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CHAPTER 13. BANK AUDIT

→ WHAT TO STUDY

- I] Introduction
- II] Understanding Accounting System in Bank
- III] Bank Audit
- IV] Form & Content of FS of Banks
- V] Conducting an Audit
- VI] Advances
- VII] Drawing Power Calculation
- VIII] Audit of Advances
- IX] Audit of Revenue Items

I] Introduction

a) Banking sector is the backbone of any economy as it is essential for sustainable socio-economy growth & financial stability in economy.

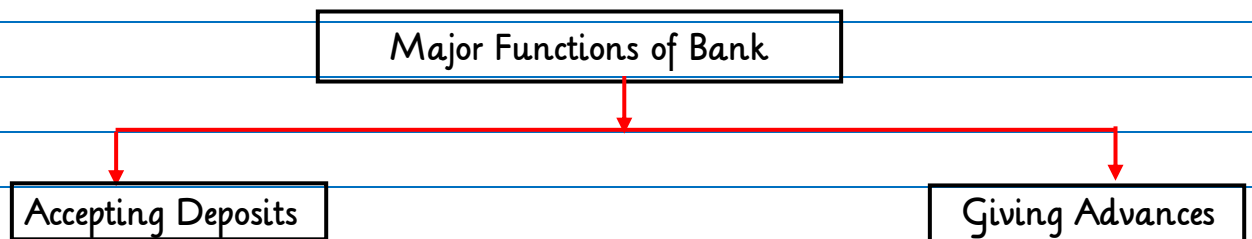
For safe & sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits.

b) Types of Banks: -

There are different types of banking institutions prevailing in India which are as follows:

Commercial Banks	Regional Rural Banks
Co-operative Banks	Payment Banks
Development Banks (more commonly known as 'Term-Lending Institutions').	Small Finance Banks

c)



RBI: - Regulating Body

Important Functions of RBI: -

- Issuance of Currency & its regulatory
- Acting as banker to banks
- Regulating the activities of commercial banks & other banks
- Issuance of Licence
- It has a power to inspect bank

d) Regulatory Framework

i.e. principal enactments governing Bank audit

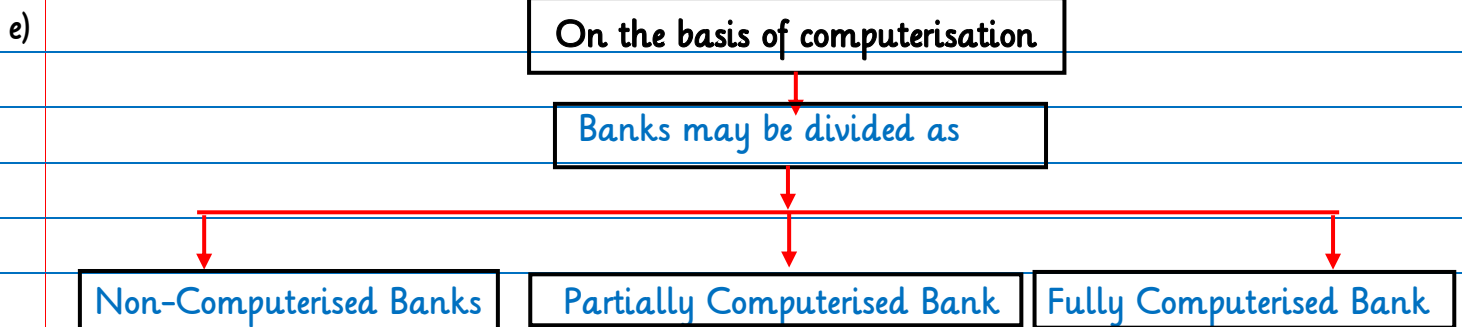
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|---------------------------------|---|
| a) RBI Act, 1934 | e) Regional Rural Bank Act, 1976 |
| b) Banking Regulation Act, 1949 | f) Information Technology Act, 2000 |
| c) Companies Act, 2013 | g) Prevention of Money Laundering Act, 2002 |
| d) SBI Act, 1955 | h) Payment and settlement systems Act, 2007 |

e) Peculiarities involved in functioning of Bank (PEQ)

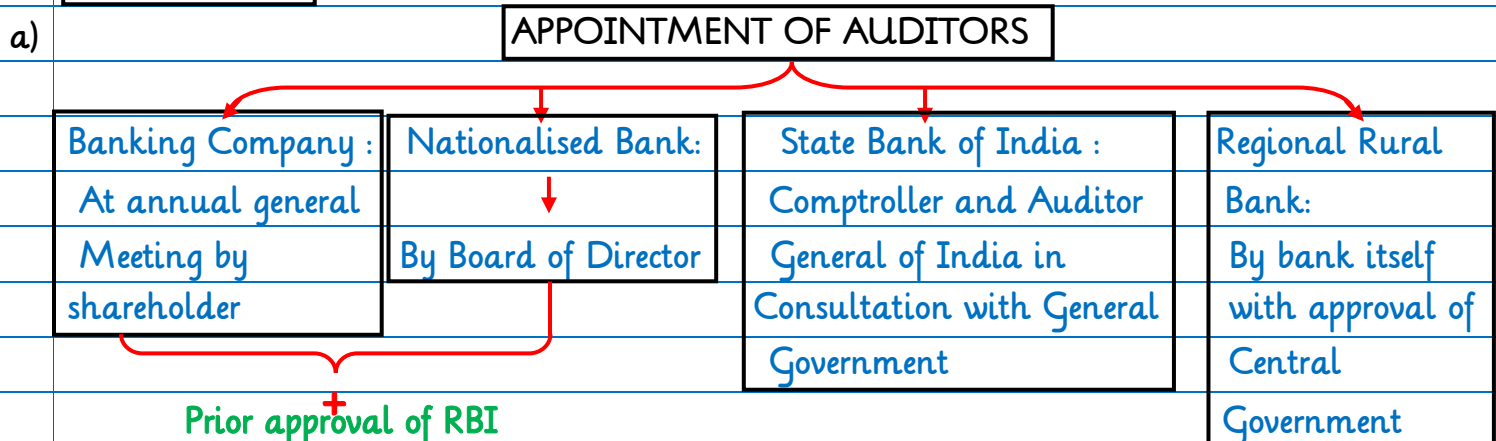
- Huge volumes and complexity of transactions;
- Wide geographical spread of bank's network;
- Large range of products and services offered;
- Extensive use of technology;
- Strict vigilance by the banking regulator etc.

II] Understanding Accounting System in Bank

- a) Banks nowadays are providing the comfort of "anytime-anywhere-banking".
- b) Real-time access to information & mobile connectivity through E-banking.
- c) Banks have voluminous business & hence it needs to be ensured in the system of recording transmission & storage of information/data.
- d) Banks need to maintain high as robust control systems to ensure that transactions are free from risk of errors, omissions, irregularities & frauds.



III] Bank Audit



b)

REMUNERATION OF AUDITORS

Banking Company

National Bank + State Bank of India

Section 142 of Companies act, 2013

Reserve bank of India (RBI) in consultation with Central Government

c)

CONDUCTING BANK AUDIT

<p>a) Initial</p> <p>Consideration: -</p> <ul style="list-style-type: none"> • Acceptances continuance • Declaration of Indebtness • Terms of Audit engagement • Commitment, Previous Audit • Establishment of team 	<p>b) Understanding</p> <p>Envirnment: -</p> <ul style="list-style-type: none"> • Identify & assess risk to develop plan • Understanding - <ul style="list-style-type: none"> → Accounting process → Risk management process → Control activities → Involvement of TCWG → Reliable Information system (PEQ Nov 16) 	<p>c) Risk assessment: -</p> <ul style="list-style-type: none"> • Apply Procedures of SA 315 & 240 • Assess Specific risk • Risk associated with out sourced activities 	<p>d) Execution : -</p> <ul style="list-style-type: none"> • Respond to Risk (SA330) • Determine Materiality and assess G.C <p>GC = Going Concern</p>	<p>e) Reporting : -</p> <ul style="list-style-type: none"> • LFAR • Stress testing • Demonitisation
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d)

Common Steps & Questions while undertaking/performing control activities

<p>Who?</p> <p>Who performs control?</p> <p>Who does he have requisite knowledge?</p>	<p>What?</p> <p>What evidence is generated that control is performed?</p>	<p>When?</p> <ul style="list-style-type: none"> • Frequency: • Is it enough to prevent, detect & correct risk of MM ? 	<p>Where?</p> <ul style="list-style-type: none"> • Where is the evidence? • Is the evidence accessible 	<p>Why?</p> <p>Why is the control performed :</p> <hr/> <p>How?</p> <ul style="list-style-type: none"> • How is control performed • Can control activities be by-passed, if yes can it be detected
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MM = Material Misstatement

- e) Engagement team discussion includes: **(PEQ)**
- Errors that may be more likely to occur;
 - Errors which have been identified in prior years;
 - Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
 - Audit responses to Engagement Risk; Pervasive Risks, and Specific Risks;
 - Need to maintain professional skepticism throughout the audit engagement;
 - Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

f) Powers of auditor – Same as discussed in Company Audit.

g) Audit Report -

STATUTORY AUDIT REPORT	LONG FORM AUDIT REPORT	TAX AUDIT REPORT
<ul style="list-style-type: none"> • As per SA 700 / 705/ 706 	<ul style="list-style-type: none"> • As per Requirements of RBI Circular 	<ul style="list-style-type: none"> • As per Income Tax Act, 1961

h) In case of a nationalised Bank

- Whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
- Whether or not the transactions of the bank, which have come to his 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 his audit;
- Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and
- Any other matter he considers should be brought to the notice of the Central Government.

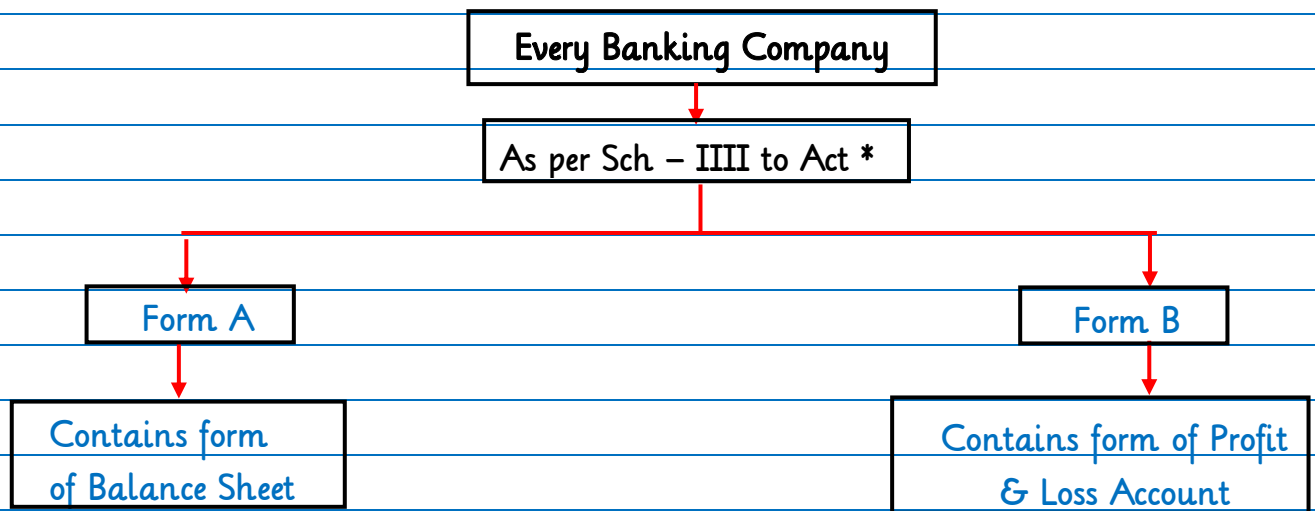
(i) LFAR (Long Form Audit Report) – This report is to be submitted before 30th June every year.

(j) Reporting to RBI – RBI is issued a circular relating to implementation of recommendation of committee on legal aspects of Bank frauds applicable to all scheduled commercial bank.

* Auditor should consider SA 250 & SA 240

* Reporting as per Sec 143(12) of Companies Act, 2013 shall apply.

IV] Sec 29(1), (2) :- Form & Content of FS of Bank



* Act → Banking Regulation Act, 1949.

* Note :- Every Banking Company needs to comply with the disclosure requirement under various Accounting Standards as specified under Companies Act, 2013.

V] Conducting an Audit

1. Initial Consideration by the statutory auditor (PEQ)
 - (i) Declaration of Indebtedness
 - (ii) Internal Assignments in Banks by Statutory Auditors
 - (iii) Planning
 - (iv) Communication with Previous Auditor
 - (v) Terms of Audit Engagements
 - (vi) Initial Engagements
 - (vii) Assessment of Engagement Risk
 - (viii) Establish the Engagement Team
 - (ix) Understanding the Bank and its Environment
2. Identifying and Assessing the Risks of Material Managements
3. Understanding the Bank and Its Environment including Internal Control
4. Understand the Bank's Accounting Process
5. Understanding the Risk Management Process (PEQ - May 19)
 - (i) Oversight and involvement in the control process by those charged with governance
 - (ii) Identification, measurement and monitoring of risks
 - (iii) Control activities
 - (iv) Monitoring activities
 - (v) Reliable information systems

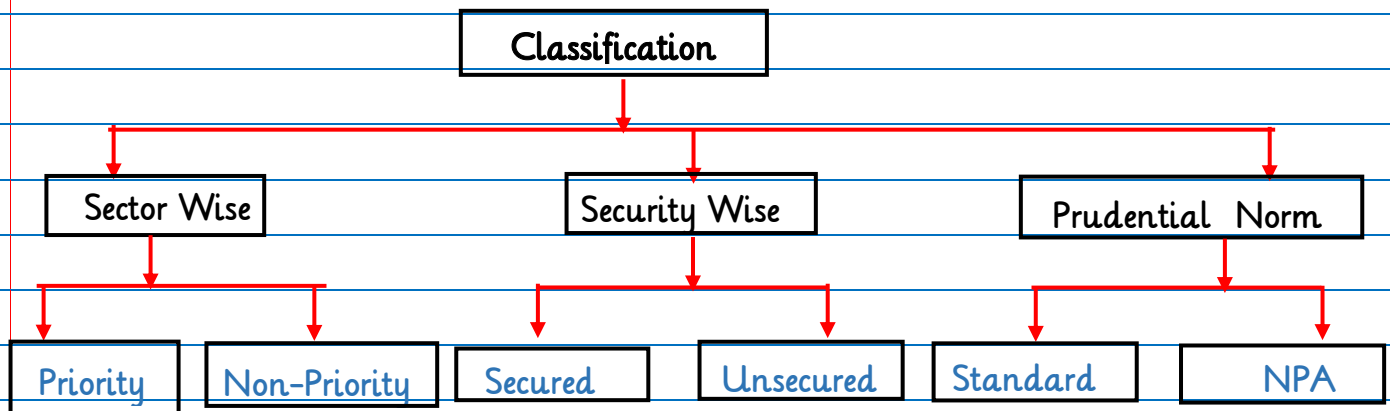
6. Engagement Team Discussion
7. Establish the Overall Audit Strategy
8. Develop the Audit Plan
9. Audit Planning Memorandum
10. Determine Audit Materiality
11. Consider Going Concern
12. Assess the Risk of Fraud including Money Laundering
13. Assess Specific Risks
14. Risk Associated with Outsourcing of Activities
15. Response to the Assessed Risks
16. Stress Testing
17. BASEL III framework
18. Reliance on/ review of other reports

VI] **Advances**

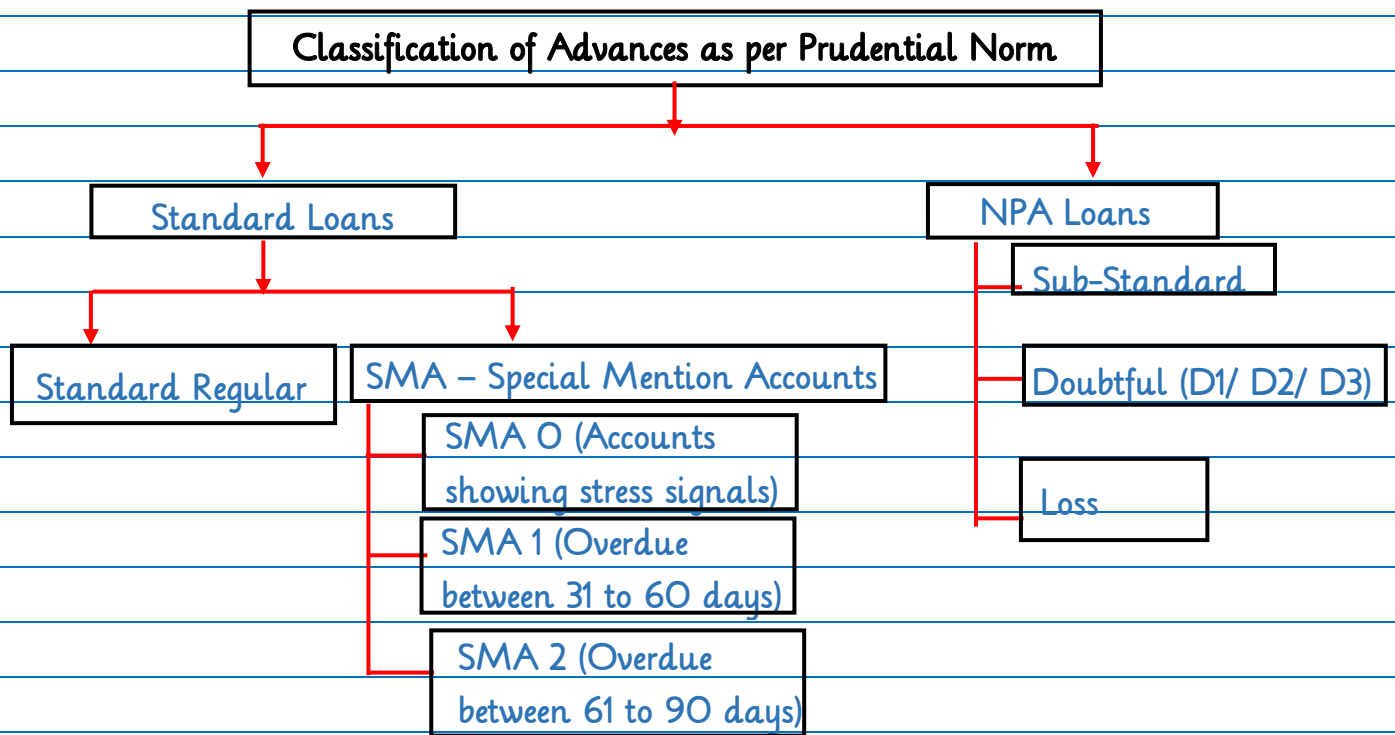
a) It is the amount given by the bank to borrower, it includes: -

- Term loan, CC, OD, Demand Loan
- Bills discounted & purchased
- Adverse balances in deposit accounts
- Interest bearing Staff Loan

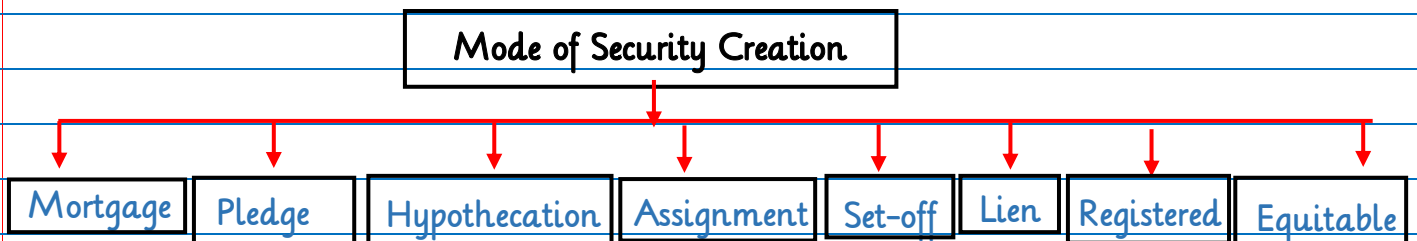
b)



c)



d)



e) Prudential norms on Income recognition Asset Classification & provisioning pertaining to Advances.

(i) NPA :- An asset becomes NPA when it ceases to generate income for the Bank

(a) Loan or Advance becomes NPA if interest/ instalment of principal is Overdue for > 90 days

(b) Bills remains Overdue for > 90 days

(c) The account remains out of order in respect of an OD/ CC account

(ii) Out of Order :- Account will be out of order if amount is over drawn and remains outstanding for > 90 days (i.e. there are no credits continuously for 90 days as on Balance Sheet date)

(iii) NBFC Prudential Norms Directions

The auditor shall verify / check / ensure the following: -

Compliance with capital requirements.

NBFC policy

Asset classification

Income on NPA's

Status of NPA's (PEQ Nov 18, 12, 08) (RTP May 16, 15/ Nov 13)

Provisioning Requirements

Sub-Standard Asset

Secured Doubtful Asset

Unsecured doubtful Asset

10%

< 1 Year → 20%

1-3 Years → 30%

> 3 Years → 50%

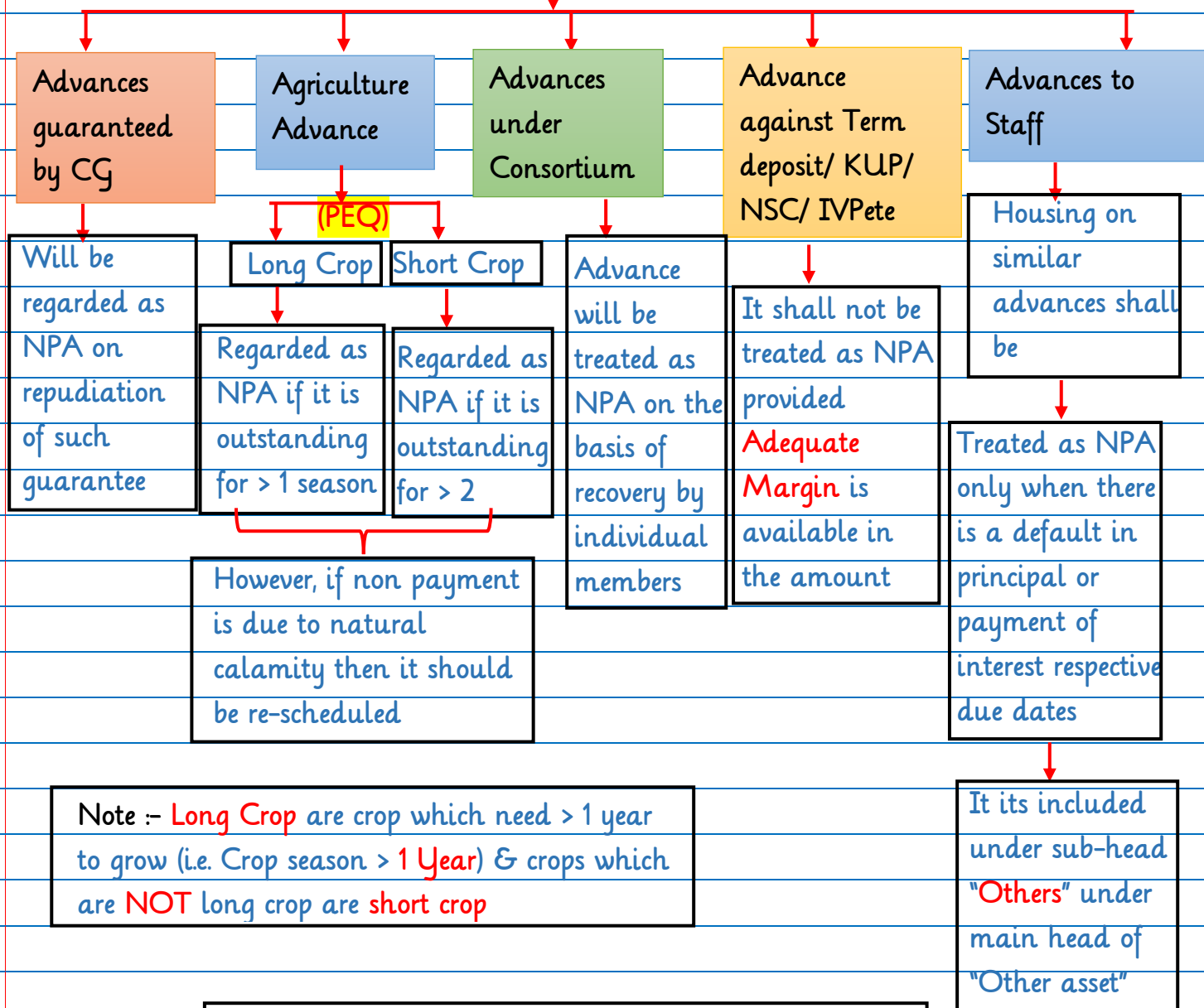
100%

	Classification	Meaning	% of Provision
a)	Standard	It shall mean the asset in which no default in repayment is perceived	0.4%
b)	NPA	Any asset, a term loan, a demand or call loan, a bill, debt under the head "Other Current Assets", any due on account of sale → overdue for a period of ≥ 6 Months. Lease rental & hire purchase → overdue for a period of ≥ 12 Months.	
c)	Sub-Standard	An asset which has been classified as NPA for a period not exceeding 18 months	10%
d)	Doubtful	A term loan or Lease asset or hire purchase asset or any other asset which remains sub-standard asset for a period 'exceeding 18 months'	
	Secured Portion	Upto 1 year 1 to 3 years More than 3 years	20% 30% 50%
	Unsecured Portion	Advances without collateral	100%
e)	Loss	An asset which is adversely affected by potential threat of non-recoverability due to erosion in value of security or non-availability of security or fraud or any omission	100%

(iv)

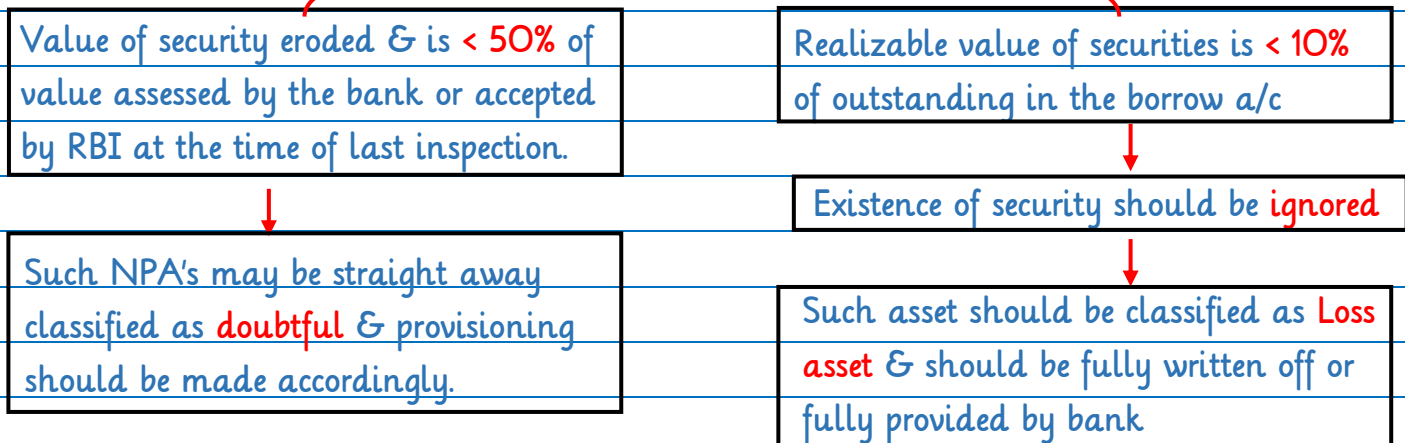
Usually Income on NPA are recorded on Cash basis

However in following cases they are considered as NPA on the basis of respected condition



(v)

Accounts where there is Erosion/Reduction in value of security/ frauds committed by borrowers (PEQ)



VII] Drawing Power Calculation

(i) All accounts should be all the time kept within

Drawing Power

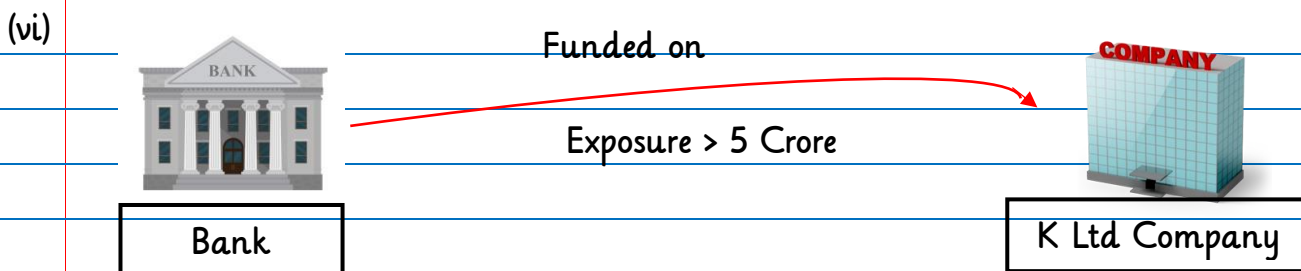
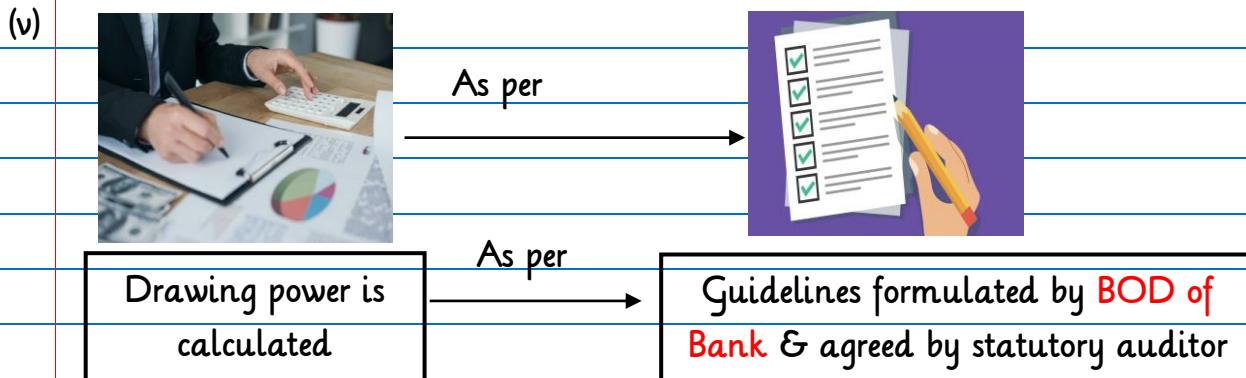
AND

Sanctioned Limit

If account exceeds sanctioned limit it should be brought to the notice of management / Head office regularly.

(ii) Banks should ensure that drawings in working capital account are covered by current assets. Drawing power is required to be arrived based on current stock & statements (statements should not be older than 3 months); if drawing power are calculated of statement older than 3 months then such amount outstanding shall be treated as irregular.

(iii) Stock statements are submitted → Quality



Lead Bank → will conduct Stock audit and shall give such report branches & the report shall be reviewed during the course of audit & special focus will be on comments given by stock auditor.

(vii)



₹

Working Capital Advances



- Drawing Power needs to be **calculated carefully** in case of working capital advances to companies engaged in construction business.
- While calculating drawing power, **mobilization advance** received by contractors **should be reduced**

VIII]

Audit of Advances

<p>(i) Auditor should obtain SAAE regarding</p> <ul style="list-style-type: none"> • Amounts are outstanding as on B/S date • Amounts represent due to bank • Amounts are supported by loan documents & other documents • No unrecorded advances • Advances are properly disclosed, classified & described in accordance with AFRF • Appropriate provisions are made as per RBI norms 	<p>(ii) SAAE are obtained by :-</p> <ul style="list-style-type: none"> • Examining the validity of the recorded amounts; • Examining loan documentation; • Reviewing the operation of the accounts; • Examining the existence, enforceability and valuation of the security; • Checking compliance with RBI norms including appropriate classification and provisioning; and • Carrying out appropriate analytical procedures 	<p>(iii) Evaluation of IC over advances :- (Most Important) (PEQ) RTP) (MTP)</p> <ul style="list-style-type: none"> • Bank makes advances only after checking credit-worthiness • Advances are sanctioned on the basis of appropriate documents & only after ensuring end use • Sufficient margins are kept • No advances are provided against own shares • Securities are registered • Good in possession as security are checked from time to time. • Drawing power register is updated every month • Operation of each advance a/c should be viewed at least once in a year
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IX]

Audit of Revenue Items

(A) INCOMES

(B) EXPENSES

(A)

INCOMES

(i)→

Interest Income

- a) Interest/ Discount on Advances/ Bills
- b) Interest on Investment
- c) Interest on CRR
- d) Interest on Inter Bank Loan
- e) Other Income

Other Income

- a) Commission, Brokerage on:- BOE, DD, NEFT, RTGS, Govt Business, LOC, guarantee Loan Processing, Mobile Banking Fees etc.
- b) Rent on Lockers
- c) Dividend, Profit on Sale of Investment
- d) Profit on Revolution
- e) Referral Income etc.

(ii)→ Audit Procedures & Approach

- a) Auditor is primarily concerned with obtaining reasonable assurance that recorded income arose from transaction are
- For the Relevant Period
 - Appropriately Calculated
 - Recorded/ Disclosed under Proper Head

b)

RBI has advanced

To record income on accrual basis i.e. as per As 9 if:

Income > 1 % of total income of the bank
(If the income is calculated on a gross basis)

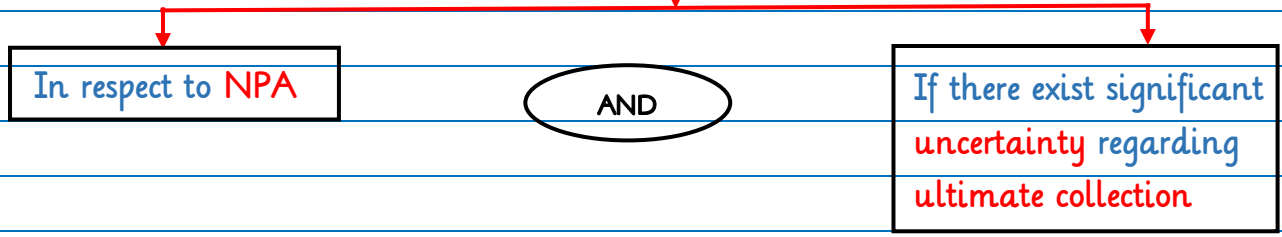
OR

Income > 1 % of net profit before tax i.e. NPBT (If the Income is calculated on net of cost basis)

- c) Other than above mentioned Incomes i.e. Income not considered as MATERIAL → recognised as on receipt basis (Auditor need not qualify the report in such situation)

d) It is an essential condition for accrual of income that there should not be doubt on ultimate collection of such income

e) **Bank should record income on receipt basis: -**



f) **Important** **On advance against term deposit, NSC, KVP, IVP & life policies**

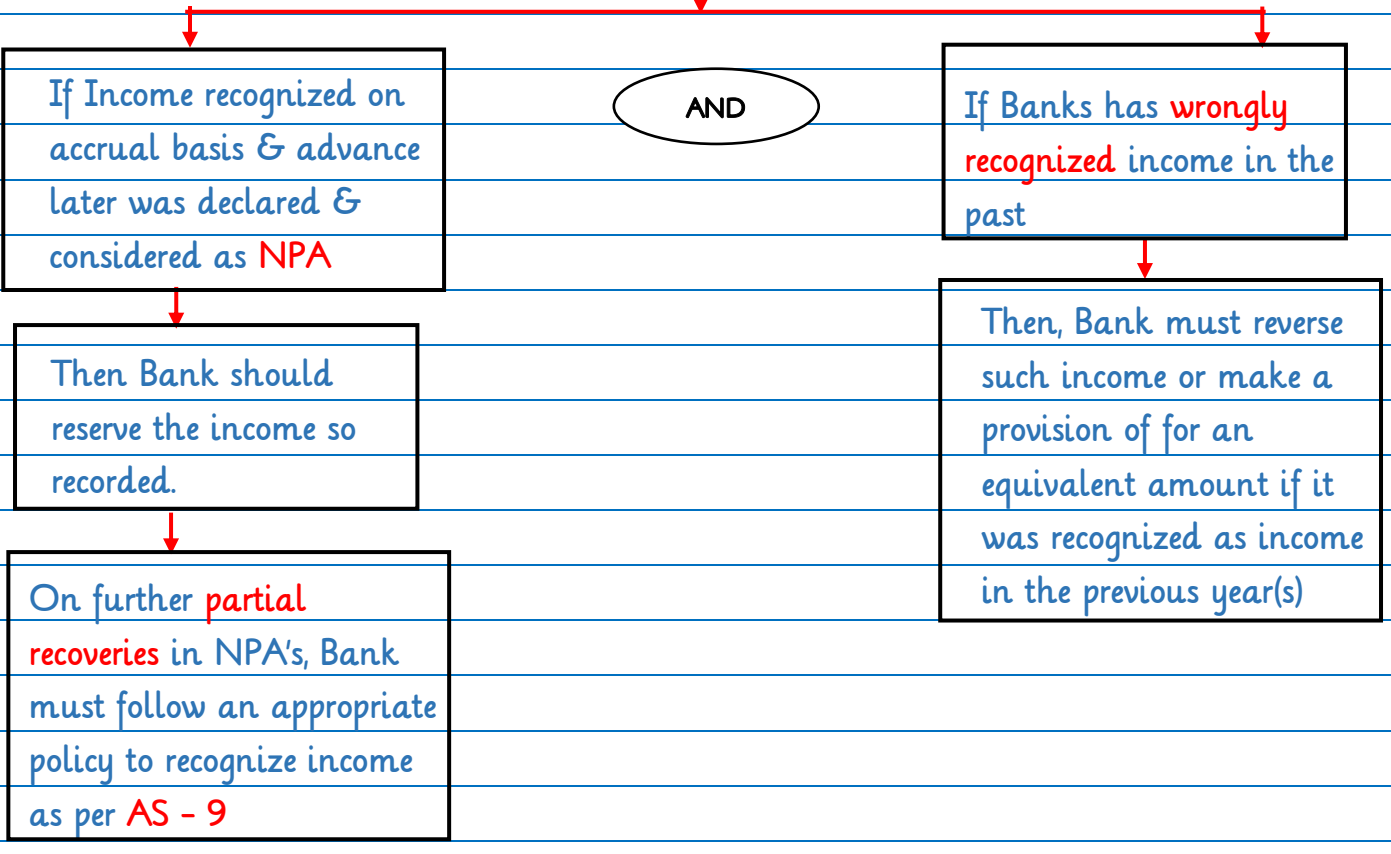
Record on accrual basis

Provided adequate margins are available

g) In case of BOE purchased at the close of the year **Discount** must be appropriately **apportioned** between the two years

h) Auditor must test-check fees & commission earned by bank.

(iii) **Reversal of Income**



(iv) **Miscellaneous Points: -**

- a) **For Financial Lease: -** Income should be treated and recorded as per **AS 19** (Provided its not NPA)
- b) **On take - out finance: -** Record the income on receipt basis
- c) **Interest Income on Investments: -** Cost on investment (eg. Premium on SLR investments) is nettled off from interest income on investment
- d) **Profit on Sale of Investment: -** It is taken to P/L a/c as it is treated as banking activity.
- e) **P/L on revaluation of investments: -** As per RBI guidelines, investments must be valued in periodic interval & **appreciation or depreciation** is taken to P/L a/c

(B)

EXPENSES

(i) **Interest Expended**

Interest On :--

- Deposits
- RBI Borrowing
- Inter Bank Borrowing
- Other

Operating Expenses

Payment towards :--

- Salaries, remuneration
- Rent, Rates, Taxes
- Printing Stationary
- Office Admin
- Advertisement
- Audit Fees
- Depreciation etc

Provision & Contingencies

Provision & Contingencies :--

- NPA
- Taxation
- Contingencies
- Diminution in value of investment

(ii) **Audit approach & procedure**

- a) Auditor must assess overall **reasonableness** of expense
- b) Auditor should obtain from the bank an **analysis** of various types of deposits & interest thereon.
- c) Auditor should obtain **general ledger a/c** at end of each quarter
- d) Auditor on test check basis **verify calculation of interest (PEQ) (Important)**
 - Interest has been **provided** on all deposits **upto the date of the balance sheet**; and verify whether there is any excess or short credit of material amount
 - Interest **rates** are in **accordance** with the **bank's internal regulations**, of the RBI directives, and agreements with the respective depositors;
 - In case of **Fixed Deposits** it should be **examined** whether the interest Rate in the accounting system are in accordance with the Interest Rate mentioned in the Fixed Deposit Receipt/ Certificate

- Interest on Saving Account should be checked on a test check basis in accordance with the rules framed by the bank in this behalf
- Interest on inter-branch balances has been provided at the rates prescribed by the head office
- Interest on overdue/ matured term deposits should be estimated and provided for

(iii) Disclosure of (PPI) Prior Period Items :- There is no specific disclosure prescribed in Form B under Third Schedule, appropriate disclosure should be made by the bank wherever required

Space of Students Notes: -

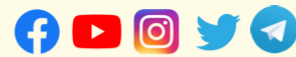
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