

## AUDIT OF BANKS

### (B) CONTROL 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**:

NATURE OF QUESTIONS	QUESTIONS TO BE CONSIDERED / ANSWERED
Who	Who performs the control? Does the above person have requisite <b>knowledge and authority</b> to perform the control?
What	What <b>evidence</b> is available to demonstrate / prove that the control is performed?
When	When and with what <b>frequency</b> is the control performed? Is the frequency enough to <b>prevent, detect &amp; correct RoMM</b> ?
Where	Where is the <b>evidence of performance</b> of the control retained? For <b>how long</b> is the evidence retained?
Why	Is the evidence <b>accessible / available</b> for audit? Why is the control being performed? What <b>type of errors</b> are prevented or detected through the performance of the control?
How	How is the control performed? What are the <b>control activities</b> ? Can these activities be <b>bypassed</b> ? Can the bypass, if any, be detected? How are <b>exceptions / deviations</b> resolved on identification? What is the <b>time frame</b> 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**:

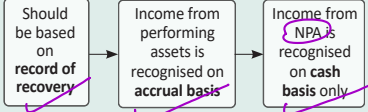
- (a) Errors that may be **more likely to occur**;
- (b) Errors which have been **identified in prior years**;
- (c) Method by which **fraud might be perpetrated by bank personnel or others** within particular account balances and/or disclosures; **ER - PR - SP**
- (d) **Audit responses** to engagement 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 misstatement** may have occurred

(ii) **Advantages of such a discussion**

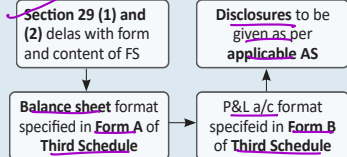
- **Specific emphasis** should be provided to the **susceptibility** of the bank's financial statements to **MMs** due to **fraud**, that enables the ET to consider an **appropriate response to fraud risks**, including those related to engagement risk, pervasive risks, and specific risks.
- It further 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



### 5. FORM AND CONTENT OF FS



### 6. AUDIT OF ACCOUNTS

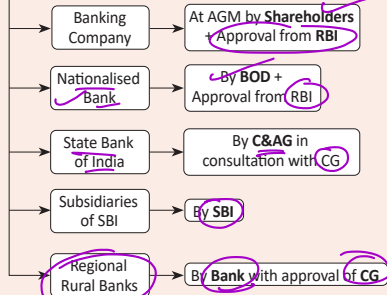


**Section 30(1)** : Accounts of a banking company shall be **audited** by a **person duly qualified** under any law to be an **auditor of companies**

## AUDIT OF BANKS

### 7. APPOINTMENT OF AUDITOR

As per the provisions of the relevant enactments:-



### 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

(c) Whether return received from offices and branches are adequate

(d) 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 OF REPORT

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

#### (B) LONG FORM AUDIT REPORT

(This Provision has been amended)

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

- RBI Circular - 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.
- Auditor should also consider the provisions of SA 250. The said standard explains that the duty of confidentiality is over-ridden by statute, law or courts.
- SA 240 states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the FS taken as a whole are free from MM, whether caused by fraud or error.

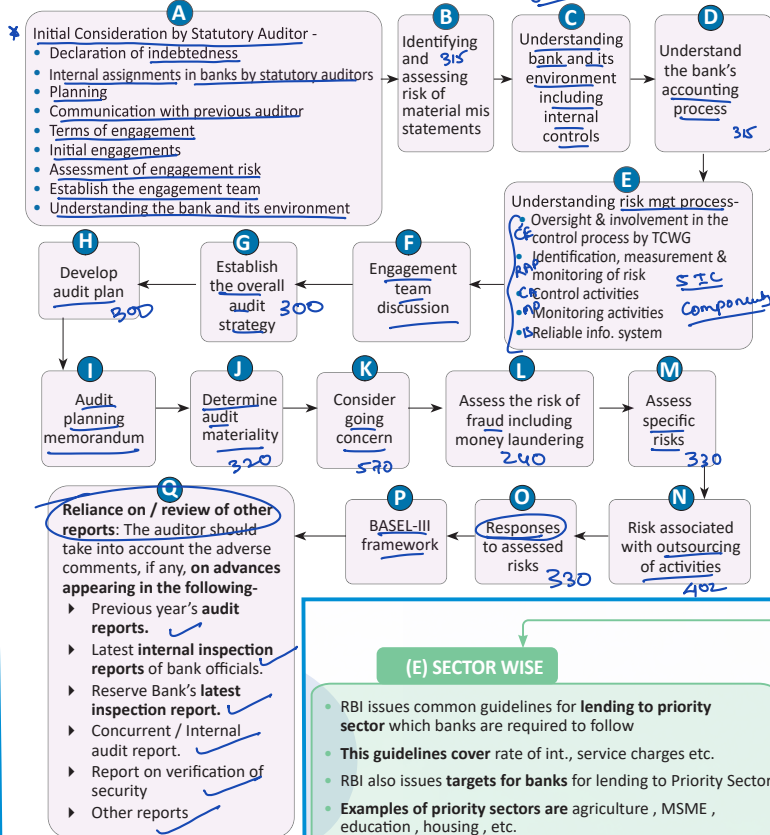
#### (D) FRAUD REPORTING UNDER THE COMPANIES ACT

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



## 9. CONDUCTING AN AUDIT

Points needs to elaborate in exam



### (A) TYPES OF ADVANCES

- (i) **Funded Loans** - Those loans where there is an actual transfer of funds from the bank to the borrower
- (ii) **Non-Funded Loans** - Those which do not involve such transfer

### (C) LEGAL REQUIREMENTS OF DISCLOSURE IN THE BALANCE SHEET

- (A)**
- (i) Bills purchased and discounted
  - (ii) Cash credits, overdrafts and loans repayable on demand
  - (iii) Term loans
- (B)**
- (i) Secured by tangible assets
  - (ii) Covered by bank/government guarantees
  - (iii) Unsecured

#### I. Advances in India:

- (i) Priority sectors
- (ii) Public sector
- (iii) Banks
- (iv) Others

#### II. Advances outside India:

- (i) Due from Banks
- (ii) Due from Others:
- (a) Bills purchased and discounted
  - (b) Syndicated loans
  - (c) Others

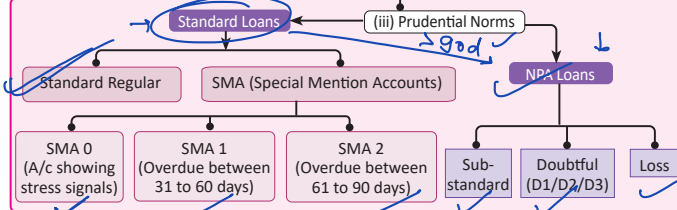
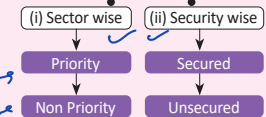
### 10. ADVANCES-BASICS

The core business of banks is accepting deposits for onward lending. Advances are amount of money or credit, given as a loan from a bank to another party with an agreement that the money will be repaid.

### (B) ADVANCES COMPRISES

- Term loans
- Cash credits, overdrafts, demand loans
- Bills discounted & purchased
- Adverse balances in deposit accounts
- Participation on risk sharing basis
- Interest bearing staff Loans

### (D) CLASSIFICATION OF ADVANCES





## AUDIT OF BANKS

### (F) NATURE OF SECURITY

#### Primary Security

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

Principal security

#### Collateral Security

It is an 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 sanctioned 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 mortgage & 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 lending 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 under lien

### (v) Set off

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

### (G) MODE OF CREATION OF SECURITY

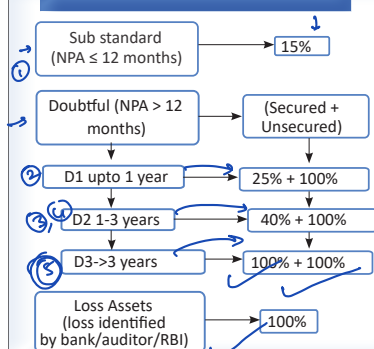
### (iii) Hypothecation

- Execution of hypothecation agreement for **moveable securities**
- No transfer of **possession or ownership**
- Borrower holds possession of goods as agent of bank
- Borrower periodically submit statements to Bank to fix DP

### (iv) Assignment

- Transfer of **existing/future debt**, right or property
- Only **actionable claims** accepted as security
- Gives assignee **absolute right** over the debts assigned

### 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/c indicates **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**.

### (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



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

Erosion 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

(i) 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 straight-away classified as loss asset.

## (O) ADVANCES AGAINST TERM DEPOSITS, NSC, 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

## (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** should be **governed by such rescheduled terms**.

## (R) AGRICULTURAL ADVANCES

As per guidelines they are of two types-

### Long duration crops

Crops with crop season longer than 1 year

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

### Short duration crops

Other than long duration crops

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



## 11. COMPUTATION OF DRAWING POWER

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**

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

(i) **Different from Sanctioned Limit** - The Sanctioned limit is the **total exposure** while **Drawing Power** refers to the **amount calculated based on primary security less margin** as on a particular date.

(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**.

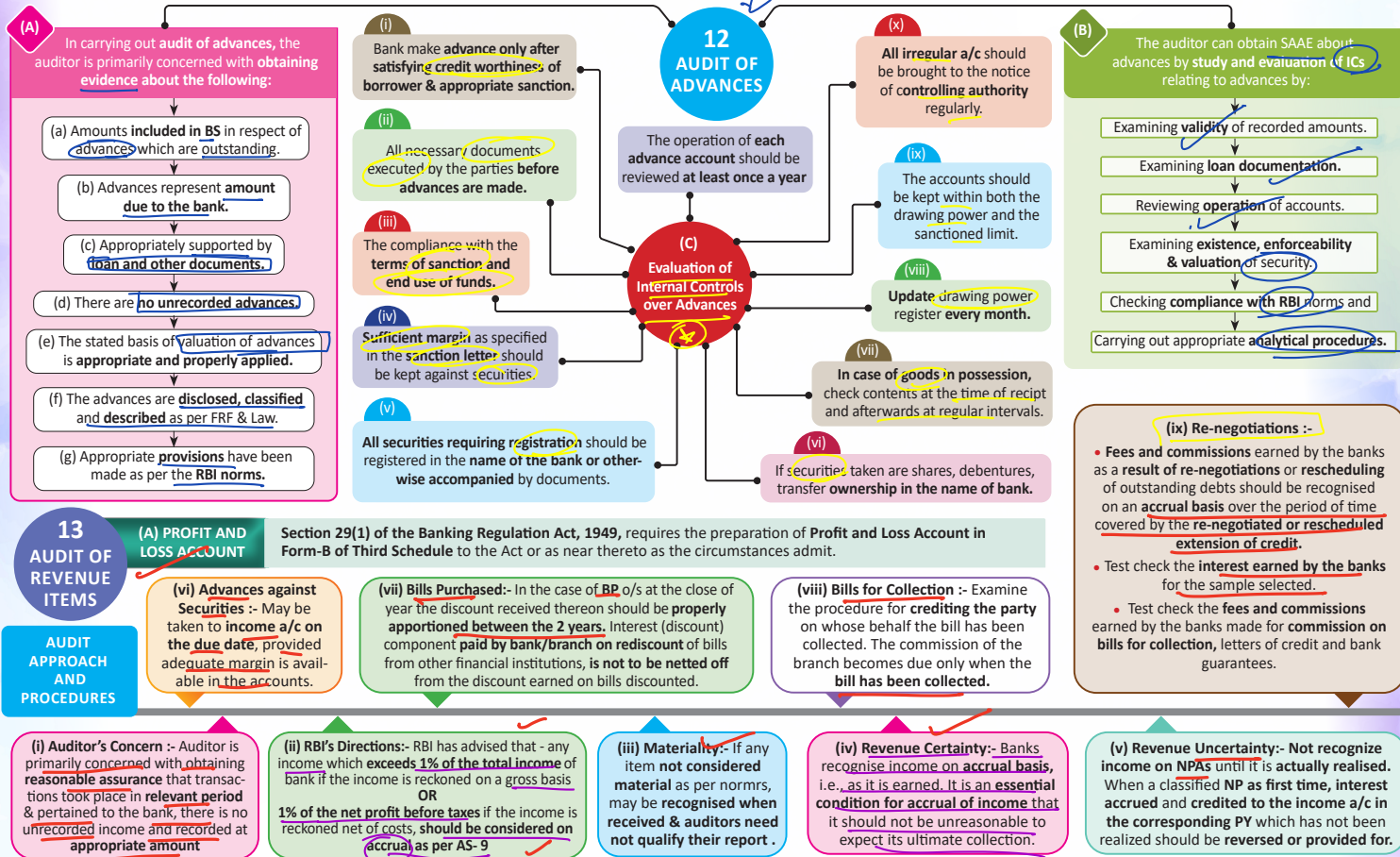
(iv) **Auditor's Concern:-** The **stock statements, quarterly returns and other statements** submitted by the borrower to the bank should be **scrutinized in detail**.

(v) **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**.



## AUDIT OF BANKS



## (D) INCOME FROM INVESTMENTS

### (A) AUDIT APPROACH AND PROCEDURES

- 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.
- 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.
- The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.
- The auditor should, on a test check basis, verify the calculation of interest and ensure that:
  - Interest has been provided on all deposits upto the date of the BS;
  - Interest rates are in accordance with the bank's internal regulations, RBI directives and agreements
  - Interest on savings accounts are as per rules framed by the bank/RBI in this behalf.
  - Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI.

### (B) AUDIT OF OPERATING EXPENSES

- The auditor should study and evaluate the system of IC relating to expenses.
- The auditor should examine whether there are any divergent trends in respect of major items of expenses.
- The auditor should perform substantive analytical procedures in respect of these expenses.
- 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.

### (B) REVERSAL OF INCOME

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

(b) 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.  
• If based on recovery, a/c is classified as NPA, it should not recognise as income 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.

### (c) On advances

(i) 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.

(ii) This will apply to Government guaranteed accounts also.

(iii) Fees, commission and other accrued income shall be reversed or provided for as Well.

(iv) Check for any large debits to interest accounts and obtain sufficient explanation for the same.

(v) In case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income or make a provision for an equivalent amount.

(iii) Interest partly/fully 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.

(a) Interest Income on Investments: This includes all income derived from securities, except income earned by way of dividends, etc., from subsidiaries and JVs abroad/ in India.

(b) 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.

(c) Profit/Loss on Re-valuation of Investments: Investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to P&L a/c.

### (C) ON PARTIAL RECOVERIES IN NPAs