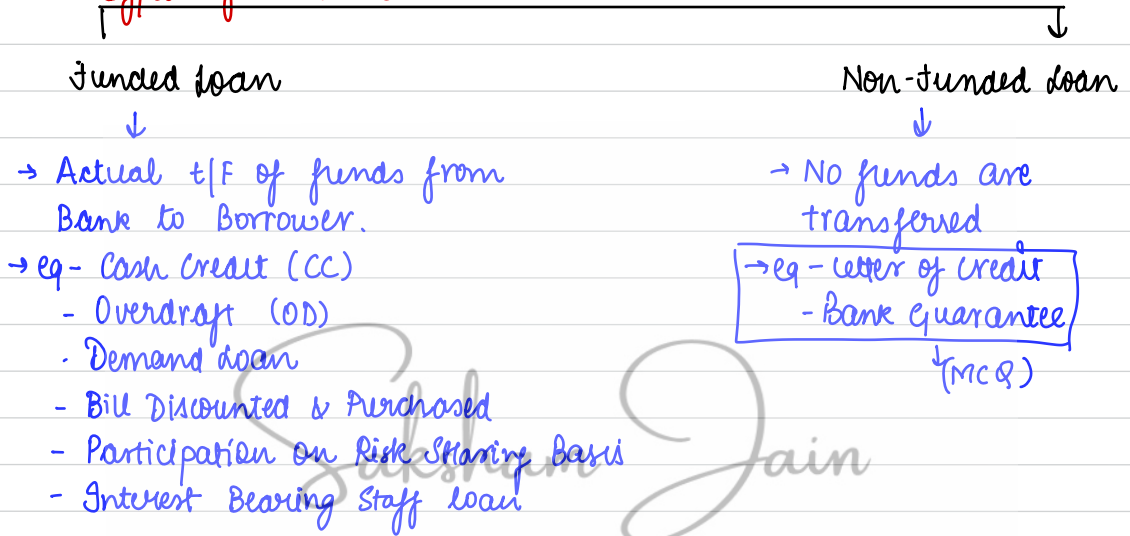


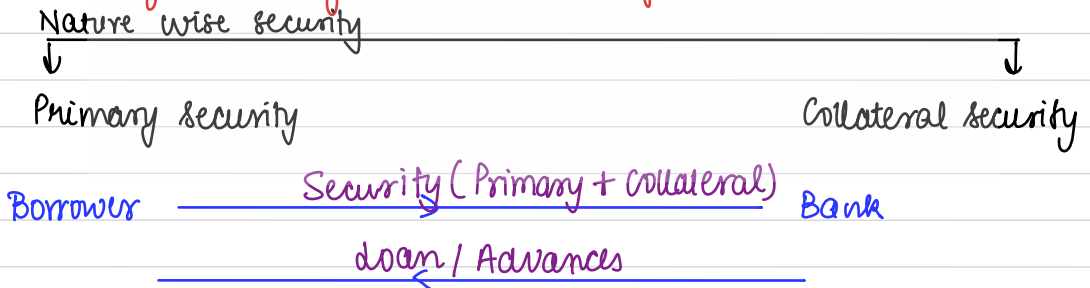
Chap-10 Audit of Banks (4-6 marks)

Division-1 Advances

* Types of Advances



* Classification of Advance security wise



- Primary security :- Main Security offered by Borrower.
- Collateral security :- Additional Security

* Mode of Creation of Security

i). Mortgage → (Immovable Securities)

a. Registered Mortgage

Raju takes home loan from Bank.



Raju mortgage home through Registered Instrument
called Mortgage Deed

b). Equitable Mortgage

Raju takes home loan by "Mere t/F of title deeds"

ii). Pledge (Priyanka Gandhi)

• X Ltd take Gold loan

• X Ltd t/F Possession of Gold to Bank

- Legal Ownership with Borrower

- Only Possession transferred.

iii). Hypothecation

→ "movable security"

Example-1). Raju takes car loan

- Ownership with Borrower.

- Possession with Borrower

Example-2). Raju takes cash credit against stock

working capital loan


- No possession of stock is transferred.

- Borrower send periodical stock statement to Bank.

Note: Hypothecation Agreement done b/w Borrower & Bank
[Movable Securities]

iv). Assignment

- Transfer of existing or future debt, right or property of one person \rightarrow to Another person.
- Actionable claims $\left\{ \begin{array}{l} \text{Book Debts} \\ \text{Life Insurance Policies} \end{array} \right. \rightarrow \text{are accepted by Banks}$

EX-1  - Assign Benefit of life Insurance Policy to secure personal loan.

EX-2  - Assign Receivable to avail loans.

v). Set-off

- Right of creditor to set off Debit Balance in Debtor's Account against any credit Balance lying in Another A/c of Debtor.
- Ex.: X Ltd \rightarrow loan 50,000 ₹
FD - 100,000 $\left\{ \right.$ Bank has right to set-off.
- Set-off allowed if both Accounts are of same name & right

Note: All Branches of one bank treated as single entity.

vi). lien

creation of legal charge → giving right to lender

↓
with consent of
owner.

↓
Right to seize / liquidate asset.

Example :- Bank put X Ltd F.D. on lien.

* Legal Requirement of Disclosure in Balance Sheet
(Refer Book)

Saksham Jain

* Non-Performing Assets
Advance where

- Interest & / or Installment of payment remain
OVERDUE > 90 days in case of Term loan
"OR"
- Account remain "OUT OF ORDER" for OD/CC
"OR"
- Bills OVERDUE > 90 days in case of Bill Discounted
or Purchased.

Notes

i). OVERDUE :- Amount not paid on Due Date becomes Overdue.

eg. → Due Date of Installment - 2/5/2025. If not paid,
loan become Overdue.

ii). OUT OF ORDER (CC/00)

An Account becomes Out of Order if

- Outstanding Balance remains continuously in EXCESS of Sanctioned Limit/Drawing Power OR
- In case, O/S Balance < Sanctioned Limit/Drawing Power No credit continuously for 90 days at Date of B.S. OR
- Credits are there but not enough to cover Interest Debited during the period.

iii). Asset classification is done as per Borrower wise & not facility wise.

eg.

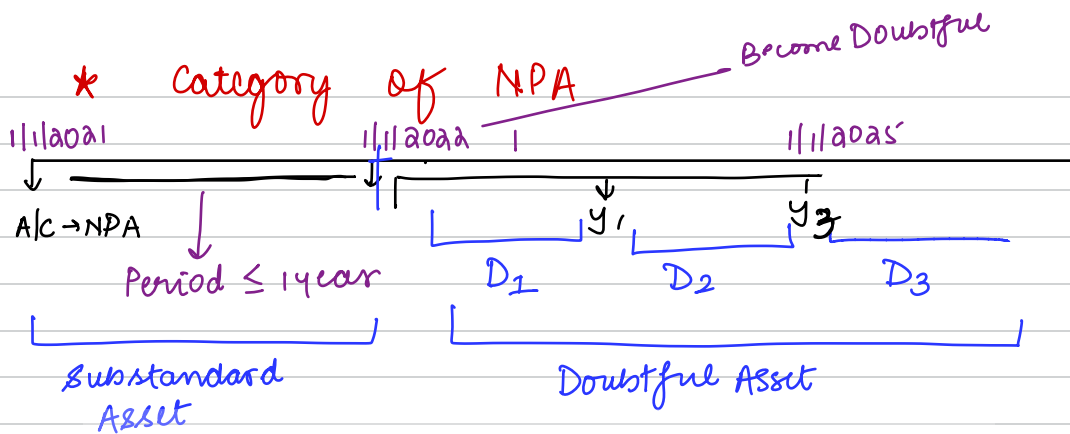
Raju $\left\{ \begin{array}{l} \text{car loan} \rightarrow \text{last 4 EMI missed} \\ \text{Home-loan} \rightarrow \text{all emi's paid on Due Date.} \end{array} \right.$

\therefore Both Car loan & Home loan would be classified as NPA.

iv). classification as NPA on Basis of RECOVERY & not available Guarantee or security.

eg. Raju taken loan of 5 cr, giving security of 8 cr. No Repayment made in last 90 days.

\downarrow
'NPA' as no recovery



Provision %

- i). Substandard → 15%
- ii). Doubtful → D₁ :- (Secured) 25% + (Unsecured) 100%
 D₂ :- 40% + 100%
 D₃ :- 100% + 100%
- iii). Loss → 100%

Bifurcation of Secured Portion & Unsecured Portion

- i). Identify total O/s loan amount = 100 lakh.
- ii). Identify Realisable value of security = 60 lakh

Formula → Secured Portion = lesser of { loan outstanding, Realisable Security value. }

→ Unsecured Portion = O/s loan - Secured Portion.

* Standard Asset

Before Standard Asset Becomes NPA, it passes through SMA stages Based on Delay in payment

SMA Classification

Category	Overdue period	Meaning
i). SMA-0	Payment Overdue 1-30 Days	- Early warning Signal
ii). SMA-1	Payment Overdue 31-60 Days	- Moderate Stress
iii). SMA-2	Payment Overdue 61-90 Days	- High Risk, on verge of NPA

* A/c Overdue > 90 Days → "NPA"

STANDARD ASSET → SMA-0 → SMA-1 → SMA-2 → NPA

* Impact of NPA

- Provisioning Requirement
- Income to be Recognized on Cash Basis (Interest)
 Income
- Reversal of income earlier booked not received.

* Special Cases

a). Government Guaranteed Advances

Central Government
Guaranteed Advances



Overdue > 90 days

- If Guarantee not invoked
Treat as Standard Asset

- Regarded as NPA for
Income Recognition purpose

CG Guarantee Advance
Atc Overdue > 90 days.

- Treat it as Standard Asset
- Recognised Income on Cash Basis

State Government
Guarantee Advances



Overdue > 90 days

- Advance is NPA for
 - Provisioning
 - Income Recognition

SG Guarantee Advance
Atc Overdue > 90 days

- NPA ✓
 - Provisioning
 - Income Recognition

b). Account regularized near B/S Date.

31/3



- chances of NPA due to inherent weakness.
- Few credit are recorded before B.S. Date.



Auditor

check sample transactions

Before 31/3

After 31/3



"DEEMED NPA"

To Trace any Reversal
entry to Prevent
Borrower Atc from
slipping to NPA.

c). Account where there is erosion in value of security / frauds committed by borrower.

- Realisable Value of security $< 50\%$ of value assessed by Bank / RBI at last inspection



NPA classification \rightarrow "DOUBTFUL ASSETS"

- Realisable Value of security $< 10\%$ of Outstanding in Borrowal Accounts.



NPA classification \rightarrow "LOSS ASSET"

D). Agriculture Advances



Long Duration Crops

- Crop Season longer than 1 year.



Short Duration Crops

- Crop not treated as long duration.

Note: Crop Season for each crop \rightarrow Decided by State level Banker's Committee in each State.

NPA Norms for agricultural advances [including Crop Term loans]

i). Short Duration Crop \rightarrow NPA if Installment [P or I] Overdue for 2 crop season.

ii). Long Duration Crops \rightarrow NPA if Installment [P+I] Overdue for 1 crop season.

Example - 1

- Crop Season = 5 months, loan Disbursed Date = 1 Jan, 2025.
- Due Date of Payment = 30th June, 2025.
- Borrower not paid on time.
- When will be it classified as NPA ?

Solⁿ : ∵ Crop Season = 5 months. → Short term.
For NPA, Overdue for 3 crop season rule.

Hence,

Date by which A/c will become NPA, if
Overdue = 30/6/25 + 10 months
= 30/4/2025.

E). Advances against Term Deposit, NSC, etc
Not to be treated as NPA if ADEQUATE MARGIN
IS AVAILABLE

Ex:- O/S loan → 800,000
Int Rate - 10%.

F.D. Secured = 10,00,000

$$y_1 \text{ O/S} = 800,000 + 10\% \\ = 8,80,000$$

✓ Adequate Margin 10,00,000

↓

$$y_2 \text{ O/S} = 8,80,000 + 10\% \\ = 9,68,000$$

✓ Adequate Margin 10,00,000

$$y_3 \rightarrow \text{O/S} \rightarrow 9,68,000 + 10\% \quad \text{10,00,000}$$

X Adequate Margin → NPA

In given case, it is assumed no repayment was made in 3 years.

F). Agricultural Advances affected by Natural Calamities

- Relief Measures by Bank

- Conversion of short term production loan into term loan.
 - Re-Scheduling of Repayment period.
 - Sanctioning of Fresh term loan.
- NPA classification → "As per Rescheduled terms".

G). Advances under Consortium



- Consortium Advances → Advancing loan to Borrower by two or more Banks.
- Bank with High Share → leads consortium.
- Drawing Power Calculation in Consortium Cash Credit → dead Bank will be responsible, for computing Drawing Power, & allocate shares to Other Members.
- Other Bank Accounting → Will treat Advances as NPA. if not receiving his share

H). Advances to Staff

Interest Bearing Staff Advances
as Banker

- To be included in Advance Portfolio of Bank

eg. Concessional car loan, Homeloan

Loan given as employer

- Shown as 'Others' under Schedule of Other Assets.

eg- loan of 10,000 without interest

Ques → When Bank employee takes loan, major portion of EMI is deducted from salary & then credited to employee A/c. ↓
Chances of NPA is very low

- If in arrangement, where Principal is paid before interest. Interest not to be considered as Overdue from 1st Quarter.

$$DP \leq SL$$

* Drawing Power

a). Meaning - maximum borrower can withdraw from working capital limit sanctioned.

b). Drawing Power vs Sanctioned limit

↓
Amount Calculated
Based on Primary Security
less margin on particular
date.

↓
Total exposure that Bank can
take on particular client
for CC, OD, etc.

c). Bank Duties

- Stock Statement should not be older than 3 months.

↓
If older > 3 months, → A/c Deemed as
"Irregular".

d). Stock Audit

- Bank should carry stock audit for all Accounts having FUNDED EXPOSURE > 5 crore.

e). Calculation of Drawing Power

i). Stock [NRV] xxx

(-) UNPAID 'STOCK'

a). Unpaid creditor (xxx)

b). Acceptance / LC (xxx)

xxx - Margin %.

ii). Debtors xxx

(-) Ineligible Debtor (xxx)

xxx - Margin %.

* Audit of Advance

(i) Audit Approach

Avatar → Carry A.P. → gather audit evidence about following

- i). Advances represent Amount Due to Bank.
- ii). Amount Due to Bank → Supported by appropriate documents.
- iii). No Unrecorded Advances.
- iv). Appropriate Provisions towards Advances have been made as per RBI Norms.
- v). Advances are - Disclosed } - in accordance with
 - classified } appropriate policy & procedures
 - Described } & relevant statutory requirements.
- vi). Basis of Valuation is appropriate & Recoverability of Advances is recognised in their valuation.
- vii). Amount included in B.S. in respect of Advances which are q/s at Date of B.S.

ii). Audit Procedure

Auditor can obtain SAE about advances

- By Study & evaluation of Internal Control relating to Advances
- Examining loan documentation.
- Check compliance with RBI Norms.
- Review operation of the Accounts.
- Examining validity of recorded amount.
- classification & provisioning
- Examining existence, enforceability & valuation of security.
- Carry out appropriate analytical procedures.

- ☺ 74 - Examine all large advances.
- Rest on Sampling Basis

Note

New Advances Sanctioned, Advances which have adverse comments by RBI Inspection team, Concurrent Auditor, Internal auditor → to be included in Auditor's review.

iii). Evaluation of Internal Controls over Advances

- Advance only
 - credit worthiness is checked
 - Proper Sanction from appropriate authorities.
- Sufficient Margin against securities.
- Necessary Documents execution before advances are made. (Agreements, letter of Hypothecation, etc)
- Compliance with terms of Sanctions & end use of funds should be ensured.
- Drawing Power to be updated every month.
- A/c should be kept within Both - Drawing Power - Sanctioning limit.
- Review of each Advances atleast once in year, plus large advances frequently.
- Securities → requiring registration should be registered in name of Bank.

* Audit of Income [Special Points]

i). RBI Direction relating to Materiality (MCQ)

Material Income → Recognised on ACCRUAL BASIS

Any Income > 1% of Total Income of Bank

a). If Recognized on GROSS BASIS

'OR'

b). Any Income > 1% of Profit Before Tax [Net Basis]

Note → Income Not material → Bank may do on Cash Basis

Answer

NO Problem

i.i) Reversal of Income (V.Imp).

Any Advances (including Bill Purchase & Discounted)

Become NPA → Interest Accrued but not received should be reversed.

* Reversal apply to Govt Guarantee Advances.

- In respect of NPA: Fees, Commission & Similar Income

- that have accrued should cease to accrue in current period
- Reversal for past periods, if uncollected.

- Interest Income wrongly Booked in Current Year

- Reverse the Interest Income

OR

- Make Provision of equal amount of Income recognised in C.Y.

- Inquiry about large Debits in Interest Income A/c, not explained. Inquire whether communication made to Borrower about Difference in Interest charged.

iii). Renegotiations

Renegotiation or Rescheduling of Outstanding Debts



Bank earns Fees & Commissions



Should be Recognised Over Period of Time covered by Re-Negotiated or Rescheduled extension of credit.

iv). Bills Purchased

Bank Purchase Bills of 12 months Amounting to 100,000 for 90,000

31/3/2025

Date of F.S.

Here Discount of 10,000/- is Bank Income.

$$10,000 \times \frac{1}{12}$$



Booked Income in C.Y.

$$10,000 \times \frac{11}{12}$$



Shown as "Other liabilities"

Let's say, Bank Rediscount of Bills from other Bank for Rs 95,000/-



Income Earned 10,000/-

Interest Paid by Bank = 5000/-

Netting off Not Allowed

v). Bills for Collection

- Bank's Procedure → Customer A/c is credited only after Bill has actually been collected from Drawee by Banks.
- Commission of Bank Become Due only when Bill Has been collected.

GIYAN



Raju → To Receive money from Shyam after 3 months



Raju Instruct [Bank] to collect money as Agent



[Collecting Agent]

Bank Income Gets Due when Bills has been collected.

NOTE → Bill for Collection & Bill Discounting are 2 different concept.

vi). Advances against securities → 'NSC, FD, etc'

If Adequate securities is available → Interest may be Recognised on Due Dates.

★ Miscellaneous Points

i). Memorandum Account

- NPA A/c → Interest Income to be recognised on cash basis.
- Bank may Recognised Interest Income Accrued in Memorandum A/c for control purposes.
- For computing of Gross Advances
Interest Recorded in Memorandum A/c should not be taken into account.

ii). On leased assets

If leased Asset become NPA, then



financing income earlier Accrued & Credited to Income



Need to Be Reversed or Provided.

iii). Partial Recovery in NPA

* If A/c is NPA - Income to be recognised on Realisation Basis.



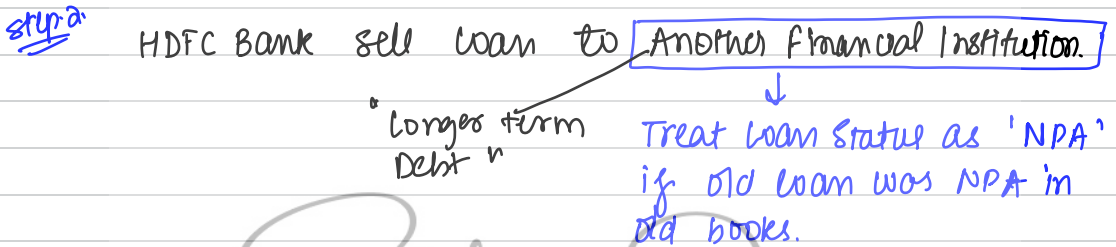
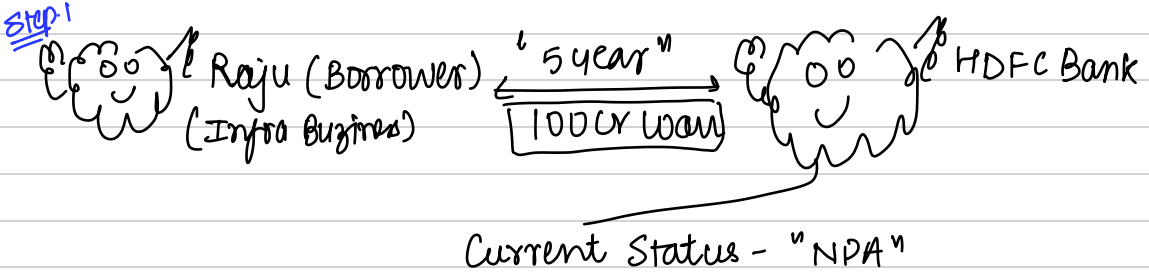
If Realised Partly / Full → Add in 'Income'

* Partial Recovery → Recognize NPA income

But

→ Don't Upgrade NPA to Standard until fully realised.

iv). On Take Out Finance



Saksham Jain

* **Other Income** — Apart from Interest Earned on Advances.

i). Interest Income on Investments

Includes - Income Derived from $\left\{ \begin{array}{l} \text{Govt securities} \\ \text{Bonds, Deb of Corporates} \end{array} \right.$

Excludes - Income earned by way of Dividend from Subsidiary & J.V.

<u>Note</u> - Gross Interest Income from Investment	xxx
(-) Broken Period Interest Paid	(xxx)
(-) Amortisation of Premium	(xxx)
Net Interest Income \rightarrow	<u>xxx</u>

CONCEPT OF BROKEN PERIOD INTEREST

eg. Bank buys Govt Security on 10th June
Last Interest Paid by RBI on 1st April
Next Interest Due on 1st October.

↓

let say. Half Yearly Interest = 10,000/-

\rightarrow Bank earn 10,000/- on 1st October, out of which let's say 4000/- relates to prior period interest.

↓

ADJUSTMENT — $10,000 - 4000 = ₹ 6000/-$ (Real income)

Concept of Amortisation of Premium

Ex \rightarrow Bank Purchase Govt Security of Face Value 100,000, of Rs 100,000.

Premium Paid = 2000/-, Remaining Maturity = 4 years

↓

Amortisation = $2000/4 = \boxed{500 \text{ per year.}}$

↓

Bank deduct 500/- every year from interest income to reflect cost.

ii). Profit on Sale of Investment
Net Profit/Loss \rightarrow Recognised in P&L

iii). Profit / loss on Revaluation of Investment
As per RBI Guideline \rightarrow Investment are valued at
Periodical Intervals.

Saksham Jain

Division-2 Expenditure Audit

* Audit of Provisions & Contingencies

- a). Obtain Understanding, How Bank computes Provision on
Standard Asset Non-Performing Asset
- Check Basis of classification of Advances
b/w Standard & NPA.
- b). Obtain Detail Breakup of Standard loan
↓
Non-Performing loan
- Agree o/s Balances with general ledger.
- c). Auditor verify loan classification → SAMPLE BASIS
- d). Ensure Compliance for Regulatory Requirement for Provisions.
as contained in various circular, have been fulfilled.
- e). Examine Other Provisions for expenses
- Check Circumstances Justify Provisioning
 - Check ADEQUACY by Discussing & obtain Explanations from Mgmt.
- f). Obtain Tax Provision computation from mgmt
- Review Nature of items Debited & Credited to P&L

Examples

- Provision for Taxation
- " made in respect of NPA
- " for contingencies.
- " Diminution in value of Investment

* Audit of Interest Expense (sample basis)

→ Auditor to verify calculation of Interest & ensure

- Interest Provided on All DEPOSITS → upto Date of B.S.

- Interest on Saving A/c's → accordance with Rules framed by Bank / RBI.

- Interest on Inter Branch Balances → Provide at Rate Prescribed by H.O. / RBI

- Interest Rate are → accordance with
Bank Internal Regulation RBI Directive Agreement with Respective Deposit holders.

→ Auditor to ascertain whether any Δ in Interest Rate on Saving A/c & Term Deposit During period.

→ Auditor → Assess Overall Reasonableness of Amount of Interest Expense by



Analysing Ratios of Interest Paid on Different Type of Deposit & Borrowing to Avg. of liabilities During year.

→ Interest Expense automatically generated → Through Batch Process in CBS system.

→ Auditor to obtain various type of deposit o/s at end of Quarter. Calculate Weighted Avg. Interest Rate.

→ Auditor, then Compare this Rate with Actual Avg Rate of Interest paid, Inquire Differences.

* Audit of operating Expenses

a). Study & evaluate Internal Control Relating to expenses, Including authorisation procedures → to Determine Nature Timing Extent of other Audit Procedure.

b). Perform Substantive Analytical Procedures in respect of expenses

eg. Assess Reasonableness of expenses

Expenses / Total operating Expenses

↓
Compare with P.Y.

c). - Verify exp. with Reference to Supporting Documents
- Check calculations if required.