, and appropriately address them in their audit plan to the extent they give rise to the risk of material misstatements in the financial statements.

In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application; the auditor while designing his plans should also understand interface controls between the various applications.



2. LEGAL FRAMEWORK

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



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.



3. FORM AND CONTENT OF FINANCIAL STATEMENTS

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.

3.1 Audit of Accounts

Sub-section (1) of section 30 of the Banking Regulation 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.

Most banks, especially those in nationalised banks or public sector, appoint four or more (depending upon their size and Board decision, as per RBI guidelines) firms of chartered accountants to act jointly as statutory central auditors (SCAs).

The appointment letter sent by banks in connection with the appointment of SCAs typically contains the following:

- Period of appointment.
- Particulars of other central auditors.
- Particulars of previous auditors.
- Procedural requirements to be complied with in accepting the assignment, e.g., letter of acceptance (the letter usually contains, *inter alia*, averment as to absence of disqualification for appointment, way in which the audit has to be conducted and confirmation of present name, constitution and address of the auditor), declaration of fidelity and secrecy, restriction on accepting other assignments from the bank, etc.
- A statement of division of work and review and reporting responsibilities amongst joint auditors in case of nationalised banks (Generally this is decided at a later stage)

- **Scope of assignment which includes any special reports or certificates to be given by the SCAs in addition to the main report. Presently, the SCAs have to furnish the following reports/certificates in addition to their main report:**
 - ☒ Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
 - ☒ Long form audit report.
 - ☒ Report on compliance with SLR requirements.
 - ☒ Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
 - ☒ Certificate on reconciliation of securities by the bank (both on its own investment account as well as PMS Banks' account).
 - ☒ Certificate on compliance by the bank in key areas of prudential and other guidelines relating to such transactions issued by the RBI.
 - ☒ Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
 - ☒ Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention(in accordance with sec 143(12) of the Companies Act, 2013.)
 - ☒ Certificate in respect of custody of unused Bank Receipt forms and their utilisation.
 - ☒ Authentication of capital adequacy ratio, including disclosure requirements and other ratios reported in the notes on accounts.
 - ☒ Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
 - ☒ Report on instances of adverse credit-deposit ratio in the rural areas.
 - ☒ Asset liability management.
 - ☒ Certificate on Corporate Governance in case of banks listed on Stock Exchange. In some banks this certification may not be got done by the central auditors.
 - ☒ Certification on claim of various interest subsidies and interest subvention.
- **Basis of computation of audit fee and scale of travel and related allowances and conveyance charges and other expense reimbursement entitlements, if any.**

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 concerned bank 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 concerned bank with the approval of the Central Government.

Note: Students may refer Chapter 12 of CA Intermediate Auditing and Assurance Study Material for **Eligibility, Qualifications, Disqualification, Appointment, Powers, Remuneration etc. of Auditor.**

4. AUDITOR'S REPORT

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which the auditor should state the following:

-  Whether, in the auditor's opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank.
-  In case the auditor had called for any explanation or information, whether it has been given and whether it is satisfactory.
-  Whether or not the transactions of the bank, which have come to the auditor's notice, have been within the powers of that bank.
-  Whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of audit.
-  Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account.
-  Any other matter which the auditor 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.

4.1 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 SA 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report", SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", SA 710, "Comparative Information-Corresponding Figures and Comparative Financial Statements" and SA 720, The Auditor's Responsibility to Other Information in Documents Containing Audited Financial Statements.

The auditor should ensure that not only the 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.

It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in the 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:

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

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.

Whether there has been any delay in transferring amounts, required to be transferred to the Investor Education and Protection Fund by the bank.

4.2 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 vide circular no. DBS.CO.PP.BC.11/11.01.005/2001-2002.

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). The said circular provides details regarding liability of accounting and auditing profession including the professional conduct, non-disclosure of client information and need to report fraud.

Auditor should also consider the compliance with provisions of Standards on Auditing.



SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", explains that the duty of confidentiality is over-ridden by statute, law or by courts. Whereas 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 according to SA 240.

Further, 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 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.

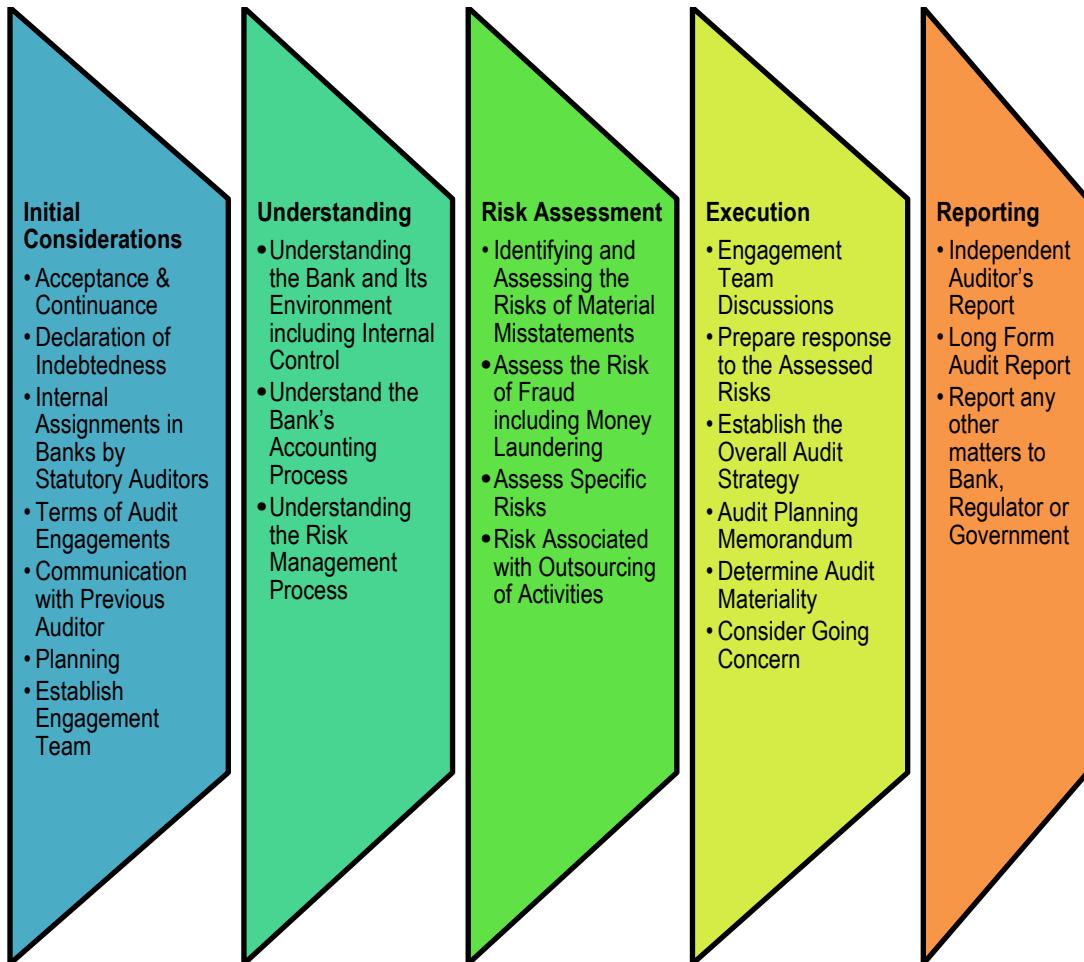
It must be noted that auditor is not expected to consider each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing normal duties comes across any instance, he/she should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive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

[Note: For detailed understanding on duty to report on fraud under Companies Act, 2013, students may refer Chapter-5 (The Company Audit) of this Study Material]



5. CONDUCTING AN AUDIT

The audit of banks or of their branches involves the following stages –



Stage I: Initial Considerations

Acceptance & Continuance: 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 in planning decisions if the audit is accepted.

Declaration of Indebtedness: The RBI has advised that the banks, before appointing their statutory central/circle/branch auditors, should obtain a declaration of indebtedness i.e., a written confirmation that credit facilities, if any, availed from any other bank or financial institution by auditor/firm/partners/staff/family members have not become non-performing assets.

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.

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, 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.

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/her in writing.

Planning: The audit plan needs to be properly documented with respect to timing, extent of checking, audit procedures to be followed at assertion level and should be flexible and updated or changed, as and when necessary.

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.

Stage II : Understanding

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 to determine the operating effectiveness of the controls, and to address the specific risks.

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.

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 by those charged with governance	Identification, measurement and monitoring of risks	Control activities	Monitoring activities	Reliable information systems
<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> 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.

Stage III : Risk Assessment

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.

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 is 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 scepticism should be maintained by the auditor 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.

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, and potentially affect many assertions.

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

Stage IV: Execution

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

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.

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.

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.

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. Judgments about materiality are

made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or combination of both.

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.

Stage V: Reporting

Students should refer to the reporting requirements explained in heading 4. Auditor's Report of this chapter.

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

5.1 Special Considerations in IT 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. The importance, extent of use and complexity of a Bank's IT system 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 study and evaluation of the accounting system and related internal controls and the nature, timing and extent of other audit procedures are affected in the IT environment.

The key security control aspects that an auditor needs to address when undertaking audit in a computerised bank include:

- Ensure that authorised, accurate and complete data is made available for processing.
- Ensure that in case of interruption due to power, mechanical or processing failures, the system restarts without distorting the completion of the entries and records.
- Ensure that the system prevents unauthorised amendments to the programmes.
- Verify whether "access controls" assigned to the staff-working match with the responsibilities as per manual. It is important for the auditor to ensure that access and authorisation rights given to employees are appropriate.
- Verify that segregation of duties is ensured while granting system access to users and that the user activities are monitored by performing an activities log review.
- Verify that changes made in the parameters or user levels are authenticated.
- Verify that charges calculated manually for accounts when function is not regulated through parameters are properly accounted for and authorised.
- Verify that all modules in the software are implemented.

- Verify that exceptional transaction reports are being authorised and verified on a daily basis by the concerned officials. It is important for auditor to understand the nature of exception and its impact on financials.
- Verify that the account master and balance cannot be modified/amended/ altered except by the authorised personnel.
- Verify that all the general ledger accounts codes authorised by Head Office are in existence in the system.
- Verify that balance in general ledger tallies with the balance in subsidiary book.
- Verify that important passwords like database administrator and branch manager's password are kept in sealed cover with branch manager so that in case of emergency and the absence of any of them, the passwords could be used to run the system promptly.
- Since back up is taken at centralised location, Central Auditor should:
 - Check that the bank takes daily and monthly backups. The backup media should be duly labelled and indexed properly and should be maintained under joint custody.
 - Ideally, daily backup should be taken in 6 sets, one for each weekday and 12 sets for each month end. Verify that backup register is maintained and updated.
- Verify that the backup media is stored in fireproof cabinet secured with lock and key and also that the off-site backups are preserved for the emergency.
- Verify that the anti-virus software of latest version is installed in servers/PCs of branches to prevent data corruption, and is being regularly updated for new viruses.
- Verify that security patches are applied to systems as and when they are released by the vendors / developers.
- Verify that access to the computer room is restricted to authorised persons only.

5.2 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.

The screenshot shows the HAFI: Audit File Inquiry interface. At the top, there are menu options: Menu, Show Memo Pad, Background Menu, and CCY Converter. Below the menu, the title "HAFI: Audit File Inquiry" is displayed. The interface is divided into two main sections: a search form on the left and search results on the right.

Search Form (Left):

- Audit Type: Radio buttons for CIF (unchecked) and Others (checked).
- SOL Set ID: Text input field containing "110011" with a search icon.
- Table Short Name: Text input field containing "ATT" with a search icon.
- A/c. ID: Text input field with a search icon.
- General Ledger Subhead Code: Text input field with a search icon.
- Entered By: Text input field containing "DOPUSER" with a search icon.
- Exceptional Events Only: Radio buttons for Yes (unchecked), No (checked), Only Referred (unchecked), Not Referred (unchecked), and All (checked).
- Start Date: Text input field.

Search Results (Right):

- Ref. No.: Text input field.
- Entered On: Text input field with a search icon.
- Authorized On: Text input field with a search icon.
- Authorized: Radio buttons for Only Authorized (checked), Not Authorized (unchecked), and All (unchecked). Below these are "And" and "Or" checkboxes.
- Operation on Selection Criteria: Radio buttons for And (checked) and Or (unchecked).
- End Date: Text input field.

At the bottom left of the search form area are "Go" and "Clear" buttons.

Image: Audit File Inquiry in case of Bank*

5.3. Stress Testing

RBI has required that all commercial banks (excluding RRBs and LABs) shall put in place a Board approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems.

5.4 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 instruments in the new definition of regulatory capital.

Demonetisation

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.

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.

* www.dopfinacle.blogspot.in



6. INTERNAL CONTROL IN CERTAIN SELECTED AREAS

6.1 System of Internal Control in Banks

Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements. Given below are examples of internal controls that are typically implemented in a bank:

Area of Focus	Examples of Internal Controls in a Bank
General	<ul style="list-style-type: none"> • The staff and officers of a bank should be shifted from one position to another frequently and without prior notice. • The work of one person should always be checked by another person (usually by an officer) in the normal course of business. • The arithmetical accuracy of the books should be proved independently every day. • All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery. • 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. • The signature book and the telegraphic code book should be kept with responsible officers and access should be allowed only to authorised officers. • The bank should take out insurance policies against loss and employees' infidelity. • The financial powers of officers of different grades should be clearly defined. • 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.
Cash	<ul style="list-style-type: none"> • Cash should be kept in the joint custody of two responsible officers. • In addition to normal checking by the chief cashier, cash should be test-checked daily and counted in full occasionally by a responsible officer other than those handling the cash. Actual cash in hand should agree with the balance shown by the Day Book every day. • The cashier should have no access to the customer's ledger accounts and the Day Book. This is an important safeguard as the Bank managements are often tempted to use cashiers because of their

	<ul style="list-style-type: none"> shorter working hours as ledger clerks in the absence of regular staff on leave, etc. This can result in a very expensive price to economy. The counterfoil of 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. Payments should be made only after the vouchers (e.g. cheques, demand drafts etc.) have been passed for payment by the authorised officer and have been entered in the customer's account. Receipt and payment scrolls or their totals should be compared with the cash column of the Day-Book by independent persons. High value cash receipts and payments should be verified by a higher officer/ branch manager and should be remitted to currency chest according to branch's retention limit on daily basis. Where the teller system is prevalent- <ul style="list-style-type: none"> A limit should be placed on the powers of tellers to make payment. 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. Total payment made by a teller should be reconciled with the cash columns of the Voucher Summary Sheet of the ledger concerned every day. There should be frequent rotation of tellers.
Clearings	<ul style="list-style-type: none"> Cheques received by the bank in inward 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 cross checked by responsible officers. The total number and amount of cheques included in these lists should be reconciled with the list of cheques debited and those returned unpaid. The total number and amount of cheques sent in outward clearing should be reconciled with the total of the clearing pay- in-slips. The unpaid cheques received in outward clearing should be verified in the same manner as the cheques returned in inward clearing. The unpaid cheques received in outward clearing should be either sent to the customers at their recorded address or the customers be informed to collect the same from bank branch.
Constituents' Ledgers	<ul style="list-style-type: none"> 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 in the constituents' accounts.

	<ul style="list-style-type: none"> No withdrawals should normally be allowed against clearing cheques deposited on the same day. An officer should check all the entries made in the ledger with the original documents particularly noting that the correct accounts have been debited or credited. Ledger keepers should not have access to Voucher Summary Sheet after they have been checked by an officer and to the Day Book. Interest debited or credited to constituents' accounts should be independently checked.
Bills for Collection	<ul style="list-style-type: none"> All the documents accompanying the bills should be received and entered in the Register by a responsible officer. At the time of dispatch, the officer should also see that all the documents are sent along with the bills. 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 bank branch or agent to which they were sent for collection. 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.
Bills Purchased	<ul style="list-style-type: none"> At the time of purchase of the bills, an officer should verify that all the documents of title are properly assigned to the bank. Sufficient margin should be kept while purchasing or discounting a bill to cover any decline in the value of the security etc. 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. All irregular outstanding account/s should be reported to the Head Office. 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.
Loans and Advances	<ul style="list-style-type: none"> 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. All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made. Sufficient margin should be kept against securities taken to cover any decline in the value thereof and to comply with Reserve Bank

	<p>directives. Such margins should be determined by the proper authorities of the bank as a general policy or after detailed scrutiny for specific accounts.</p> <ul style="list-style-type: none"> • All the securities should be received and returned by responsible officer. They should be kept in the Joint custody of two such officers. • 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. • 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/warehouses should be regularly and frequently inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank. • 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. • 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 authorised officer. • All accounts should be kept within both the drawing power and the sanctioned limit as per prescribed norms i.e. additional temporary limit, for a maximum of 20% of existing limit and 90 days maximum tenure. • 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. • The operation (in each advance account) should be reviewed at least once every year.)
Telegraphic Transfers and Demand Drafts	<ul style="list-style-type: none"> • The signatures on a demand draft should be checked by an officer with the Signature Book. • All the T.Ts and D.Ds. sold/ issued by a branch should be immediately confirmed by an advice to the paying branch. • 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.
Inter Branch Accounts	<ul style="list-style-type: none"> • 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, • 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.

Credit Card Operations	<ul style="list-style-type: none"> • There should be effective screening of applications with reasonably good credit assessments. • There should be strict control over storage and issue of cards. • There should be a system whereby a merchant confirms the status of 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. • There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards. • Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards. • All the reimbursement (gross of commission) should be immediately charged to the customer's account. • There should be a system to ensure that statements are sent regularly and promptly to the customer. • There should be a system to monitor and follow-up customers' payments. • Payments overdue beyond a reasonable period should be identified and attended to carefully. For defaulting customers, credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses. • There should be a system of periodic review of credit card holders' 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.
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6.2 Compliance with CRR and SLR requirements

(i) **Cash Reserve Ratio (CRR)** is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. One of the important determinants of cash balances to be maintained by banking companies and other scheduled banks is the requirement for maintenance of a certain minimum cash reserve. While the requirement for maintenance of cash reserve by banking companies is contained in the Banking Regulation Act, 1949, corresponding requirement for scheduled banks is contained in the Reserve Bank of India Act, 1934. 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.

(ii) **Statutory Liquidity Ratio (SLR) Requirements** – SLR is the requirement that every scheduled commercial bank in India is required to maintain in the form of gold, cash and government approved securities before providing credit to the customers. 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 fiscal 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 should cover two aspects:

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

Maintenance of liquid assets as prescribed u/s 24 of Banking Regulation Act.

Audit Approach and Procedure:

Area of Focus	Suggested Audit Procedures
Compliance with CRR and SLR requirements	<ul style="list-style-type: none"> • Obtain an understanding of the relevant circulars/ instructions of the RBI, particularly regarding composition of items of DTL. • Request 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/her. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates. • 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. • While examining the computation of DTL, specifically examine that the following items have been excluded from liabilities- <ul style="list-style-type: none"> ○ Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery. ○ Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates. ○ 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. ○ Margins held and kept in sundry deposits for funded facilities. • Similarly, specifically examine that the following items have been included in liabilities-

	<ul style="list-style-type: none"> ○ Net credit balance in branch adjustment accounts including these relating to foreign branches. ○ Interest on deposit as at the end of the firm half year reversed in the beginning of the next half-year. ○ 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' ○ 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. ● Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches. ● It may be noted that, even though interest accrues daily, 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. ● 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 the report. ● While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he/she has relied on the returns received from the unaudited branches in forming an 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.
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7. VERIFICATION OF ASSETS AND BALANCES

Before beginning verification of assets and balances, the auditor should obtain an accurate schedule of accounts in the prescribed format. 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



Audit Procedures:

Area of Focus	Suggested Audit Procedures
Cash	<ul style="list-style-type: none"> • Carry out the physical verification of cash (including foreign currency, gold/silver coins, if any) as close to the balance sheet date as possible. • The cash balance as physically verified should be agreed with the balance shown in the cash book and the cash balance book.
Balance with Reserve Bank of India	<p>Applicable only to branches having account with the Reserve Bank of India.</p> <ul style="list-style-type: none"> • 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, paying special attention to the following items appearing in the reconciliation statements: <ul style="list-style-type: none"> ○ Cash transactions remaining unresponded; ○ Revenue items requiring adjustments/write-offs; and ○ 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.
Balance with Other Banks (Other than Reserve Bank of India)	<p>Apart from the procedures described above in examining the balances with Reserve Bank of India, while reviewing the reconciliation statements, the auditor should pay particular attention to the following.</p> <ul style="list-style-type: none"> • 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. • Examine that no cheque sent or received in clearing is outstanding. • Examine that all bills or outstation 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
Money at Call and Short Notice	<ul style="list-style-type: none"> • Examine whether there is a proper system of 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 lending's 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. • Examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger. • 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. • Verify that the interest has been properly accrued and accounted for on year-end outstanding balances of call/ short notice money.

II. INVESTMENTS

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 effect on the financial statements. The latter aspect assumes special significance in the case of banks where investment transactions should 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 audit procedures relating to investments. Every bank has drawn their own investment policy, which is drawn strictly in conjunction with RBI Master circular on investments. The entire compliance need to be evaluated in terms of requirements of investment policy / master circular RBI.

Audit Procedures:

Area of Focus	Suggested Audit Procedures
Internal Control Evaluation and Review of Investment Policy	<ul style="list-style-type: none"> • 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. • It should clearly outline the broad investment objectives separately for the investments on its own account and investments on behalf of customers.

Separation of Investment Functions	<ul style="list-style-type: none"> 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).
Examination of Reconciliation	<ul style="list-style-type: none"> 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 Public Debt Office (PDO), and examine the control and reconciliation of BRs issued by the bank.
Examination of Documents	<ul style="list-style-type: none"> Ascertain whether the investments made by the bank are within its authority. 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 acquisition/disposal of investments should be verified with reference to the broker's contract note, bill of costs, receipts and other similar evidence.
Physical Verification	<ul style="list-style-type: none"> Verify the investment scrips physically at the close of business on the date of the balance sheet. In respect of scrip less dealings in investments through the OTC Exchange of India, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository 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 extended 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. BRs should not be issued in respect of transactions in government securities for which SGL facility is available. 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 an undertaking from them that they hold the securities on behalf of the bank.
Examination of Valuation	<ul style="list-style-type: none"> Examine whether the method of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate. Examine whether the investments have been properly

	<p>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.</p> <ul style="list-style-type: none"> • Examine compliance by the bank with the guidelines of the RBI relating to valuation of investments. • 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. • Verify whether adequate disclosure of any change in method of valuation of investment is made. • Examine whether the profit or loss on sale of investments has been computed and accounted for properly. • Verify that there is a proper system for recording and maintenance of TDS certificates received by the bank.
Dealings in Securities on Behalf of Others	<ul style="list-style-type: none"> • Examine whether prior approvals for carrying out such dealings have been obtained. • Examine whether bank's income from such activities has been recorded and is fairly stated in the bank's financial statements. • Consider whether the bank has any material undisclosed liability from a breach of its fiduciary duties, including the safekeeping of assets.
Special-purpose Certificates Relating to Investments	<ul style="list-style-type: none"> • Examine whether the bank 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.
Examination classification and shifting	<ul style="list-style-type: none"> • 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.

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 internal audit report 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.

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).

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

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

Area of Focus	Suggested Audit Procedures
Evaluation of Internal Controls over Advances	<ul style="list-style-type: none"> • Examine loan documentation; • Examine the validity of the recorded amounts; • Examine the existence, enforceability and valuation of the security; • Ensure compliance with the terms of sanction and end use of funds. • Ensure compliance with Loan Policy of Bank as well as RBI norms including appropriate classification and provisioning • Review the operation of the accounts;
Substantive Audit Procedures	<ul style="list-style-type: none"> • Check whether the amounts included in balance sheet for advances accounts are outstanding as on the date of the balance sheet. • Check that advances represent amount due to the bank. • Verify that amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances. • Ensure there are no unrecorded advances. • Check that the stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation. • Verify that the advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements. • Check that appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices. • Examine all large advances while other advances may be examined

	<ul style="list-style-type: none"> on a sample basis Verify completeness and accuracy of interest being charged
Recoverability of Advances	<ul style="list-style-type: none"> Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions. Review latest financial statements of borrowers. Review reports on inspection of security. Review Auditors' reports in the case of borrowers enjoying aggregate credit limits of Rupees 10 lakh or above for working capital from the banking system.

Verification of Provision for Non-performing assets: An important aspect of audit of advances relates to their classification and provisioning (for provisioning norms refer Chapter 12 of Intermediate Auditing & Assurance Study Module). This implies that a proper provision should be made in respect of advances where the recovery is doubtful. 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.

Area of Focus	Suggested Audit Procedures
Classification and Provision	<ul style="list-style-type: none"> Examine whether the classification made by the branch is appropriate. Particularly, examine the classification of advances where there are threats to recovery. Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly. <p>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 based on the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory</p>

	<p>evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.</p> <p>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 significant to determine the classification and hence specific care be taken in this regard. NPA should be recognized only based on concept of Past Due/ Overdue concept, and not based on the Balance Sheet date.</p>
Drawing Power Calculation	<ul style="list-style-type: none"> Ensure that the drawing power is calculated as per the extant guidelines (i.e. the Credit Policy of the Bank) 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 stipulated limit. 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	<ul style="list-style-type: none"> Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of ad hoc sanction, should 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	<ul style="list-style-type: none"> 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 realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked. 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.

	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> Ensure that NPA norms have been applied in accordance with the crop season determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops – short term/ long term - raised by an agriculturist, the NPA norms would also be made applicable to agricultural term loans availed of by them. Also ensure that these norms are 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, ensure that identification of NPAs has been done on the same basis as non-agricultural advances.
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.
Restructured Advances	RBI has given revised 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	Examine all the accounts upgraded from NPA to standard category during the year, to ensure that the upgrading of each account is strictly in terms of RBI guidelines.
Audit Procedure for Accounts falling under CDR (Corporate Debt Restructuring) Programme	<p>Following audit procedures are to be carried out to assess / gain an understanding about the borrower account-</p> <ul style="list-style-type: none"> 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. 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

	<p>at the time of original sanction of loan or at the time of reference to CDR).</p> <ul style="list-style-type: none"> • Auditor should 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 bank. 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 should verify the necessary approvals / recommendations by CDR core group if auditor comes across any BIFR cases. • Auditor should ensure that accounts wherein recovery suits have been filed, the initiative to resolve under CDR system is taken by at least 75% of the creditors by value and 60% in number provided the account meets the basic criteria for becoming eligible under CDR mechanism. • The auditor should see whether the income on projects under implementation which have been classified as standard has been accounted for on accrual basis pursuant to the RBI's income recognition norms.
Treatment of accounts restructured under CDR program: Classification and Provisioning:	<p>The criteria for classification of accounts will be based on 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,</p> <ul style="list-style-type: none"> • Ensure that the lender bank 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. • Ensure that in case a standard asset has been restructured second or more time, it has been downgraded to "sub-standard" asset. • 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. • Verify provision of adequate security coverage of loan in case of restructuring of principal amounts.
Sale/ Purchase of NPAs	<p>In case of Sale/Purchase of NPA by Bank, the auditor should examine</p> <ul style="list-style-type: none"> • the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

	<ul style="list-style-type: none"> • only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years. • the assets have been sold/ purchased “without recourse” only. • 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. • the NPA has been sold at cash basis only. • the bank has not purchased an NPA which it had originally sold. <p>In case of sale of an NPA, the auditor should also ensure that:</p> <ul style="list-style-type: none"> • on the sale of the NPA, the same has been removed from the books of the account. • 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 because sale of other non-performing financial assets. <p>Similarly, in case of purchase of NPAs, the auditor should verify that:</p> <ul style="list-style-type: none"> • the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank. • 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. • for the purpose of capital adequacy, banks have assigned 100% risk weights to the NPAs purchased from other banks.
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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).

Section 9 of the Banking Regulation Act, 1949, prohibits 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.

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 following:

Area of Focus	Suggested Audit Procedures
Internal Controls	<p>Examine the system of internal controls broadly covering the following:</p> <ul style="list-style-type: none"> • Control over expenditures incurred on fixed assets acquired or self-constructed. • Accountability and utilisation controls. • Information controls for ensuring availability of reliable information about fixed assets. • Ascertain whether the accounts in respect of fixed assets are maintained at the branch or centrally. • Ascertain the location of documents of title or other documents evidencing ownership of various items of fixed assets. • Examine whether acquisitions, disposals, etc. effected at the branch during the year have been properly communicated to the head office.
Premises	<ul style="list-style-type: none"> • 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. • 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 the 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/ payments to contractors for such assets should be shown under a separate item under the head "fixed assets". • 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

	<p>Accounting Standard. The auditor should also check the impairment, if any, by applying the principles laid down in relevant Accounting Standard.</p> <ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> 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. The auditor 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 case of transfer of fixed assets, like furniture, office equipment, etc. from one branch to another; the auditor should examine whether accumulated depreciation in respect of such assets is also transferred. In case of intangible assets, verify whether the relevant guidelines given by RBI by way of Circulars and the requirements of AS 26 have been followed. Examine 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 equipment's or the theft alarm system of the bank. 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.
Sale of Fixed Assets	<ul style="list-style-type: none"> Verify the copy of sale deed and receipt of the sale value, in respect of fixed assets sold during the year. Ensure that the profit/ loss on sale of assets has been properly accounted for.
Leased Assets	<ul style="list-style-type: none"> 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".
Impairment of Assets	<ul style="list-style-type: none"> • Verify whether the guidelines given by RBI's circular on compliance with Accounting Standards, issued in April 2004 and the requirements of AS 28 have been followed.

V. OTHER ASSETS: The auditor may carry out the audit of various items appearing under the head 'other assets' in the following manner:

Audit Procedures

Area of Focus	Suggested Audit Procedures
Inter-Office Adjustments	Examine whether Inter-branch accounts are normally reconciled at the central level. 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 should ensure that any discrepancies found in inter-branch accounts have been properly dealt with in the books. The auditor can obtain the relevant information primarily from branch audit reports.
Interest Accrued	<ul style="list-style-type: none"> • 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. • 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.
Tax Paid in Advance/Tax Deducted at Source	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • Evaluate the existence, effectiveness and continuity of internal controls over these items in the normal course of audit. It may be noted that the branch auditor is required to specifically comment on the adequacy of the relevant internal controls in the LFAR. • Physically verify the stationery and stamps on hand as at the year-end, especially stationery of security items. Any shortage should be

	<ul style="list-style-type: none"> inquired into as it could expose the bank to a potential loss from misuse. 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	<ul style="list-style-type: none"> 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. Check that the ownership of the property is legally vested with 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". Ensure compliance with Section 9 of Banking Regulation Act, on holding period of such assets.

VI. 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:

Audit Procedures

Area of Focus	Suggested Audit Procedures
Non-Interest-Bearing Staff Advances	<ul style="list-style-type: none"> 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. Ensure that the same relates to employees on the rolls of the bank on the date of the preparation of financial statements.
Loans and Advances to Officials and Relatives	<ul style="list-style-type: none"> The auditor should verify that loans have been ordinarily sanctioned by the next higher sanctioning authority Loans to senior officers or of higher amount should have been reported to the Board.
Security Deposits	<ul style="list-style-type: none"> Examine 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) with reference to documents

	<ul style="list-style-type: none"> containing relevant terms and conditions, and receipts obtained from the parties concerned. 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 considered in detail and appropriate provision be made against the amount which is doubtful to recover.
Suspense Account	<ul style="list-style-type: none"> 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	<ul style="list-style-type: none"> Examine whether the basis of allocation of expenditure to different periods is reasonable. 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	<ul style="list-style-type: none"> Review the ageing statements pertaining to these items. Examine the recoverability of old outstanding items. 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. For major variance as compared to the previous year figures, verify whether reasons for the same have been recorded and reviewed.



8. VERIFICATION OF CAPITAL & LIABILITIES

I. CAPITAL

The auditor may carry out the audit of various items under 'Share Capital' in the following manner:

Audit Procedures

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.

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. 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 (OECD) or had special lending arrangements under the International Monetary Fund’s (IMF) 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 distinct 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.

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.

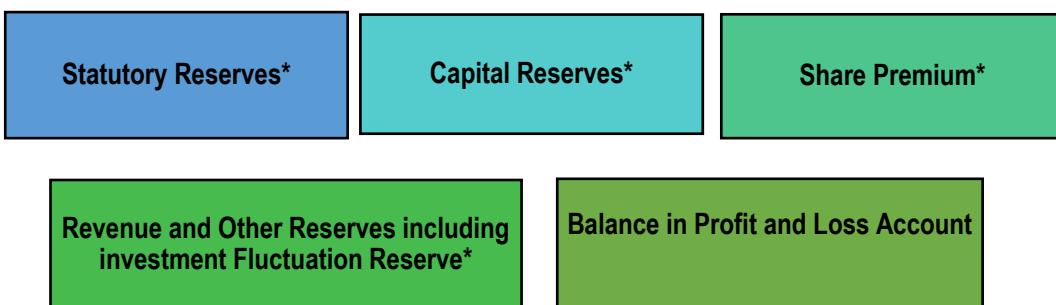
Capital Risk Adequacy Ratio (CRAR): The CRAR is computed as follows:

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

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 for CRAR.

II. RESERVES AND SURPLUS

The following are required to be disclosed in the balance sheet under the head 'Reserves and Surplus'.



*In respect of these items above, opening balance, additions during the year and deductions during the year are to be shown separately in respect of each item

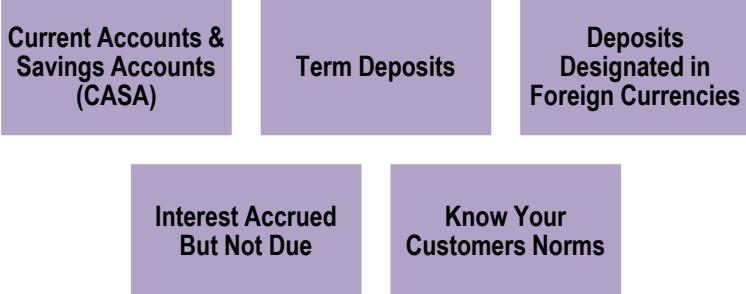
Audit Procedures

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. Compliance with foreign laws in respect of overseas branches, need to be verified by the auditor.

III. DEPOSITS

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 following areas should be considered when auditing Deposits:



Audit Procedures:

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

Area of Focus	Suggested Audit Procedures
Deposits	<ul style="list-style-type: none"> • Verify the balances in individual accounts on a sample basis. • 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. • Check the calculations of interest on a test check basis. • Examine whether the procedure for obtaining balance confirmation periodically has been followed consistently. Examine, on a sampling basis, the confirmations received. • Ensure that debit balances in current accounts are not netted out on the liabilities side but are appropriately included under the head 'advances'. • Ascertain whether inoperative accounts are 'revived' only with proper authority. • Examine whether the deposit receipts and cash certificates are issued serially and all of them are accounted for in the registers. • Examine whether foreign currency deposits have been converted into Indian rupees at the rate notified in this behalf by the head office. • Examine whether any resultant increase or decrease has been taken to the profit and loss account. • Verify that interest on deposits has been paid on the basis of 360 days in a year. • 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'. • Examine the inoperative/ dormant accounts carefully. • Ensure that framework relating to 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place by the bank.

IV. BORROWINGS

Borrowings of a bank are required to be shown in balance sheet as follows.



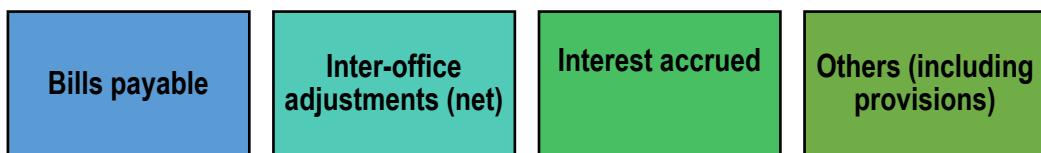
The total amount of secured borrowings included under the above heads is to be shown by way of a note to the relevant schedule. Secured borrowings for this purpose include borrowings/refinance in India as well as outside India. It may be noted that the inter-office transactions are not borrowings and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

Audit Procedures:

Area of Focus	Suggested Audit Procedures
Borrowings	<ul style="list-style-type: none"> • Obtain and verify confirmation certificates and other supporting documents such as, agreements, correspondence, etc. • 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. • 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. • 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. • 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. • Examine whether the amount shown in the branch accounts is properly classified based on security or otherwise.

V. 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'.



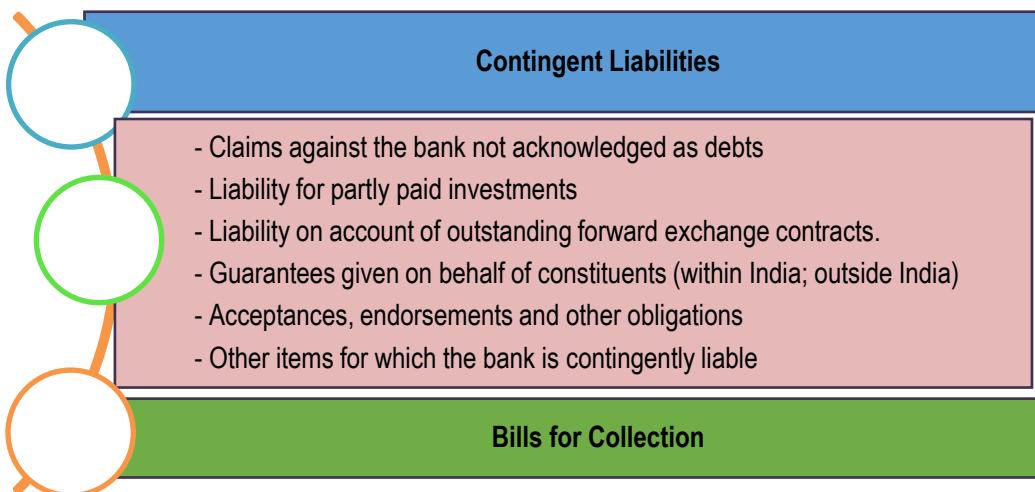
Audit Procedures:

The auditor may verify the various items under the head 'other liabilities and provisions' in the following manner.

Area of Focus	Suggested Audit Procedures
Bills Payable	<p>Evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following-</p> <ul style="list-style-type: none"> • Drafts, mail transfers, traveller's cheques, etc. should be made out in standard printed forms. • Unused forms relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer. • 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. • The signatures on a demand draft should be checked by an officer with the specimen signature book. • 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. <p>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.</p> <p>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 be examined specially in so far as large value items outstanding on the balance sheet date are concerned.</p>
Others (Including Provisions)	<p>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</p>

	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	Examine interest accrued 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'.

VI. CONTINGENT LIABILITIES



Audit Procedures

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:

Area of Focus	Suggested Audit Procedures
Contingent Liabilities	<ul style="list-style-type: none"> • 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. • 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. • Verify in case of LCs for import of goods, the payment to the overseas suppliers is made based on shipping documents and after ensuring that the said documents are in strict conformity with the terms of LCs.

	<ul style="list-style-type: none"> • 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. • Test the completeness of the recorded obligations. • 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. • Review whether comfort letters issued by the bank has been considered for disclosure of contingent liabilities. • 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. • 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.
Claims Against the Bank Not Acknowledged as Debts	<ul style="list-style-type: none"> • Examine the relevant evidence, e.g., correspondence with lawyers/ others, claimants, workers/officers, and workmen's/officers' unions. • 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. • 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	<ul style="list-style-type: none"> • 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.
Guarantees Given on Behalf of Constituents	<ul style="list-style-type: none"> • 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

	<ul style="list-style-type: none"> customers before issuance of guarantees as per the prescribed procedures, etc. • 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 is periodically verified and reconciled with the book records, etc. • Examine the guarantee register to seek evidence whether the prescribed procedure of marking off the expired guarantees is being followed or not. • 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. • Examine that expired guarantees are not included in this head. Verify guarantees with the copies of the letters of guarantee issued by the bank and with the counter-guarantees received from the customers. The auditor 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".
Acceptances, Endorsements and Other Obligations	<ul style="list-style-type: none"> • 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. • 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. • Examine whether the bank has incurred a potential financial obligation in respect of letters of comfort and if such obligation has been cast, ensure the amount to be disclosed under contingent liability.
Other Items for which the Bank is Contingently Liable	<ul style="list-style-type: none"> • Determine and verify any other items under this head as required. For example, outstanding underwriting contracts, bills rediscounting, disputed tax demands, interest rate swaps, etc.
Bills for Collection	<ul style="list-style-type: none"> • Ensure that the bills drawn on other branches of the bank are not included in bills for collection. • Verify outward bills for collection with reference to the corresponding register maintained. • Examine collections made subsequent to the date of the balance

	<p>sheet to obtain further evidence about the existence and completeness of bills for collection as on the date of Balance Sheet.</p> <ul style="list-style-type: none"> • Examine the procedure for crediting the party on whose behalf a bill has been collected. Confirm that this procedure is in consonance with the nature of obligations of the bank in respect of bills for collection. • Examine that adequate internal controls exist 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.
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9. 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

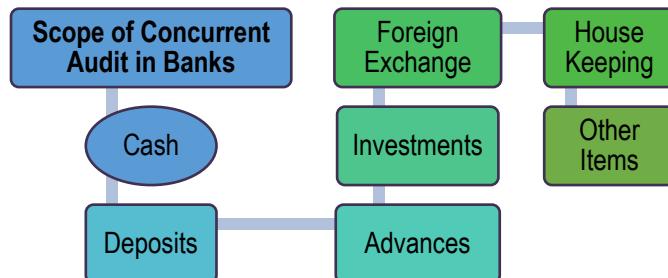
this audit is to verify the authenticity of the transaction/activity within the shortest possible time after the same takes place. It is akin to internal audit which is a concept recognised under the Companies Act. In view of the complexities of economic activities it is now well recognised that there must be 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.

9.1 Scope of Concurrent Audit

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). In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving lesser amounts. The detailed scope of the concurrent audit may be determined and approved by the ACB.

Further, the guidelines issued by the RBI cover all the key 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:



9.2 Concurrent Audit System in Commercial Banks

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.

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.

9.3 Coverage of Business/Branches

Banks are required to cover 50 percent of total deposits and 50 per cent of total advances under concurrent audit. This means that banks should put their large branches under this audit. It is also necessary to ensure that the coverage encompasses the following considerations:

Large and very large branches

Special branches handling Foreign Exchange, Merchant Banking, large Corporate Wholesale Banking 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.

Note: Branches subjected to concurrent audit should not normally be included for revenue/income audit.

9.4 Types of Activities to be Covered

The areas that are typically covered as part of a concurrent audit and the suggested audit procedures are as follows:

Area of Focus	Suggested Audit Procedures
Cash	<ul style="list-style-type: none"> • Daily cash transactions with particular reference to any abnormal/high value receipts and payments. • Proper accounting of inward and outward cash remittances. • Proper accounting of currency chest transactions, its prompt reporting to the RBI. • Expenses incurred by cash payment involving sizeable amount.
Investments	<ul style="list-style-type: none"> • Ensure that in respect of purchase or sale of securities the branch has acted within its delegated power having regard to its Head Office instructions. • Ensure that the securities held in the books of the branch are physically held by it. • Ensure that the branch is complying with the RBI/head Office guidelines regarding BRs, SGL forms, delivery of scrips, documentation and accounting. • Ensure that the sale or purchase transactions are done at rates beneficial to the bank.
Deposits	<ul style="list-style-type: none"> • Check the transactions about deposits received and repaid. • Percentage check of interest paid on deposits may be made including calculation of interest on large deposits. • 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.
Advances	<ul style="list-style-type: none"> • Ensure that loans and advances have been sanctioned properly in accordance with delegated authority. • Ensure that securities and documents have been received and properly charged/ registered. • Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, recovery/ renewal of sanction limits, etc. • Verify whether there is any misutilisation of the loans and whether there are instances indicative of diversion of funds. • Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions. • Check the bank guarantees issued, whether they have been

	<p>properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.</p> <ul style="list-style-type: none"> • Ensure proper follow-up of overdue bills of exchange. • Verify whether the classification of advances has been done as per RBI guidelines. • Verify whether the claims to DICGC and ECGC is submitted in time. • Verify that instances of exceeding delegated powers have been promptly reported to controlling/Head Office by the branch and have been confirmed or ratified at the required level.
Area of Focus	Suggested Audit Procedures
Foreign Exchange	<ul style="list-style-type: none"> • Check foreign bills negotiated under letters of credit. • Check FCNR and other non-resident accounts whether the debits and credits are permissible under rules. • Check whether inward/outward remittance have been properly accounted for. • 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. • Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank. • Ensure that the overbought/oversold position maintained in different currencies is reasonable, considering the foreign exchange operations. • Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations. • Ensure verification/reconciliation of Nostro and Vostro account transactions/balances.
House Keeping	<ul style="list-style-type: none"> • Ensure that the maintenance and balancing of accounts, ledgers and registers including clean cash is proper. • Early reconciliation of entries outstanding in the inter-branch and inter-bank accounts, Suspense Account, Sundry Deposits Account, DRR Account, Drafts Account, etc. • Ensure timely adjustment of large value entries. • Carry out a percentage check of calculations of interest, discount, commission and exchange. • Check whether debits in income account have been permitted by the competent authorities. • Check the transactions of staff accounts. • Examine the day book to verify as to how the differences in

	<p>clearing have been adjusted.</p> <ul style="list-style-type: none"> • Detection & prevention of revenue leakages through close examination of income and expenditure persists. • Verify cheques returned/bills returned register and look into reasons for return of those instruments. • Checking of inward and outward remittances (DDs, MTs & TTs).
Other items	<ul style="list-style-type: none"> • 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. • Ensure that the branch gives proper compliance to the internal inspection/audit reports. • Ensure that customers' complaints are dealt with promptly. • Verify the statements, returns, statutory returns etc. submitted to RBI/ HQ.

9.5 Appointment of Auditors and Accountability

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

9.6 Remuneration of Concurrent Auditor

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.

9.7 Reporting Systems

- 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 key features brought out during the concurrent audits should be placed before the ACB.

- 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.
- Before submission of the report the auditor should discuss the important issues on which he/she wishes to report with the branch manager and concerned officers. This will enable the auditor to take into consideration the opposite view point and clarify any doubts.
- Minor irregularities pointed out by the concurrent auditors are to be rectified in a timely manner. Serious irregularities should be reported to the controlling offices/ Head Offices for immediate action.
- 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).
- 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.



10. 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.

TEST YOUR KNOWLEDGE

Theoretical Questions

1. Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. State your views on the following issues which were brought to your notice by your Audit Manager:
 - (a) The bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year.
 - (b) The bank is a consortium member of Cash Credit Facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing.
2. As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?
3. Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines.
4. In course of audit of Good Samaritan Bank as at 31st March, 19 you observed the following:
 - (a) In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government?
 - (b) The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances.

Multiple Choice Questions:

1. You are the internal auditor of FCD Bank Limited for the year 2018-19 and the bank maintains all the data on computer. You are instructed by your senior to verify the loan against fixed deposits of the Navi Mumbai branch. As per the scope of audit, you need to ensure that proper lien has been marked on all the fixed deposits against which loan has been issued. Which of the following procedure you will follow for the same:
 - (a) Ensure that all the fixed deposit receipts are attached along with the approved loan documents.

- (b) Ensure that all the fixed deposit receipts, against which the loan has been sanctioned, are discharged in favour of bank and check that the lien is marked in the computer software.
- (c) Discuss the process followed for lien marking with the branch manager.
- (d) Ensure that all the fixed deposit receipts, against which the loan has been sanctioned, are discharged in favour of bank, check that the lien is marked in the computer software and the fixed deposit should be kept separately with the branch manager.
2. PFS Bank was engaged in the business of providing Portfolio Management Services to its customers, for which it took prior approval from RBI. Your firm has been appointed as the statutory auditors of the Bank's financial statements for the year 2018-19. Your senior has instructed you to verify the transactions of Portfolio Management Services (PMS). While verifying the transactions you noticed that the bank has not prepared separate record for PMS transactions from the Bank's own investments. As a statutory auditor what will be your decision for verification of PMS transactions?
- (a) It is not necessary to maintain separate records for PMS clients from Bank's own investments, so the auditor can verify the PMS transactions as part of investment verification for Bank's financial statements and submit the audit report accordingly.
- (b) As per RBI guidelines PMS investments need to be audited separately by the external auditors and the auditors are required to give a certificate separately for the same. So, in the above case the auditor should not verify the PMS transactions till the Bank segregates the transactions from its own investments.
- (c) The auditor can give a qualified opinion in his audit report on the financial statements of the Bank and report the matter in special purpose certificate.
- (d) Auditor should verify that PMS funds are not utilised for lending, inter-bank deposits or deposits to corporate bodies and bills re-discounting only. So, whether the PMS transactions are recorded separately or not will not matter for the auditor.
3. Your firm has been appointed statutory auditor by a Nationalised Bank for the year 2018-19. Your senior advised you to check all the standard assets shown in the balance sheet as on 31st March 2019. While verification you observed that one of the accounts was regularised on 28th March 2019, for which the interest and instalment amount was overdue from the quarter ending 30th September 2018. The account was regularised after the repayment of overdue interest and instalment amounts was done on 26th March 2019. Only the last day of the financial year was reckoned as the date of account becoming NPA by the Bank. As a statutory auditor will you agree with the Bank's policy?
- (a) As the interest charged in the account was overdue for more than 90days from the end of quarter, it should be classified as NPA and should be considered as sub-standard asset for the balance sheet as on 31st March 2019.

- (b) As the overdue interest and instalment amount was paid before the balance sheet date there is no reason to classify the account as NPA.
- (c) The auditor should not agree with the Bank's policy to regularise the account before balance sheet date as overdue interest indicates more than normal risk attached to the business.
- (d) Bank can regularise the account before balance sheet date but should ensure that the amount has been paid through genuine resources and not by sanction of additional facilities, and the account remains in order subsequently.

Case Study Based MCQs

The Chanakya Bank Ltd. was having 150 branches all over India by the year ending 31st March, 2019. Ten branches of the bank were already covered for concurrent audit and the Bank's Audit Committee decided to include the below mentioned branches for concurrent audit from the year 2019-20.

1. Banaras branch which deals in treasury functions like investments and inter bank borrowings but not in bill re-discounting.
2. Allahabad branch which started foreign exchange business from February 2019.
3. Rae Bareilly branch whose aggregate deposits were more than 35% of the aggregate deposits of the bank.

Sista and Chartered Accountants were appointed as the stock auditors by the Bank's audit committee for five branches for year 2019-20. The Bank's management appointed and fixed the remuneration of Sista and Chartered Accountants as the statutory auditors also for the year 2019-20, for the same five branches for which they were given the assignment of stock audit.

At the Kanpur branch of the bank there were high value cash deposits in one of the current account from April 2019. Your firm has been appointed as the concurrent auditors for the Kanpur branch for the year 2019-20. The cash collected by the branch was remitted to currency chest on the very same day but, during the concurrent audit for the month of April 2019 itself the auditor noticed that the branch has not filed the requests sent via e-mail to currency chest for the cash remittance.

Answer the below questions based on the above paragraph:

1. Whether the decision of audit committee to include the three branches mentioned in above paragraph for concurrent audit is as per RBI Guidelines?
 - (a) The decision of audit committee is valid as according to RBI Guidelines, all the three branches fulfil the criteria for compulsory concurrent audit.
 - (b) Banaras and Allahabad branch falls under the compulsory audit criteria as per RBI Guidelines, however Rae Bareilly branch whose aggregate deposits are less than 50%

- of the aggregate deposits of the Bank is not required to be compulsorily covered for concurrent audit.
- (c) As Banaras branch doesn't deal in bill re-discounting, it is not required to be covered under concurrent audit. Allahabad and Rae Bareilly branch are compulsorily required to be covered under concurrent audit as per RBI Guidelines.
- (d) Allahabad branch has started foreign exchange business in February 2019 and as per RBI Guidelines only the branches dealing in Foreign exchange business from more than three years are covered under concurrent audit. Therefore, Allahabad branch is not covered under compulsory concurrent audit criteria as per RBI Guidelines but the Banaras and Rae Bareilly branch are covered under compulsory concurrent audit criteria.
2. Sista and Chartered Accountants were already appointed for stock audit by the audit committee for the five branches, so whether Sista and Chartered Accountants are authorised to accept the appointment as statutory auditors for the same branches?
- (a) Sista and Chartered Accountants cannot accept the appointment as it was not offered by the audit committee and Bank's management is not authorised to appoint the auditors.
- (b) Sista and Chartered Accountants can accept the appointment as they were already appointed for the stock audit of those branches by the audit committee.
- (c) Sista and Chartered Accountants can accept the appointment as they have been appointed statutory auditors for the same five branches for which they were conducting stock audit.
- (d) Sista and Chartered Accountants cannot accept the appointment as the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the Bank during the same year.
3. Whether the Bank's Management is authorise to appoint and fix the remuneration of statutory auditors without consulting the Audit Committee of the Board of Directors or members in Annual General Meeting?
- (a) Bank's Management cannot appoint or fix the remuneration of the statutory auditor unless the same is passed by a resolution in the Annual General Meeting of the Bank.
- (b) Bank's Management can appoint and fix the remuneration of statutory auditors only in consultation with the Audit Committee of the Board of Directors.
- (c) Sista and Chartered Accountants were already appointed for stock audit by the audit committee, therefore only audit committee was authorise to appoint or fix their remuneration as statutory auditors.

- (d) Sista and Chartered Accountants were already appointed for stock audit by the audit committee, so the Bank's Management is authorise to appoint the same firm as the statutory auditors without consulting the audit committee or members in the Annual General Meeting.
4. You have been asked by your senior to verify the high value cash deposits at the Kanpur branch. What parameters/ documents will you verify as the concurrent auditor of the branch?
- Concurrent auditor has to verify the details of cash remittance to Currency Chest only.
 - You need to verify the KYC documents of the customer/s and the reason for high value cash deposit in the account like nature of business or sale of property etc.
 - Verify the KYC documents of the account in which cash is deposited; verify the reason for high value cash deposit in the account like nature of business/ transaction etc.; verify the discrepancies found in the cash of the customer/s, if any and ensure that the records of Currency Chest remittance is maintained properly.
 - As a concurrent auditor you need to verify the reason of regular cash deposit in the account/s and the nature of discrepancies, if any, found in cash deposited by the customer/s.
5. How the discrepancy of not filing the details of cash remittances to currency chest by Kanpur branch of the bank should be dealt by the concurrent auditor in his audit report?
- The auditor should report the matter as a major irregularity in his audit report to the management.
 - The auditor should verify the details from e-mail sent to currency chest and close the matter.
 - As it is a minor irregularity the auditor can ignore the same.
 - The auditor should discuss the importance of filing the copy of e-mail sent for cash remittance with the Branch Manager and check for its compliance in the next audit period.

Answers to Theoretical Questions

1. (a) It is not a prudent practice to treat dividend on shares of corporate bodies and units of mutual funds as income unless these are actually received. Accordingly, income from dividend on shares of corporate bodies and units of mutual funds should be booked on cash basis. In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the

payment of interest and repayment of principal have been guaranteed by the central government or a State government. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9 as well. In the instant case, therefore, the recognition of income by the bank on accrual basis is not in order.

- (b) The bank is a consortium member of cash credit facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest, the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.
2. Refer Para no 6.2.
 3. Refer Para no. 9.1
 4. (a) **Government Guaranteed Advance:** If a government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.
Since the bank has not revoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.
The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.
In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.
- (b) **The Audit Programme to Verify Advances against Life Insurance Policies is as under-**
 - (i) 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.

- (ii) The auditor should also examine whether premium has been paid on the policies and whether they are in force.
- (iii) Certificate regarding surrender value obtained from the insurer should be examined.
- (iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.

Answers to Multiple Choice Questions

1. (b) 2. (b) 3. (d)

Answers to Case Study Based MCQs

1. (b) 2. (d) 3. (a) 4. (c) 5. (d)

