

### (C) REGULATORY BODY

The functioning of banking industry regulated by the RBI which acts as the Central Bank of India.

### (i) RBI is responsible for: | (ii) Important

- Development and supervision of the constituents
- Determining. in conjunction with the CG, the monetary and credit policies
- Regulating the activities of commercial and other banks

- functions of RBI are: BB CC
- Issuance of currency;
- Regulation of currency issue:
- Acting as banker to the
- CG&SG: and Acting as banker to commercial and other

banks. No bank can commence the business of banking or open new branches without obtaining license from RBI. The RBI also has the power to inspect any bank.

Banking Regulation Act. 1949. State Bank of India Act. 1955. Companies Act. 2013.

State Bank of India (Subsidiary Banks) Act 1959. (2)

Banking Companies (Acquisition and Transfer of Undertakings) Act. 1970. Regional Rural Banks Act, 1976.

Banking Companies (Acquisition and Transfer of Undertakings) Act. 1980.

Information Technology Act, 2000.

Prevention of Money Laundering Act, 2002. <u>a</u>

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. SARFAESI

Credit Information Companies Regulation Act, 2005.

Payment and Settlement Systems Act, 2007.

## SYSTEM IN BANKS

- From the time that customers had to physically visit and deal with a bank, there is a sea change in banking as use of technology and its continuous evolution has enabled hanks to reach their customers in providing them the convenience and comfort of anytime-anywherebanking by letting them access their information/data on real time basis, as stored in a safe and secure environment on the hank's servers
- Banks may be divided into three board categorises based on the level of computerisation
  - Non-computerised banks
  - Partially computerised banks.
  - Fully computerised banks

- In CIS environment it is imperative that the auditor is familiar with and satisfied that all the norms/ parameters as per the latest applicable RBI guidelines.
- The auditor should not go by the assumption that the system demonstrates that the system driven information is based on the required parameters.
- He should use professional skepticism and prudence wherever he feels that something manually needs to be performed to check the authenticity and consistency of the information obtained from the system & document the results

### 3. BANK AUDIT APPROACH

(A) DRAWING AN AUDIT PLAN :-An audit plan should be drawn up based on:

The nature and level of operations

Nature of adverse features

Level of compliance based on previous reports and

Audit risks based on inadequacy/ breach in ICs







### ENVIRONMENT AT THE BANK

A bank should have appropriate controls to mitigate its risks, including effective segregation of duties. accurate measurement and reporting of positions, etc. The following are certain common questions / steps, which have to be kept in mind while undertaking/performing control activities:

## CONSIDERED / ANSWERED

Who performs the control? Does the above person have requisite knowledge and authority to perform the control?

What evidence is available to demonstrate /prove that the control is performed?

When

How

When and with what frequency is the control performed? Is the frequency enough to

prevent, detect & correct RoMM? Where is the evidence of performance of the control retained?

For how long is the evidence Where retained?

> Is the evidence accessible/ available for audit? Why is the control being

performed? What type of errors are prevented or detected through the performance of the control?

How is the control performed? What are the control activities? Can these activities be bypassed?

Can the bypass, if any, be detected? How are exceptions / deviations resolved on identification?

What is the time frame for resolving the exceptions?

### (C) ENGAGEMENT TEAM DISCUSSIONS:

All personnel performing an engagement, including any

experts contracted by the firm in connection with that engagement are known to be the "Engagement Team".

The engagement team should hold discussions to gain better understanding of the bank & its environment including internal control, and also to assess the potential for material misstatements of the financial statements.

(i) The engagement team discussion ordinarily includes a discussion of the following matters:

- (a) Errors that may be more likely to occur;
- (b) Errors which have been identified in prior years;
  - (c) Method by which fraud might be

perpetrated by bank personnel or others within particular account balances and/or disclosures: ER-PR-JP

- d) Audit responses to engagement risk, pervasive risks, and specific risks;
- (e) Need to maintain professional skepticism throughout the audit engagement:
- (f) Need to alert for information or other conditions that indicates that a material - Ale misstatement may have occurred

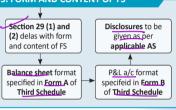
### (ii) Advantages of such a discussion

- Specific emphasis should be provided to the susceptibility of the bank's financial statements to MMs due to fraud, that enables the ET to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.
- It further enables the audit engagement partner to delegate the work to the experienced ET members, and to determine the procedures to be followed when fraud is identified.
- · Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

### 4. INCOME RECOGNITION POLICY







### 6. AUDIT OF ACCOUNTS



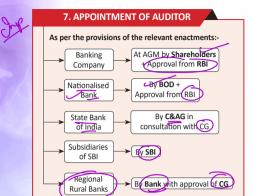
Section 30(1): Accounts of a banking company shall be audited by a person duly qualified under any law to be an auditor of comapnies



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Appointment of

**Auditor** 

#### 8. AUDITOR'S REPORT

In case of nationalised bank, auditor is required to make a report to CG in which he has to state the following:

Whether in his opinion FS present a T/F view of the affairs of the bank & In case he called for any explanation/ info., whether it has been given and is satisfactory

Whether or not transactions which have come to his notice have been within the power of bank Whether return received from offices and branches are adequate

Any other matter to be brought to notice of CG



The report of auditors of SBI is also to be made to the CG and is almost identical to the auditor's report in the case of a nationalised bank.

### (A) FORMAT

- As given in SA-700
- Section 143 also applies
- CARO not applicable?

### (B) LONG FORM AUDIT REPORT

### (This Provision has been amended)

- (a) This report is to be given by statutory branch auditors (SPA) as well as statutory central auditors.
- (b) It is in form of questionnaire where observations/ comments have to be provided on imp matters.
- (c) These are <u>submit-</u> ted by the <u>statutory</u> branch auditors to statutory central auditors.
- (d) The consolidation is done at **head office level** and LFAR for bank is submitted by **SCAs to MGT.**

- (e) LFAR after due examination, should be placed before the ACB of the bank indicating the action taken/proposed
  - to be taken for rectification of the irregularities & a copy of the LFAR & the relative agenda note, together with the Board's views or directions, is

### submitted to RBI within 60 days

of submission of LFAR by statutory auditors.

### (C) REPORTING TO RBI

- (i) RBTCircular If an accounting professional (Internal/ external/ institutional auditor) finds anything susceptible to fraud/ act of excess power/ smell any foul play in transactions, he shall refer it to regulator. Any deliberate failure shall render auditor liable for action.
- (ii) Auditor should also consider the provisions of <u>SA 250</u>. The said standard explains that the duty of confidentiality is <u>over-ridden</u> by statute, law or courts.
- (iii) SA 240 states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the FSs taken as a whole are free from MM, whether caused by fraud or error.

### (D) FRAUD REPORTING UNDER THE COMPANIES ACT

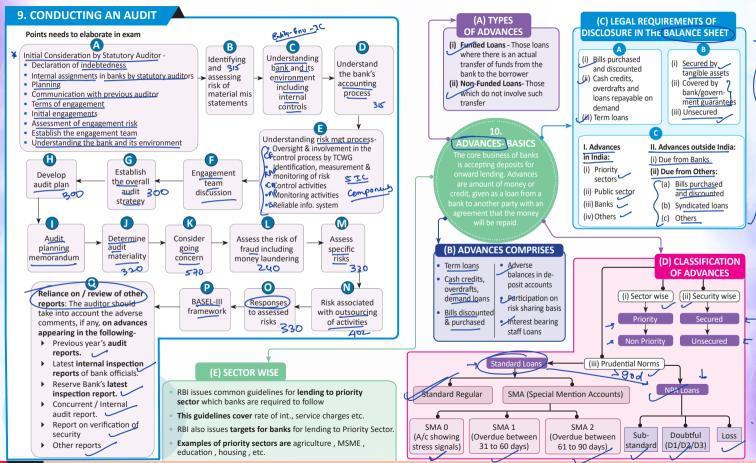
Report matter to CG in such time and manner as may be prescribed











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Primary Security Collateral Security

The security offered by the borrower for bank finance or the one against which credit has been extended by the bank.

Principal It is an security additional security & can be in any form

i.e. tangible or intangible asset. movable or immovable asset.

### (H) NON-PERFORMING ASSETS

- A NPA is a loan/advance where interest/ installment is overdue for more than 90 days
- Account is out of order for overdraft/ cash credit bill remains overdue for more than 90 days

### (I) OUT OF ORDER

- O/S balance is continuously in excess of santioned limit/drawing power
- No credits for continuous 90 days
- · Credits not enough to cover interest debited during the same period

### (J) OVER DUE

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank

### (i) Mortgage

Several types are there but most important are the Registered Mortgage and the Equitable Mortgage

- Registered Mortgage Affected by a registered instrument called the 'Mortgage Deed' signed by mortgagor & registers property as a security
  - Equitable mortgage- It is effected by a mere delivery of title deeds with intent to create security thereof

(ii) Pledge

· Bailment or delivery of

goods by the borrower to the

Tending bank with the

intention of creating a charge

• Legal ownership remains

with pledger while banker gets

certain defined interests in

the goods

· Pledge of goods

constitutes a specific

(or fixed) charge

## (vi) Lien

It is creation of a legal charge with consent of the owner, which gives lender right to seize/ liquidate the asset

halance debt only

### (G) MODE OF CREATION OF SECURITY

- Execution of hypothecation agreement for moveable securities
- · No transfer of

under lien

- possession or ownership
- Borrower holds possession of goods as agent of bank Borrower periodically
  - submit statements to Bank to fix DP

#### (v) Set off

- · Right of creditor to adjust debit balance against any credit
- · Can be exercised for time barred

### (iv) Assignment Transfer of existing/ future debt, right or property

- Only actionable claims accepted as security
- Gives asignee absolute right over the debts assigned

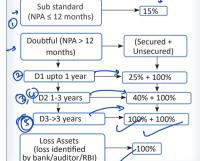
### (M) ADVANCES UNDER CONSORTIUM

Based on record of recovery of individual member banks

If remittance pooled by one bank or bank receiving remittances is not parting with share of other member banks, account shall be treated as NPA

The participating banks shall get their share transferred from lead bank for proper asset classification

## PROVISIONS ON NPA



### (K) ACCOUNTS REGULARIZED NEAR THE BS DATE

- Where few credits are recorded before the BS should be handled with care & without scope for subjectivity
- If a cindicates inherent weakness on the basis of the data - should be deemed as NPA.

### (L) GOVERNMENT GUARANTEED ADVANCES

- (CG) Where the guarantee is not invoked/repudiated would be classified as standard assets, but regarded as NPA for Income Recognition purpose.
- SG. The situation would be different if the advance is guaranteed by state government, where advance is to be considered NPA if it remains overdue for more than 90 days for both provisioning & income recognition purposes.





### (N) EROSION IN THE VALUE OF SECURITY/ FRAUDS COMMITTED BY BORROWERS

Frosion means the gradual destruction or diminution of something not prudent to follow stages of asset classification. It should be straight-away classified as doubtful or loss asset as appropriate as follows

Erosion in the value of security can be reckoned as significant when the realisable value of the security is < 50 % of the value assessed by the bank or accepted by RBI at the time of last inspection

(ii)
If the realisable
value of the security, as assessed by the
bank/ approved valuers/
RBI is < 10 % of the o/s in
the borrowal accounts, the
existence of security should
be ignored and the asset
should be straightaway classified as
loss asset.

### (O) ADVANCES AGAINST TERM DEPOSITS, NSC1, KVPS/ IVPS, ETC.

Need not be treated as NPAs
- provided adequate margin is
available

### (Q) ADVANCES TO STAFF

- To be included as part of advances
   portfolio of the bank
- Classified as NPA on default in repayment of instalment
- Included under the sub-head "Others" under other assets

11.

COMPUTATION

OF DRAWING POWER

less margin as on a

particular date.

(P) AGRICULTURAL ADVANCES AFFECTED BY NATURAL CALAMITIES

Master Circular issued by the RBI deals elaborately with the classification and income recognition issues due to impairment caused by natural calamities.

Banks may decide on their **own relief measures**, subject to the guidelines contained in RBI's latest Master Circular

In such cases, the NPA classification would be governed by such rescheduled terms.

### (R) AGRICULTURAL ADVANCES

As per guidelines they are of two types-

Crops with crop season longer than 1 year

Short duration crops

Other than long duration crops

Treated as NPA , if installment is overdue for 1 crop season

Treated as NPA , if installmet is overdue for 2 crop seasons

Different from Sanctioned Limit -The Sanctioned Limit is the total exposure while Drawing Power refers to the amount calculated based on primary security

Meaning: Drawing Power generally addressed as "DP" is an important concept for Cash Credit (CC) facility availed from banks and financial institutions. It is the limit upto which entity can withdraw from the WC limit sanctioned

Considerations:- All accounts should be kept within both the drawing power and the sanctioned limit at all times.

(iii)

Bank's Duties:- Banks should ensure that drawings in the WC account are covered by the adequacy of the current assets & required to be arrived at based on current stock statement.

(iv)
Auditor's Concern:- The stock
statements, quarterly returns
and other statements submitted by the borrower to the bank
should be scrutinized in detail.

Computation of DP: Ensure that drawing power is calculated as per guidelines formulated by the BODs of the respective bank and agreed upon by the concerned statutory auditors. (vi)

Stock Audit: The stock audit should be carried out by the bank for all accounts having funded exposure of more than ₹ 5 crores.

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**AUDIT OF BANKS** 





The auditor can obtain SAAE about

advances by study and evaluation of ICs

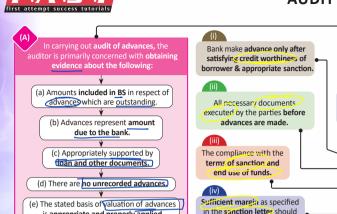
Examining validity of recorded amounts.

Examining loan documentation.

Reviewing operation of accounts.

Examining existence, enforceability





(x) 12 All irregular a/c should AUDIT OF be brought to the notice ADVANCES of controlling authority regularly. The operation of each advance account should be reviewed at least once a vear The accounts should be kept within both the drawing power and the sanctioned limit **Evaluation of** Internal Controls Update drawing power over Advances register every month.

(vii)

& valuation of security. Checking compliance with RBI porms and Carrying out appropriate analytical procedures.

be kept against securities. In case of goods in possession, check contents at the time of recipt and afterwards at regular intervals. All securities requiring registration should be registered in the name of the bank or other-If securities taken are shares, debentures, wise accompanied by documents.

(ix) Re-negotiations :-

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

 Test check the interest earned by the banks for the sample selected.

· Test check the fees and commissions earned by the banks made for commission on bills for collection, letters of credit and bank guarantees.

13 AUDIT OF REVENUE **ITEMS** 

AUDIT

APPROACH

AND

**PROCEDURES** 

(A) PROFIT AND LOSS ACCOUNT

is appropriate and properly applied.

(f) The advances are disclosed, classified

and described as per FRF & Law.

(g) Appropriate provisions have been

made as per the RBI norms.

Section 29(1) of the Banking Regulation Act, 1949, requires the preparation of Profit and Loss Account in

Form-B of Third Schedule to the Act or as near thereto as the circumstances admit.

(vi) Advances against Securities :- May be taken to income a/c on the due date, provided adequate margin is available in the accounts.

(vii) Bills Purchased:- In the case of BP o/s at the close of year the discount received thereon should be properly apportioned between the 2 years. Interest (discount) component paid by bank/branch on rediscount of bills from other financial institutions, is not to be netted off from the discount earned on hills discounted

(viii) Bills for Collection :- Examine the procedure for crediting the party on whose behalf the bill has been collected. The commission of the branch becomes due only when the hill has been collected.

transfer ownership in the name of bank.

(i) Auditor's Concern :- Auditor is primarily concerned with obtaining reasonable assurance that transactions took place in relevant period & pertained to the bank, there is no unrecorded income and recorded at appropriate amount

(ii) RBI's Directions:- RBI has advised that - any income which exceeds 1% of the total income of bank if the income is reckoned on a gross basis

1% of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per AS- 9

(iii) Material ty:- If any item not considered material as per normrs. may be recognised when received & auditors need not qualify their report.

(iv) Revenue Certainty:- Banks recognise income on accrual basis. i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection.

(v) Revenue Uncertainty:- Not recognize income on NPAs until it is actually realised. When a classified NP as first time, interest accrued and credited to the income a/c in the corresponding PY which has not been realized should be reversed or provided for.

(B) REVERSAL OF INCOME

### **AUDIT OF BANKS**



AUDIT OF EXPENSES

### (D) INCOME FROM INVESTMENTS

# (a)

On leased assets Component of finance income which was accrued & credited before asset become NPA should be reversed.

On take out finance

 Take out loan is method of financing where by a loan that is procured later is used to replace the initial loan.

classified as NPA, it should unless realised from customer.

(i)

In the absence of a clear agreement between the bank and the borrower banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.

(ii)

The appropriate policy to be followed is to recognise income as per AS-9.

On advances

This will apply

to Government

guaranteed

accounts

Fees.

commission and

other accrued income

shall be reversed or

which have wrongly

recognised income in the

ncome or make a provi-

sion for an equiva-

lent amount.

Where any account becomes NPA during the current year, interest accrued and credited shall be reversed or provided for if the same is not realised.

(iv)

Check for any large debits to interest accounts and 9 obtain sufficient explanation for the same.

(C) ON PARTIAL

**RECOVERIES** Interest partly/fully IN NPAs realised in NPAs can be taken to income

(iv)

Ensure that credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

Interest Income on Investments: This includes all income derived from securities, except income earned by way of dividends. etc.. from subsidiar-

ies and JVs abroad/

in India.

Profit on Sale of Investments: Investments are

dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to P&L a/c.

Profit/Loss on Revaluation of Investments: Investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to P&La/c.

## (A) AUDIT APPROACH AND

- The auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year.
- The auditor should obtain from the bank an analysis of various types of deposits o/s at the end of each quarter.
- The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences
- (iv) The auditor should obtain general ledger break-up for the interest expense incurred on deposits and borrowing each month/quarter.
- The auditor should analyse month on month cost analysis and document the reasons for the variances as per the benchmark stated.
- He should examine whether the interest expense considered in the cost analysis agrees with the general ledger.
- (vii) The auditor should understand the process of computation of the average balance and re-compute the same on sample basis
- (viii) The auditor should, on a test check basis, verify the calculation of interest and ensure
  - (a) Interest has been provided on all deposits upto the date of the BS:
  - (b) Interest rates are in accordance with the bank's internal regulations, RBI directives and agreements
  - (c) Interest on savings accounts are as per rules framed by the bank/RBH in this behalf.
  - (d) Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI. 🥌

## (B) AUDIT OF OPERATING

- (i) The auditor should study and evaluate the system of IC elating to expenses.
- (ii) The auditor should examine whether there are any divergent trends in respect of major items of expenses. (iii) The auditor should perform sub-
- stantive analytical procedures in respect of these expenses.
- (iv) The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

### (C) AUDIT OF PROVISIONS AND CONTINGENCIES



The auditor should ensure that the compliances for various regulatory requirements. Obtain an understanding as to how the bank computes provisions.

The auditor may verify the loan classification on a sample basis.

The auditor should obtain the detailed break up of standard loans, non-performing loans.

The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to P&L a/c to ascertain that the same are appropriately considered in the tax provision computation.

### (D) DISCLOSURE OF THE PRIOR PERIOD ITEMS

Form B-3rd Sch- Does not specifically provide for disclosure of the impact of prior period items on the current year's P&L, such disclosures, wherever warranted, may be given.

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