Chapter 10

Question

Advances generally constitute a major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. Explain the broad considerations about which the auditor is primarily concerned with obtaining evidence in carrying out audit of advances.

Solution

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

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

(i) Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.

(ii) Advances represent amount due to the bank.

(iii) Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.

(iv) There are no unrecorded advances.

(v) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.

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

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

Question

During the audit of Smile Bank, CA Sweety focused on understanding the risk management process of the bank. She reviewed how management developed controls and used performance indicators to monitor key business and financial risks. CA Sweety also assessed whether the risk management system effectively identified and mitigated risks in required areas. How should CA Sweety evaluate the adequacy of the bank's risk management controls?

Solution

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:

(i) Oversight and involvement in the control process by those charged with governance: Those charged with governance (Board of Directors/Managing Director) 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.

(ii) Identification, measurement and monitoring of risks: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

(iii) Control activities: A bank should have appropriate controls to mitigate 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 up limits, reporting and approval of exceptions, physical security and contingency planning.

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

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

Question

Mahavir and Associates is appointed as the statutory auditor of KBC Bank for the financial year 2023-2024. During the audit, Ms. Chandana, an article trainee, noticed that Sidharth Industries had an outstanding loan of ` 50,00,000 as on March 31, 2024. On March 29, 2024, the company made a payment of ` 10,00,000, reducing the outstanding loan balance to ` 40,00,000. However, on April 4, 2024, Sidharth Industries initiated a reversal transaction of ` 8,00,000, increasing the outstanding loan balance back to ` 48,00,000. The payment and subsequent reversal occurred within a short period, with the final outstanding balance remaining ` 48,00,000 after the reversal.

Considering this scenario, what should be the response of Mahavir and Associates to this matter, particularly regarding the classification of the borrower's account and the potential risk of it slipping into the NPA category?

Solution

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

The auditor should check for sample transactions immediately before the closing of the financial year and immediately after the closing of the financial year to get a knowledge of the objective behind the transactions if they have any relation to each other in the borrower accounts or if any/some transactions are being reversed during the first few days after closing which might show an arrangement to prevent the Borrower account(s) from slipping into the NPA category.

In the given case of Sidharth Industries, a payment of ₹10,00,000 was made on March 29, 2024 reducing the outstanding loan balance to `40,00,000. and subsequently reversed by ₹8,00,000 on April 4, 2024. Thus, Mahavir and Associates should carefully assess the classification of Sidharth Industries' Account, and determine if the payment and reversal transactions indicate an attempt to prevent the account from slipping into the NPA category. If yes, the account should be classified as an NPA in compliance with regulatory guidelines.

Question

During the course of statutory branch audit of a nationalized bank, CA Amrish is performing audit procedures in relation to the advances. He has verified the selected sample of borrower accounts representing advances and found nothing unusual. In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. List out few such documentary evidence which can be made use of by CA Amrish.

Solution

In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. CA Amrish, the auditor should take into account the adverse comments, if any, on advances appearing in the following:-

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

Question

National Bank has advanced cash credit facility of ` 25 Lakh to Sun Industries. Following is the extract of account of Sun Industries reflecting in CBS of Bank from December 1, 2023 to March 31, 2024: -

Date	Particulars	Dr.	Cr.	Balance (Dr.)
01/12/2023	To Transfer	45,000		24,75,000
31/12/2023	By Clearing		1,00,000	23,75,000
31/12/2023	To Interest	25,000		24,00,000
31/01/2024	To Interest	24,700		24,24,700
29/02/2024	To Interest	24,800		24,49,500
31/03/2024	To Inspection charges	1,000		24,50,500
31/03/2024	To Interest	24,900		24,75,400

Drawing power during the above period was consistent at ` 25 Lakh. The account was classified as "Standard asset" as on 31.12.2023 in books of Bank. The security charged with the bank remains intact throughout this period.

Comment on "asset classification" of above account as on 31st March 2024 in books of Bank in accordance with RBI norms.

Solution

In accordance with RBI norms on asset classification, a non-performing asset is a loan or advance where the account remains "out of order" in respect of an Overdraft/Cash Credit.

An account should be treated as 'out of order' if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period.

In the given case, although outstanding balance in account is less than sanctioned limit/drawing power of ` 25 lacs, there are no credits continuously for 90 days as on the date of Balance sheet. Therefore, it has become out of order and is required to be classified as NPA.

Under non-performing assets, it would be classified as "Sub-Standard Asset" as it has remained NPA for a period of less than or equal to 12 months.

Question

M/s JKL & Associates, Chartered Accountants, are the statutory auditors of M/s IBS Bank Limited for the financial year 2024-25. During the audit, they observed the following items included under interest income in the financial statements of the bank:

- An amount of ` 5 lakh relating to a short-term crop loan, where the instalment was overdue for one crop season.
- An amount of ` 7 lakh relating to an advance guaranteed equally by the Government of India and the Government of Tamil Nadu, where the instalment has been overdue for more than six months.

From the above facts and details, what should be the correct treatment of the above interest income in the bank's financial statements? State the amount that can be recognised as interest income with appropriate reasoning. Also, determine the amount to be classified as Non-Performing Asset (NPA), with reference to applicable RBI norms.

Solution

Classification of Non-Performing Asset (NPA) & Treatment of Interest Income:

(i) **Short-Term Crop Loan:** As per RBI norms, a loan granted for short-duration crops is to be classified as NPA only if the installment remains overdue for two crop seasons.

In the given case, the installment is overdue for only one crop season, hence, the account is not classified as NPA. Therefore, the interest income of ` 5 lakh can be recognised in the financial statements.

(ii) **Advance Guaranteed Equally by Government of India and Government of Tamil Nadu:** If an advance is guaranteed by the Central Government, it need not be classified as NPA until the guarantee is invoked and repudiated. Thus, Central Government guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets but regarded as NPA for Income Recognition purpose. The situation would be different if the advance is guaranteed by the State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

In the given case, since the guarantee is shared equally between the Central Government and the State Government (Tamil Nadu), and the installment is overdue for more than 6 months, the portion of loan guaranteed by the Central Government (50%) is not to be classified as NPA unless the guarantee is invoked and repudiated. The remaining 50%, guaranteed by the State Government, must be classified as NPA as the installment is overdue for more than 90 days.

Question

Agrim, a CA student, is part of an engagement team conducting audit of Madurai branch of ARB Bank. CA Bhuvan, engagement partner, has asked him to verify provision made by branch as on March 31st, 2024 in respect of the following non-performing assets: -

Name of Account	NPA classification	Outstanding amount as on March 31st, 2024 (In ` lakhs)	Amount of provision made (In ` lakhs)
AK Industries	Doubtful (D1)	10.00	5.00
Jupiter Traders	Substandard asset	50.00	7.50
VT & Co.	Doubtful (D2)	30.00	30.00
ASD & Sons	Loss	1.00	1.00

The engagement partner has already verified NPA classification. Outstanding amounts as on March 31st, 2024, relating to each NPA account listed above (except ASD & Sons) are fully secured. However, only personal guarantee of proprietor (Net worth of proprietor `50 lakhs) is available in account of ASD & Sons. Comment on the correctness of the above provisions.

Agrim is in dilemma regarding classification of above accounts as NPA although these are fully secured or guaranteed. Guide him.

Solution

The auditor is required to ensure that provision for NPA is made as per its classification in different categories which are given as under:

Categories of Non-Performing Assets:	Provision required
Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
Doubtful Assets: Would be one which has remained in the substandard category for a period of 12 months. **Sub-categories**: Doubtful up to 1 Year (D1)	(Secured + Unsecured) 25% + 100%

Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	100% + 100%
Loss Assets	100%

From the above provision, it can be concluded that in case of:

AK Industries- It has been classified as Doubtful (D1) category. Therefore, it requires provision of 25% of secured amount. That is provision of Rs 2.50 lakh (i.e 25% of `10 lakh) should be made instead of ` 5 lakh.

Jupiter Traders- It has been classified as Substandard asset. It requires provision of 15% of outstanding amount (i.e 15% of ` 50 lakhs) which comes to ` 7.50 lakh. Therefore, provision made by the branch is correct.

VT & Co.- It has been classified as Doubtful (D2) category. It requires provision of 40% of secured amount. That is provision of ` 12.00 lakh (40% of ` 30 lakhs) should be made instead of ` 30 lakh.

ASD & Sons- It has been classified as a loss asset which requires provision of 100% of outstanding amount. Therefore, the provision made by the branch is correct.

Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Hence, these accounts have been classified as NPA on the record of recovery although these are fully secured or guaranteed.

Thus, Amount to be classified as NPA will be `3.5 lakh (i.e., 50% of ` 7 lakh) and amount of interest income to be recognised will be ` 5 lakh.

Question

M/s JKL & Associates, Chartered Accountants, are the statutory auditors of M/s IBS Bank Limited for the financial year 2024-25. During the audit, they observed the following items included under interest income in the financial statements of the bank:

- An amount of ` 5 lakh relating to a short-term crop loan, where the instalment was overdue for one crop season.
- An amount of ` 7 lakh relating to an advance guaranteed equally by the Government of India and the Government of Tamil Nadu, where the instalment has been overdue for more than six months.

From the above facts and details, what should be the correct treatment of the above interest income in the bank's financial statements? State the amount that can be recognised as interest income with appropriate reasoning. Also, determine the amount to be classified as Non-Performing Asset (NPA), with reference to applicable RBI norms.

Solution

Classification of Non-Performing Asset (NPA) & Treatment of Interest Income:

(i) **Short-Term Crop Loan:** As per RBI norms, a loan granted for short-duration crops is to be classified as NPA only if the installment remains overdue for two crop seasons.

In the given case, the installment is overdue for only one crop season, hence, the account is not classified as NPA. Therefore, the interest income of ` 5 lakh can be recognised in the financial statements.

(ii) **Advance Guaranteed Equally by Government of India and Government of Tamil Nadu:** If an advance is guaranteed by the Central Government, it need not be classified as NPA until the guarantee is invoked and repudiated. Thus, Central Government guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets but regarded as NPA for Income Recognition purpose. The situation would be different if the advance is guaranteed by the State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

In the given case, since the guarantee is shared equally between the Central Government and the State Government (Tamil Nadu), and the installment is overdue for more than 6 months, the portion of loan guaranteed by the Central Government (50%) is not to be classified as NPA unless the guarantee is invoked and repudiated. The remaining 50%, guaranteed by the State Government, must be classified as NPA as the installment is overdue for more than 90 days.

Question

Compute the Drawing power for Cash Credit limit granted to S Ltd. by Trust Bank for the month of March 2025 from the following information:

Particulars	Amount in (`)
Value of stocks	50,000
Value of debtors (including debtors of 5,000 for an invoice dated 17.11.2024)	45,000
Value of creditors for goods	15,000
Sanctioned limit	45,000

Margin on stock is 20% and on debtors is 50%.

Note: Debtors older than 3 months are ineligible for calculation of D.P.

Solution

Computation of Drawing power of S Ltd. for the month of March 2025:

Value of stocks	` 50,000
Less: creditors for goods	` 15,000
Value of Paid stocks	` 35,000
Less: Margin @ 20%	` 7,000
Drawing power (A)	` 28,000
Value of debtors	` 45,000

Less: debtors exceeding 90 days	` 5,000
	` 40,000
Less: Margin @ 50%	` 20,000
Drawing Power (B)	` 20,000
Drawing Power (A+B)	` 48,000

The sanctioned limit given in the question is ` 45000 whereas drawing power as per the above working is ` 48000. Accordingly, drawing power for Cash Credit Limit granted to S Ltd. by Trust Bank for the month of March 2025 would be restricted to sanctioned limit i.e., ` 45000.

Question

K Ltd. is availing cash credit limit of ` 25 crores from LMN Bank Ltd. The drawing power of the company range between ` 22 crores and ` 25 crores during the year 2023-24. The limit availed by the company remained less than ` 20 crores during all the days of the financial year 2023-24. The company has not deposited any amount in the cash credit account and there are no other credits to this account during the last two quarters. How will this account be classified in the books of LMN Bank Ltd. as on 31-03-2024? Explain.

Solution

An account should be treated as 'out of order' if: -

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

In the given case, K Ltd. is availing cash credit limit of ` 25 crores from LMN Bank Ltd and the drawing power of the company range between ` 22 crores and ` 25 crores during the year 2023-24. The limit availed by K Ltd. remained less than ` 20 crores during all the days of the financial year 2023-24 and the company has not deposited any amount in the cash credit account and there are no other credits to this account during the last two quarters.

Thus, account should be treated as out of order in the books of LMN Bank Ltd. as the outstanding balance in the principal operating account (` 20 crore) is less than the sanctioned limit/drawing power (` 22 cores and ` 25 crores), but there are no credits continuously for 90 days as on the date of Balance Sheet.

Question

You are the auditor of Plus Bank Limited. The bank has made following provisions for the year ended on 31.03.2024:

Particulars	***Amount (` in crores)***
Provision for Bad Debts	*66*
Provision for Sub-standard Assets	*78*

Provision for Expenses	*24*
Provision for Income Tax	*55*

You are in the process of verifying the provisions and contingencies of the bank. What audit approach and procedures will you adopt to verify the above?

Solution

For audit of provisions and contingencies the auditor should:

- ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.