

Chapter 10 – Audit of Banks

Types of bank

Commercial banks

The most widespread banking institutions in India, that provide a number of products and services to the general public and other segments of the economy. Two of its main functions are:-

- accepting deposits and
- granting advances.

Regional Rural Banks

Known as RRBs are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. Examples are :- Punjab Gramin Bank, Tripura Gramin Bank, Allahabad UP Gramin Bank, Andhra Pradesh Grameen Vikas Bank, etc.

Co-operative Banks

Function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors. Examples are :- The Gujarat State Co-operative Bank Ltd., Chhatisgarh Rajya Sahakari Bank Maryadit, etc.

Payments Banks

Are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However, customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards, Internet banking & Mobile Banking. Examples are :- Airtel Payments Bank, India Post Payments Bank, Paytm Payments Bank, etc.

Development Banks

It has been conceptualised to provide funds for infrastructural facilities important for the economic growth of the country. Examples are:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI), etc.

Small Finance Banks

Have been set up by the RBI to make available basic financial and banking facilities to the unserved and unorganised sectors like small marginal farmers, small & micro business units, etc. Examples are:- Equitas Small Finance Bank, AU Small Finance Bank, etc.

Regulating Body – Reserve Bank of India

- The functioning of the banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country.
- RBI is responsible for

- development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as
- for determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour.
- Important functions of RBI are
 - issuance of currency;
 - regulation of currency issue;
 - acting as banker to the central and state governments;
 - and acting as banker to commercial and other types of banks including term-lending institutions.
- Besides, RBI has also been entrusted with the responsibility of
 - regulating the activities of commercial and other banks.
 - No bank can
 - commence the business of banking or
 - open new branches without obtaining a licence from RBI.
 - The RBI also has the power to inspect any bank.

Independent audit of financial statements of banks is important for a healthy, safe and sound banking system.

Regulatory Framework

- Reserve Bank of India Act, 1934
- Banking Regulation Act, 1949.
- State Bank of India Act, 1955.
- Companies Act, 2013.
- 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.
- Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.
- Credit Information Companies Regulation Act, 2005.
- Payment and Settlement Systems Act, 2007.

Banking Operations – Conducted only at Branches

Banking operations are conducted only at the branches,

- while other offices act as controlling authorities or administrative offices
- that lay down policies, systems and internal control procedures for conduct of business, in compliance with the statutory/regulatory impositions and in compliance of accepted accounting principles and practices that cover all transactions and economic events.

These controlling/ administrative offices also-

- stipulate the delegation of powers and fix responsibilities and accountability and
- these are involved generally in effective supervision, monitoring and control over the business activities and operations, including seeking faithful compliance of the bank's laid down policies/ procedures /controls and deal with deviations therefrom.

Some of the different features of Bank

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

Types of Bank Audit Reports to be issued

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

1. Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
2. Long Form Audit Report. (LFAR)
3. Report on compliance with SLR requirements. (Statutory Liquidity Ratio Statutory Liquidity Ratio or SLR is a minimum percentage of deposits that a commercial bank has to maintain in the form of liquid cash, gold or other securities. It is basically the reserve requirement that banks are expected to keep before offering credit to customers.)
4. Report on whether the Treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
5. Report on whether the income recognition, asset classification and provisioning (IRACP) have been made as per the guidelines issued by the RBI from time to time.
6. Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
7. Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
8. Report on instances of adverse credit-deposit ratio in the rural areas.

Understanding the Accounting System in Banks

There is a sea change in banking

- as use of technology
- and its continuous evolution has
 - enabled banks to reach their customers

- providing them the convenience and
- comfort of
 - anytime-anywhere-banking
 - by letting them access their information/data
 - on real time basis,
 - as stored in a safe and secure environment
 - on the bank's servers.

The transactions in banks have become voluminous and

- it needs to be ensured that in the
- system of
 - recording,
 - transmission and
 - storage of information/ data
 - is optimally maintained and
- control systems
 - ensure that
 - the same is
 - free of risks of
 - errors, omissions, irregularities and frauds;

In the computerised environment, it is imperative that the auditor is familiar with and satisfied that all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.

The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that 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 systems and document the results of such activities performed.

Form and Content of Financial Statements

- Sub-sections (1) and (2) of section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication.
- These sub-sections are also applicable to nationalised banks, State Bank of India, and Regional Rural Banks.
- Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.
- Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

- Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013, read with Rule 7 of the Companies (Accounts) Rules 2014, in so far as they apply to banking companies or the Accounting Standards issued by the ICAI.

Audit of Accounts

Sub-section (1) of section 30 of the Act requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.

Eligibility, Qualifications And Disqualifications Of Auditor

As per section 141 of The Companies Act, 2013

Appointment of auditor

The auditor of a

- banking company is to be appointed
 - at the annual general meeting of the shareholders
- auditor of a nationalised bank
 - is to be appointed by the bank concerned
 - acting through its Board of Directors.
- In either case, approval of the Reserve Bank is required before the appointment is made.
- The auditors of regional rural banks are to be appointed
 - by the bank concerned with the approval of the Central Government.

Remuneration of Auditor

- The remuneration of an auditor of a banking company is to be fixed in accordance with the provisions of section 142 of the Companies Act, 2013 (i.e., by the company in general meeting or in such manner as the company in general meeting may determine).
- The remuneration of auditors of nationalised banks and State Bank of India is to be fixed by the Reserve Bank of India in consultation with the Central Government.

Powers of Auditor

The auditor of a banking company, nationalised bank, State Bank of India, or a regional rural bank has the same powers as those of a company auditor in the matter of access to the books, accounts, documents and vouchers.

Auditor's Report

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

- whether, in his opinion,
 - financial statements presents
 - 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; (Returns from branch are adequate or not)
- any
 - other matter which
 - he considers
 - should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

Format of Report

The auditors,

- central as well as branch,
 - should also ensure that the audit report issued by them
 - complies with the requirements of
 - SAs on Audit Report.

The auditor should ensure that

- information relating to number of unaudited branches is given
- quantification of
 - advances,
 - deposits,
 - interest income and
 - Interest expense for such unaudited branches has also been disclosed in the audit report.

Long Form Audit Report

- Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks (as well as their branches), require the auditors to also furnish a long form audit report (LFAR).
- The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.
- The LFAR is to be submitted before 30th June every year.
- To ensure timely submission of LFAR, proper planning for completion of the LFAR is required.

Reporting to RBI

The RBI issued a Circular relating to implementation of recommendations of the Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:

- “If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action”.
- As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI.
- Auditor should also consider the provisions of **SA 250** “Consideration of Laws and Regulations in an Audit of Financial Statements”. The said Standard explains that the duty of confidentiality is over-ridden by statute, law or courts.
- **SA 240** “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” states that an auditor conducting an audit in accordance with SAs is responsible for obtaining **reasonable** assurance that the financial statements taken as a whole are **free from material misstatement**, whether caused by fraud or error.
- It must be noted that auditor is **not expected to look** into **each** and **every transaction** but to **evaluate the system as a whole**. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

Bank Audit Approach

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 in or breach of internal controls and the familiarisation exercise carried out

Control Environment at the Bank

- Check whether the bank 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.

The following are certain common questions /steps, which have to be kept in mind while undertaking/ performing control activities

Who	<ul style="list-style-type: none"> • Who performs the control? • Does the above person have requisite knowledge and authority to perform the control?
What	<ul style="list-style-type: none"> • What evidence is available to demonstrate /prove that the control is performed?
When	<ul style="list-style-type: none"> • When and with what frequency is the control performed? • Is the frequency enough to prevent, detect and correct risk of material misstatements?
Where	<ul style="list-style-type: none"> • Where is the evidence of performance of the control retained? • For how long is the evidence retained? • Is the evidence accessible/ available for audit?
Why	<ul style="list-style-type: none"> • Why is the control being performed? • What type of errors are prevented or detected through the performance of the control?
How	<ul style="list-style-type: none"> • How is the control performed? • What are the control activities? (SOD, Approval, Reconciliation etc) • 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?

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 and its environment, including internal control, and also
 - to assess the potential for material misstatements of the financial statements.
- All these discussions should be appropriately documented for future reference.
- These discussions are ordinarily done at the **planning stage** of an audit.

Engagement team discussion ordinarily includes

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

- Errors** that may be more **likely** to occur;
- 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;
- d. Audit **responses** to Engagement Risk, Pervasive Risks, and Specific Risks;
- e. Need to maintain **professional skepticism** throughout the audit.
- f. **Need to alert** for information or other conditions that indicate that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Advantages of such a discussion :-

- Specific **emphasis can be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud** that enables the engagement team 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 engagement team members, and to determine the procedures to be followed when fraud is identified.
- Further, audit engagement partners may review the **need for specialists** to address the issues relating to fraud.

Conducting an Audit

The audit of banks or their branches involves the following stages –

Initial consideration by the statutory auditor

Declaration of Indebtedness

- The RBI has advised that the banks, **before appointing** their statutory central/branch auditors,
 - should obtain a declaration of indebtedness.
- Indebtedness refers to the situation of owing money to the bank in any case, whatsoever.

Internal Assignments in Banks by Statutory Auditors

The RBI decided that the audit firms **should not undertake statutory audit** assignment while they are **associated** with internal assignments in the bank during the same year, like Concurrent audits (Internal Audit of Banks conducted monthly during the year)

Planning

SA 300, "Planning an Audit of Financial Statements" requires that the auditor shall undertake the following activities prior to starting an initial audit

- Performing **procedures required** by **SA 220** regarding the acceptance of the client relationship and the specific audit engagement; and
- Establish understanding of **terms** of **engagement** as per SA 210

Communication with Previous Auditor

As per **Clause (8)** of the **Part I** of the **First Schedule** to the Chartered Accountants Act, 1949, CA in practice cannot accept position as auditor previously held by another CA without first

communicating with him in writing. He should get a **NO Objection Certificate** (NOC) from the previous auditor through this communication as to know whether he has any objections to such an appointment made, for any valid reasons.

Terms of Audit Engagements

SA 210 requires that for each period to be audited, the auditor should agree on the terms of the audit engagement with the bank before beginning significant portions of fieldwork.

Initial Engagements

- The auditor needs to perform the **audit procedures** as mentioned in SA 510 "Initial Audit Engagements–Opening Balances" and
- if after performing that procedures,
 - the auditor concludes that the **opening balances** contain **misstatements** which **materially affect** FS for the current period and
 - the **effect** of the same is **not properly accounted** for and
 - adequately **disclosed**,
 - the auditor should express a **qualified opinion** or an adverse opinion, as appropriate.

Assessment of Engagement Risk

- The assessment of engagement risk
 - is a critical part of the audit process and
 - should be done **prior** to the **acceptance** of an audit engagement
 - since it **affects** the **decision** of **accepting** the engagement and
 - **also** in **planning decisions** if the audit is accepted.

Establish the Engagement experienced Team

The assignment of **qualified** and **experienced** professionals is an important component of managing engagement risk. The **size** and **composition** of the engagement team would **depend** on size, nature and complexity of the bank's operation.

Understanding the Bank and its Environment

SA 315 lays down that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to **identify** and **assess** the **risks** of material misstatement of FS whether due to fraud or error and sufficient to design and perform further audit procedures.

Identifying and Assessing the Risks of Material Misstatements

SA 315 requires the auditor to **identify** and **assess** the **risks** of material misstatement at FS level and the assertion level for classes of transactions, account balances and disclosures to provide a basis for designing and performing further audit procedures.

Understanding the Bank and Its Environment Including Internal Control

An understanding of the bank and its environment, including its internal control, enables the auditor:

- to **identify** and **assess** risk;
- to develop an **audit plan** so as to determine the operating effectiveness of the controls and to **address** the specific risks.

Understanding the Bank's Accounting Process

- The accounting process produces **financial** and **operational** information for management's use and it also **contributes** to the bank's **internal control**.
- Thus, understanding of the accounting process is **necessary** to **identify** and **assess** the **risks** of **material misstatement** whether due to fraud or not and to design and perform further audit procedures.

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:

Oversight and involvement in the control process by those charged with governance (Control Environment)

- **TCWG** (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.

Identification, measurement and monitoring of risks (Risk assessment)

- Risks that could significantly impact the achievement of a bank's goals should be **identified**, **measured** and **monitored** against **pre-approved limits and criteria**.

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.

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**.

Reliable information systems

- Banks require reliable information systems that provide adequate **financial**, **operational** and **compliance** information on a **timely** and **consistent** basis. TCWG and management require risk management information that is easily understood and that enables them to **assess the changing** nature of a **bank's risk profile**.

Engagement Team Discussions

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

Establish the Overall Audit Strategy

SA 300 "Planning an Audit of financial Statements" states that the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this purpose, the audit engagement partner should:

- **establish** the overall audit **strategy** prior to the commencement of an audit; and
- involve **key** engagement **team** members and other appropriate **specialists** while establishing the overall audit strategy, which depends on the characteristics of the audit engagement.

Develop the Audit Plan

SA 300 deals with the **auditor's responsibility** to plan an audit of financial statements in an **effective manner**. It requires the involvement of all the key members of the engagement team while planning an audit.

Audit Planning Memorandum

The auditor should summarise the audit plan by preparing an audit planning memorandum in order to:

- Describe the **expected scope** and **extent** of the audit procedures to be performed by the auditor.
- Highlight **all significant issues** and **risks** identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls.
- Provide **evidence** that they have planned the audit engagement appropriately and have **responded** to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

Determine Audit Materiality

The auditor should consider the **relationship** between the audit **materiality** and audit **risk** when conducting an audit. The determination of audit materiality is a matter of professional judgement and depends upon the knowledge of the bank, assessment of engagement risk and the reporting requirements for FS.

Consider Going Concern

While obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

Assess the Risk of Fraud including Money Laundering

As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is

- to identify and assess the risks of material misstatement in FS due to fraud,
- to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.

The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

The RBI has from time to time issued guidelines (" Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

Assess Specific Risks

The auditors should identify and assess the risks of material misstatement at FS level which refers to risks that relate pervasively to FS as a whole and potentially affect many assertions.

Risk Associated with Outsourcing of Activities

The modern day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

Response to the Assessed Risks

SA 330 "The Auditor's Responses to Assessed Risks" requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at FS level. The auditor should design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.

Stress Testing

Stress testing is a software testing activity that determines the robustness of software by testing beyond the limits of normal operation. Stress testing is particularly important for "mission critical" software, but is used for all types of software. (Source – Wikipedia)

RBI has required that all commercial banks shall put in place a Board approved 'Stress Testing framework' to suit their individual

requirements which would integrate into their risk management systems.

BASEL III framework

- The set of agreements by the BCBS (Basel Committee on Banking Supervision), which mainly focuses on risks to banks and the financial system are called Basel accord.
- The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) has undertaken an extensive review of the regulatory framework in the wake of the subprime crisis.
- In the document titled 'Basel III: A global regulatory framework for more resilient banks and banking systems', released by the BCBS in December 2010, it has inter alia proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital. (Items to be included while calculating the capital adequacy ratio)

Reliance on / review of other reports

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.

The above reports should be reviewed in detail. The Statutory Central Auditors must review the Annual Financial Inspection report of RBI relating to the bank and ensure that the variations in provisions, etc. reported by RBI have been properly considered by the bank management.

Advances**What are advances?**

- Advances are amounts of money or credit, given as a loan from a bank to another party with an agreement that the money will be repaid.
- Bank charges interest on advances as the consideration for advances.
- Biggest item on the asset side.
- Major source of income for banks

Auditor's View

Auditors must have sound knowledge of the

- various functional areas of the bank/branches,
- its processes, procedures, systems
- Guidelines, rules and regulation and

- prevailing internal controls with regard to advances.

Type of Advances

- Funded
- Non-Funded

Types of Advances			
Funded	actual transfer of funds	Term Loans	
		Cash Credits	Cash Credit is a short term loan approved by banks for businesses, financial institutions and companies to meet their working capital requirements. The borrowing company can take money, even without a credit balance.
		Overdraft	
		Demand Loan	
		Bills Discounted	
		Participation on risk sharing basis	
		Interest bearing staff loan	
Non-Funded	do not involve such transfer	Examples of non-funded loans are Letters of credit, Bank guarantees, etc.	

Letter of Credit Process

- The Buyer enters into a contract with the Seller.
- The Buyer submits an application for a Letter of Credit to their bank (called the Issuing Bank).
- The Issuing Bank issues the Letter of Credit and sends it to the Advising Bank (the Seller's bank).
- The Advising Bank then informs the Seller about the Letter of Credit.

Substantive procedures

In carrying out his substantive procedures,

- the auditor should examine all large advances while other advances may be examined on a sampling basis.
- The accounts identified to be problem accounts, however, need to be examined in detail unless the amount involved is insignificant.
- The extent of sample checking would also depend on the auditor's assessment of efficacy of internal controls.

What constitutes a 'large advance' would need to be determined in the context of volume of operations of the branch e.g. an advance may be considered to be a large advance if the year-end balance is in excess of ₹ 10 crore or 10% of the aggregate year-end advances of the branch, whichever is less.

Legal requirements of Disclosure in the Balance Sheet

Nature wise

- Bills purchased and discounted
- Cash credits, Overdrafts and loans repayable on demand
- Term Loans

Security wise

- Secured by tangible assets
- Covered by Bank/Government guarantees
- Unsecured

Location wise

- Advances in India:
 - Priority sectors

- Public sector
- Banks
- Others

II. Advances outside India:

- Due from Banks
- Due from Others:
 - Bills Purchased and discounted
 - Syndicated loans
 - Others

Classification of Advances

SECTOR WISE

Priority Sector

RBI issues common guidelines for lending to the Priority Sector which banks are required to follow. These guidelines cover rate of interest; service charges, receipt, sanction, rejection, disbursement Register; issue of Loan Application Acknowledgement. RBI also issues targets for banks for lending to the Priority Sector.

Examples of Priority Sectors are Agriculture , MSME , Education , Housing , etc.

SECURITY WISE

Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time else the Banks have legal authority to sell the collateral to recover its money.

Primary Security

Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

Collateral security

It is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of Security

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Bankers General Lien The term lien refers to a legal claim or legal right which is made against the assets that are held as security for satisfying a debt
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments.

Mode of Creation of Security

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien.

Mortgage

Mortgages are of several kinds but the most important are the

- **Registered Mortgage**
 - It can be affected by a registered instrument called the '**Mortgage Deed**' signed by the mortgagor.
 - It registers the property to the mortgagee as a security.
- **Equitable Mortgage.** (Equitable mortgage is also known as Mortgage by deposit of title deeds)
 - Equitable mortgage, on the other hand, is effected by a **mere delivery** of **title deeds** or other documents of title with intent to create security thereof.

Pledge

- A pledge involves **bailment or delivery of goods** by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance.
- The legal **ownership** of the goods **remains** with the **pledger** while the lending banker gets certain defined interests in the goods.
- The pledge of goods constitutes a specific (or fixed) charge.

Hypothecation

- The hypothecation is the creation of an equitable charge, in favour of the lending bank **by execution of hypothecation agreement** in respect of the **moveable securities** belonging to the borrower.
- **Neither ownership nor possession is transferred to the bank.**
- However, the **borrower holds the physical possession of the goods as an agent/trustee of the bank.**
- The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

Assignment

- Assignment represents a **transfer** of an **existing** or **future debt**, right or property belonging to a person in favor of another person.
- Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.
- An assignment gives the assignee absolute right over the money/debts assigned to him.

Set-off

- Set-off is a **statutory right** of a **creditor** to **adjust, wholly or partly**, the **debit balance** in the **debtor's account** against any credit balance lying in another account of the debtor.
- The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).
- For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

Lien

Lien is creation of a **legal charge** with **consent** of the **owner**, which gives the lender a legal right to seize and dispose / liquidate the asset under lien.

Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances

Non-performing Assets

An asset becomes an NPA when it ceases to generate income for the Bank.

A non-performing asset (NPA) is a loan or an advance where :-

- **Interest** and/ or **instalment** of principal remain **overdue** for a **period of more than 90 days** in respect of a term loan;
- the account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/ CC);
- the bill remains overdue for a period of **more than 90 days** in the case of bills purchased and discounted.

Out of order

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for **90 days**.

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 **not enough to cover the interest debited** during the same period, these accounts should be treated as 'out of order'.

Overdue

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.

Provision Requirement

Categories of Non-Performing Assets	Provision required
Substandard Assets:	15%

Would be one, which has remained NPA for a period less than or equal to 12 months.	
Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months.	(Secured + Unsecured)
Sub-categories: Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	25% + 100% 40% + 100% 100% + 100%
Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Other points w.r.t Provisioning Basis of classification

- 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 the purpose of treating an advance as NPA or otherwise.

Borrower-wise and not facility-wise

- Asset classification would be borrower-wise and not facility-wise.
- For Example :- Mr. Raman has availed two Loan facilities – a Car Loan as well as a Housing Loan from XYZ Bank Ltd. He is regular in depositing the Housing Loan EMI but has not deposited the last 4 EMI's of the Car Loan due to paucity of funds. Hence, in this case, not only the Car loan but the Housing Loan would also be treated as an NPA, although it is going good and there are no irregularities because the NPA classification is Borrower wise (Mr. Raman) and not Facility wise (Car & Housing Loan individually).

Accounts regularised 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 and after 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

Government Guaranteed advances

- Central Govt. 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.

Income Recognition Policy

- The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations.
- Income from non performing assets (NPA) is not recognized on accrual basis but is booked as income only when it is actually received.

Advances under consortium

Basics

Consortium advances mean advancing loans to a borrower by two or more Banks jointly by forming a Consortium.

This will help the Banks

- to consolidate the appraisal benefit of different Banks and
- reduce the risks and
- also help the Banks to keep the exposure within the permissible limit

Joint appraisal, control and monitoring will facilitate for exchange of valuable information among the Banks

Usually, a Bank with a higher share will lead the consortium. It will be called – Lead Bank.

Asset classification

- Asset classification of accounts under consortium should be based on the record of recovery of the individual member banks.
- Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of the other member banks and therefore, be treated as NPA.
- The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Drawing Power

- The **Lead Bank** would be responsible for computing the drawing power (DP) of the borrower and allocate the same to member banks.
- In certain special circumstances, at the request of the Borrower, the Lead Bank may allot a higher or lower share of drawing power to the member bank, as against their share of advances.

Accounts where there is erosion in the value of security / frauds committed by borrowers

Erosion means the gradual destruction or diminution of something. It should be straight-away classified as doubtful or loss asset as appropriate as follows :-

Realisable value of the security is less than 50 per cent

- Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be.
- Such NPAs may be straight-away classified under **doubtful category** and provisioning should be made as applicable to doubtful assets.

Realisable value of the security is less than 10 per cent of the outstanding in the borrowal accounts

- If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is **less than 10 percent of the outstanding in the borrowal accounts**, the existence of security should be ignored and the asset should be straight-away classified as **loss asset**. It may be either written off or fully provided for by the bank.

Advances Against Term Deposits, NSCs, KVPs/ IVPs, etc.

Advances against Term Deposits, NSCs eligible for surrender, KVP/IVP and life policies need not be treated as NPAs, provided **adequate margin** is available in the accounts.

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** for example
 - Conversion of the **short term production loan into a term loan** or
 - **Rescheduling** of the repayment period and the sanctioning of fresh short term loan,
 - subject to the guidelines contained in RBI's latest Master Circular on Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances.

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

Advances to Staff

- Interest-bearing staff advances as a **banker** should be **included** as part of the **advances portfolio** of the bank.
- In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards.
- Such loans/advances should be classified as NPA **only** when there is a **default** in **repayment** of **instalment** of **principal** or payment of **interest** on the respective due dates.
- The staff advances by a bank as an **employer** and **not** as a **banker** are required to be included under the sub-head **'Others'** under the schedule of Other Assets.

Agricultural Advances

As per the guidelines, Agricultural Advances are of two types:

1. Agricultural Advances for "long duration" crops; and
2. Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops **with a crop season longer than one year** and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the **period up to harvesting of the crops raised**, would be determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for **short duration crops** will be treated as **NPA**, if the instalment of principal or interest thereon remains overdue for **two crop seasons**; and
- A loan granted for **long duration crops** will be treated as **NPA** if the instalment of principal or interest thereon remains overdue for **one crop season**.

Audit of Advances

Advances generally constitute the major part of the assets of the bank. There are a large number of borrowers to whom a 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

1. **Amounts** included in the balance sheet in respect of advances are **outstanding** at the date of the balance sheet.
2. Advances represent the **amount due to the bank**.
3. There are **no unrecorded advances**.

4. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
5. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
6. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
7. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
8. Internal controls for sanctioning advances and reviewing them are designed, operating effectively, throughout the period.
9. Carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis.

The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented on by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- 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.

Evaluation of Internal Controls over Advances:

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures.

In general, the internal controls over advances should include, inter alia, the following:

CREDIT WORTHINESS and Sanction

The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.

DOCUMENTS

All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.

COMPLIANCE

The compliance with the terms of sanction and end use of funds should be ensured.

SUFFICIENT MARGIN

- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof.
- The availability of sufficient margin needs to be ensured at regular intervals.

SECURITIES OWNERSHIP

If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.

SECURITIES REGISTRATION

All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.

CONTENTS OF THE PACKAGE

In the case of goods in the possession of the bank, contents of the packages should be tested at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.

DRAWING POWER REGISTER

Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.

LIMIT

The accounts should be kept within both the drawing power and the sanctioned limit.

IRREGULAR ACCOUNTS

All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.

REVIEW

The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

COMPUTATION OF DRAWING POWER

- Drawing Power generally addressed as "DP" is an important concept for Cash Credit (CC) facility available from banks and financial institutions.
- Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

Sanctioned limit is the total exposure

- The Sanctioned limit is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc.

Drawing Power = value of primary security less margin

- Drawing Power refers to the amount calculated based on primary security less margin as on a particular date.
- All accounts should be kept within both the drawing power and the sanctioned limit at all times. The accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head office regularly.

Ensure drawings are covered by the adequacy of the current assets

- Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets.
- Drawing power is required to be arrived at based on the current stock statement.
- However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months otherwise it will be deemed as irregular.

Auditor's Concern

- The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinised in detail.
- The audited Annual Report submitted by the borrower should be scrutinised properly.
- The audited statements and records submitted by the borrower should be compared and the reasons for deviations, if any, should be ascertained.

Computation of DP

- It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors.

- Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

Stock Audit

- The stock audit should be carried out by the bank for all accounts having funded exposure of more than 5 crores.
- Auditors can also advise for stock audit in other cases if the situation warrants the same.
- Branches should obtain the stock audit reports from lead banks in the cases where the Bank is not the leader of the consortium of working capital.
- The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

Compute the Drawing Power for Cash Credit A/c of S Limited for the month of March 2024 with following information:

Particulars	Amount (in ₹)
Stock	50,000
Debtors (Including Debtor of ₹ 5,000 for an invoice dated 17.11.2023)	45,000
Sundry creditors	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 DP

Computation of Drawing Power for CC A/c of S Ltd

Particulars of current assets	Amount (₹)	DP Amt (₹)
(A) Stocks		
Stocks at realizable value	50,000	
Less: Unpaid stocks		
- Sundry creditors	15,000	
Paid for stocks	35,000	
Margin @ 20%	7,000	28,000
(B) Debtors		
Total Debtors	45,000	
Less: Ineligible debtors	5,000	
Eligible debtors	40,000	
Margin @ 50%	20,000	20,000
Total Drawing Power		48,000

The sanctioned limit given in the question is ₹ 45000 whereas drawing power as per the above working is ₹ 48000. So, drawing power would be restricted to sanctioned limit i.e., ₹ 45000

Audit of Revenue Items (Income)**Items which are included in the income of the bank****Interest Earned**

- Interest/Discount on Advances/Bills
- Interest Income on Investments
- Interest on Balances with RBI and Other Inter-bank Funds

- Others: This includes any other interest/discount income not included in the above heads

Other Income

- Commission, Exchange and Brokerage – This item comprises of the following:
 - Commission on bills for collection.
 - Commission/exchange on remittances and transfers, e.g. demand drafts, NEFT, RTGS, etc.
 - Commission on letters of credit and guarantees, letter of comforts.
 - Loan processing, arranger and syndication fees.
 - Mobile banking fees.
 - Credit/Debit card fee income including annual fee income, merchant acquiring income, interchange fees, etc.
 - Rent from letting out of lockers
 - Commission on Government business.
 - Commission on other permitted agency business including consultancy and other services.
 - Brokerage on securities.
 - Fee on insurance referral.
 - Commission on referral of mutual fund clients.
 - Service/transaction banking charges including charges levied for transaction at other branches.
 - Income from rendering other services like custodian, demat, investment advisory, management and other based services.
- Profit on Sale of Investments
- Profit/Loss on Revaluation of Investments
- Profit on sale of Land, Buildings and Other Assets
- Profit/Loss on Revaluation of Fixed Assets
- Profit on exchange transactions
- Income earned by way of dividends, etc.
- Miscellaneous income.

Audit Approach and Procedures For Income

Auditor's Concern

In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amounts.

RBI's Directions – Accrual basis and Receipt Basis.

- RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per AS 9.

Materiality

- If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify their report in that situation.

Revenue Certainty

- Banks recognise income (such as interest, fees and commission) 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.
- In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.

Revenue Uncertainty:

- In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non performing assets until it is actually realised
- When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for.
- This will apply to Government guaranteed accounts also.

Renegotiations:

- 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

Advances against Securities

Interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira Vikas Patras (IVPs), Kisan Vikas Patras (KVPs) and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.

Bills Purchased

- In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly accounted for in the correct accounting periods.
- 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 bills discounted.

Bills for Collection

- In the case of bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected.
- The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its agents, etc.
- The commission of the branch becomes due only when the bill has been collected.

Reversal of Income:

- If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.
- In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.
- Further, banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).
- Furthermore, the auditor should inquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

On leased assets

- The component of finance income (as defined in AS 19 Leases) on the leased asset which was accrued and credited to the income account before the asset became non-performing and remaining unrealised, should be reversed or provided for in the current accounting period.

On Take-out finance

- A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan.
- Takeout loans are commonly used in property development (Source :- Investopedia) In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).
- All types of borrowers can get a take-out loan from a credit issuer to pay off past debts. Take-out loans can be used as a long-term personal loan to pay off previous outstanding balances with other creditors. They are most commonly used in

real estate construction to help a borrower replace a short-term construction loan and obtain more-favourable financing terms. The take-out loan's terms can include monthly payments or a one-time balloon payment at maturity.

- Take-out loans are an important way of stabilising your financing by replacing a short-term, higher-interest-rate loan with a long-term, lower-interest-rate one.

Objectives of Takeout Finance

- To expand sources of Finance for infrastructure projects by facilitating participation of new entities
- To address sectoral/group/entity exposure issues and asset liability in mis-match concerns of tenders
- To boost the availability of longer tenor debt finance for projects

Example of a Take-Out Loan - NOT for exams. - Source Investopedia
Assume XYZ company has received approval for plans to build a commercial real estate office building over 12 to 18 months. It may obtain a short-term loan for the financing it needs to build the property, with full repayment required in 18 months. The property plans are achieved ahead of schedule and the building is completed in 12 months. XYZ now has more negotiating power, because the fully complete property is able to be used as collateral. Thus, it decides to obtain a take-out loan, which provides it with the principal to pay off the previous loan six months early.

The new loan allows XYZ to make monthly payments over 15 years at an interest rate that is half of that of the short-term loan. With the take-out loan, it can repay its short-term loan six months early, saving on interest costs. XYZ now has 15 years to pay its new take-out loan at a much lower rate of interest, using the completed property as collateral.

Income Recognition On Partial Recoveries in NPAs:

- Interest partly/fully realised in NPAs can be taken to income.
- It should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.
- In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.
- The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted for.

Memorandum Account

- On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account and stop further application of interest.
- However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes.

- For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

Income from Investments

Interest Income on Investments

This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India. (Such dividends from subsidiaries are shown separately and not as income from investments.)

Broken period interest paid on securities purchased and amortisation of premium on SLR investments is net off from the interest income on investments

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 profit and loss account.

Profit/Loss on Revaluation of Investments

In terms of guidelines issued by the RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to profit and loss account.

EXPENSES

Categories

Expenditure is to be shown under three broad heads:

- Interest expense.
- Operating expense.
- Provisions and contingencies.

Audit Approach and Procedures Interest Expense

In carrying out an audit of interest expense, the auditor is primarily concerned with

Reasonableness of amount of interest.

- 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 outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate (Rate of interest for different categories).
- The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits.
- If any material difference is found then it should be further enquired into by the auditor.

Comparison with previous year interest

- 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.

Comparison with budget

- The auditor should also compare the interest expenses with the budgeted figures and should enquire into material differences.
- Auditors should also obtain understanding of the budgeting procedures.

Verify the calculation of Interest

- 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 balance sheet;
 - Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;
 - Interest amounts credited on various deposits are in accordance with the rules framed by the bank/RBI on this behalf.
 - Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI.

Changes in the interest rate

- The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period.
- The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly.

Completeness

- The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers.

Operating expenses

For audit of operating expenses, the auditor should

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- Study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.

Changing Trends

- The auditor should examine whether there are any changing trends in respect of major items of expenses.

Substantive analytical procedures in respect of expenses

- The auditor should perform substantive analytical procedures in respect of these expenses. e.g. assess the reasonableness of

expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

Verify expenses from documents and check calculations

- The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

Audit of Provisions and contingencies

Ensure compliance with regulatory requirements

- The auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.

Understanding the computation of provision and classification of assets

- The auditor should 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 nonperforming assets.

Verify the classification on sampling basis

- The auditor may verify the loan classification on a sample basis.
- The auditor should obtain the detailed breakup of standard loans, nonperforming loans and agree the outstanding balances with the general ledger.

Check the computation of Tax Provision

- The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to the profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.

Examining other provisions

- The other provisions for expenses should be examined according in the light of
 - circumstances warranting the provisioning and
 - the adequacy of the same
 - by discussing and obtaining the explanations from the bank's management.

Expenditure is to be shown under three broad heads:

- Interest expense
 - Interest on Deposits
 - Interest on Reserve Bank of India/Inter-Bank Borrowings
 - Others
- Operating expense
 - Payments to and Provisions for Employees

- Rent, Taxes and Lighting
- Printing and Stationery
- Advertisement and Publicity
- Depreciation on Bank's Property
- Directors' Fees, Allowances and Expenses
- Auditors' Fees and Expenses
- Legal expenses,
- Postage, Telegrams, Telephones, etc.
- Repairs and Maintenance
- Insurance
- Marketing Expenses
- Other Expenses

Provisions and contingencies

- Provisions made in respect of the Non-performing assets.
- Provisions for Taxation
- Provisions for Diminution in the value of investments
- Provisions for contingencies

Disclosure of the prior period items

Since the format of the profit and loss accounts of banks prescribed in Form B under Third Schedule to the Banking Regulation Act, 1949 does not specifically provide for disclosure of the impact of prior period items on the current year's profit and loss, such disclosures, wherever warranted, may be given.

SMA – Special Mention Accounts – Concept with Question

- SMA 0 – Accounts showing stress signals
- SMA 1 – Overdue between 31 to 60 days
- SMA 2 – Overdue between 61 to 90 days

Question

CA. Puranjay is appointed as statutory branch auditor of two branches of a nationalised bank for the year 2023–24. While verifying advances of one semi-urban branch, he noticed a substantial number of accounts categorised as SMA (Special mention accounts). In this context, explain the nature and significance of SMA. (RTP, Nov 2022, NA)

Answer

- Special Mention Account (SMA) is an account which is exhibiting signs of **incipient stress** resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.
- In case of SMAs, there are **overdues** for a **period of 0 to 90 days**. Since the period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.
- Such a classification is significant as early recognition of such accounts enables banks to initiate timely **remedial actions** to prevent potential slippages of such accounts into NPAs