# Bank Audit Referencer

**Eastern India Regional Council**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

# President, Vice-President, ICAI & Team EIRC 2016 – 17

**CA M. Devaraja Reddy**
President, ICAI

**CA Nilesh Shivji Vikamsey**
Vice-President, ICAI

**CA Anirban Datta**
Chairman, EIRC

**CA Manish Goyal**
Vice Chairman, EIRC

**CA Sonu Jain**
Secretary, EIRC

**CA Sumit Binani**
Treasurer, EIRC

**CA Nitesh Kumar More**
Member, EIRC

**CA Sanjib Sanghi**
Member, EIRC

**CA (Dr.) Debashis Mitra**
Council Member, ICAI

**CA Ranjeet Kumar Agarwal**
Council Member, ICAI

**CA Sushil Kumar Goyal**
Council Member, ICAI

**Mr. Sunil Kanoria**
Council Member, ICAI
(Nominated)

Eastern India Regional Council of The Institute of Chartered Accountants of India.



**Published by CA Anirban Datta, Chairman, EIRC**
On behalf of EIRC of The ICAI
ICAI Bhawan, 7 Anandilal Poddar Sarani (Russell Street)
Kolkata – 700 071
Phone : 3021-1140 / 1141
Fax : (91-33) 2227-2317
E.mail : eirc@icai.in
Website : www.eirc-icai.org

**Printed by :**
*Dayglo*
Suite No. 307
1 British India Street
Calcutta - 700 069
Phone : 2248-2167, 2210-5517
E.mail : dayglo.in@gmail.com

**March 2016**

# ABOUT THE ICAI

The Institute of Chartered Accountants of India is a statutory body established by an Act of Parliament viz., The Chartered Accountants Act, 1949 in the year 1949 for regulating the profession of Chartered Accountancy in the country. The Institute, which functions under the administrative control of Ministry of Corporate Affairs, Government of India, has five Regional Councils at Mumbai, Chennai, Kanpur, Kolkata and New Delhi. It presently has 149 Branches covering the length and breadth of the country, 22 Chapters outside India and an overseas office in Dubai.

Founded 66 years ago with just seventeen hundred members, the Institute has grown to cross mark of 2,40,000 members and 11,00,000 students as of now. A significant majority of our membership is in practice and a good deal of specialisation in traditional areas of direct/indirect taxes and in emergent specialism's inter-alia, in financial services, information technology, insurance sector, joint ventures, mutual funds, exchange risk management, risk and assurance service environment/energy/quality audits, investment counseling, corporate structuring and foreign collaborations. The other half was/is in employment, many occupying senior positions such as CMDs in Banks/Financial Institutions, CEOs in leading and reputed public/private sector companies etc.

One of the important elements of the developmental role of the Institute is to make contributions to Government authorities and Regulations viz., the Ministry of Corporate Affairs, Trade Policy Division of the Ministry of Commerce, CBDT, RBI, IRDA, C&AG, SEBI etc. to name a few, on relevant matters of importance to the economy and profession.

On International front, the Institute, a permanent member of International and Regional Accounting bodies, like International Federation of Accountants(IFAC), International Accounting Standards Board(IASB), Confederation of Asian and Pacific Accountants(CAPA) and South Asian Federation of Accountants(SAFA) has made its presence felt through its effective and sustained contribution Professional bodies like American Institute of Certified Public Accountants(AICPA) in U.S.A. The Institute of Chartered Accountants in England and Wales(ICAEW) in U.K. and a host of similar bodies in many other countries have signed MOUs with our Institute for professional collaboration in areas such as education, examination, training etc. and on issues confronting the accounting profession worldwide.

The Institute, being a statutory body, is administered by a Council which is the highest policy making body of the chartered accountancy profession. The Council is comprised of 40 members of whom 32 are elected from among its members spread all over the country. The remaining eight members are nominated by the Central Government representing such authorities as the Comptroller and Auditor General of India, Ministry of Finance, Ministry of Corporate Affairs and persons of eminence from the fields of law, banking, economic, business, finance, industry, management, public affairs etc.

# ABOUT EIRC

In 1952, Eastern India Regional Council (EIRC of ICAI) was constituted with its jurisdiction on West Bengal, Orissa, Assam, Tripura, Sikkim, Arunachal Pradesh, Mehalaya, Nagaland, Manipur, Mizoram and the Union Territory of Andaman & Nicobar Islands. The founder Chairman was Mr. Molay Deb and the office of EIRC was located in the 2nd Floor of 7, Hastings Street(Now renamed as Kiron Shankar Roy Road)

On 10th December, 1975, the foundation stone of the present EIRC Building at 7, Russell Street (Now renamed as AnandilalPoddarSarani) was led by the then Chief Justice, Calcutta High Court, Hon'ble Justice Shankar Prasad Mitra. On 14th April, 1977, the building was inaugurated by the then Hon'ble Governor of West Bengal, His Excellency Shri A.L. Dias.

On 17th January, 2014, the Second State of Art Building at 382/A, Prantik Pally, Rajdanga, Kasba, Kolkata-700107 has been inaugurated and the same is in operation to cater its dedicated service to its more than 23,000 Members and 90,000 Students.

EIRC has 11 Branches, 18 Study Circles, 5 Study Circles for Members in Industry, 5 CPE Chapters and 8 Study Groups.

EIRC has the privilege and pride in presenting 10 Presidents to ICAI and each one of them has enriched and empowered the profession through their visionary leadership and innovative dynamism.

The cherished dream of EIRC is to kindle the spark within the fraternity and to make the members world class professionals as well as good human beings – to contribute as an active partner in the nation building exercise.

# CHAIRMAN'S MESSAGE

Dear Professional Colleagues,

It gives me immense pleasure & pride to present before you the Bank Audit Referencer for the first time by Eastern India Regional Council of The Institute of Chartered Accountants of India. It has been our endevaour to consolidate relevant matters in a concise form, so that it can be of immense use to you for conducting Bank Audit more efficiently.

With Indian Economy becoming a vibrant one, its necessary for India's Banking Industry to strengthen itself significantly so as to support the Indian economy to grow faster than the other economies of the world. For a safe and sound banking system, one of the most essential requirement is reliable &clear financial information supported by quality audit of all banking transactions to regain the confidence of all the stakeholders of society at large. Here comes the role of the auditors of banks who play a pivotal role in enhancing the credibility of the banking system. Thus in order to equip our members with updated knowledge on banking industry Eastern India Regional Council has brought out this referencer for more meaningful use.

I wish to place on record the contribution and unstinted support by all my colleagues in the Regional Council & Central Council in bringing out this Referencer. I must make special mention of CA Nitesh Kumar More, Chairman, Research Committee who has taken tireless effort to bring out this referencer at such a short notice so as to enable us to launch the same in the Seminar on Bank Audit on 19th March 2016.

I am sure that the members will find this referencer useful in providing a comprehensive overview of the functioning of banks and on critical aspects of bank audit. I would be glad to receive inputs and suggestions from the readers of this publication for making this Referencer more useful in future.

Date : 19th March 2016
Place : Kolkata

**CA Anirban Datta**
**Chairman, EIRC**

# CHAIRMAN, RESEARCH COMMITTEE'S MESSAGE

***As Chairman of Research Committee of EIRC of The ICAI, it's my duty to bring good publications for the benefit of the Members. This publication is only a step forward in this direction.***

In recent times, a number of important developments have taken place in the banking sector which certainly needs the attention of the auditors. In view of the same, we have brought out this Bank Audit Referencer to keep the auditors of banks updated of all the latest developments in the Banking Sector.

Efforts have been taken to compile this referencer lucidly and vividly to simplify the professional work of our members. Various topics related to bank audit has been covered in the most concise manner so as to make this Referencer handy.

I take this opportunity to place on record my sincere gratitude to CA Anirban Datta, Chairman, EIRC for keeping faith on me and for nominating me as Chairman of Research Committee of EIRC. I would like to place on record my sincere appreciation for the dedicated team of professionals who have worked seriously in making this referencer a reality. Though we have taken all efforts for making this document error free, but chances of certain errors can't be ruled out. In case you come across any error, please send your suggestions to eircreferencer@gmail.com.

I am sure that with bank audit being just round the corner, this referencer would be immensely helpful to all the users.

**CA Nitesh Kumar More**
**Chairman, Research Committee**
**& Member, EIRC**

Date : 19th March 2016
Place : Kolkata

# ACKNOWLEDGEMENT

We are thankful to all the tireless efforts in earnestly contributing for the Bank Audit Referencer. Without their kindest support this would not have been a success.

CA Abhay V Kamat

CA Abhijit Sanzgiri

CA Ashutosh Pednekar

CA Dewang Wagani

CA Ketan Saiya

CA Kuntal P Shah

CA Niranjan Joshi

CA Nitant Trilokekar

CA Rahul Joglekar

CA Sunirmal Chatterjee

CA Uday Sathaye

CA Vipul Choksi

CA Vivek Newatia

**Officers of EIRC**

Dr Alok Ray, Joint Secretary & Regional Head

Mr Amit Paul

Mr Saibal Chakraborty

Mr Pradyut Chakraborty

CA Jyoti Luharuka

# INDEX

# RISK BASED AUDIT IN BANKS

Special audit considerations arise in audit of banks because of:

- Particular nature of risks associated with the transactions undertaken;
- Scale of operations and resultant significant exposures which can arise within short period of time;
- Extensive dependence on IT to process transactions;
- Effect of the statutory and regulatory requirements; and
- Continuing development of new products services and practices not matched by concurrent development of accounting principles and auditing practices.

Evolution of technology and providing services through RTGS/ NEFT, Net Banking and Mobiles has exposed Banks to a huge operational and financial risk.

A sound internal audit function plays an important role in contributing to the effectiveness of the internal control system. Audit function should provide high quality counsel to management on effectiveness of risk management and internal controls including regulatory compliance. Historically, internal audit system in banks has been concentrating on transaction testing, testing of accuracy and reliability of accounting records and financial reports, integrity, reliability and timeliness of control reports, and adherence to legal and regulatory requirements. In the changing scenario such testing by itself would not be sufficient. There is a need for widening as well as redirecting scope of internal audit to evaluate adequacy and effectiveness of risk management procedures and internal control systems in banks.

Internal audit is an independent management function which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism including the entity's strategic risk management and the internal control system.

Internal audit constitutes a separate component of the Internal control with the objective to determine whether other controls are well designed and operating effectively.

To achieve these objectives, banks will have to gradually move towards risk-based internal audit which will include, in addition to selective transaction testing, an evaluation of the risk management systems and control procedures prevailing in various areas of a bank's operations. The implementation of risk-based internal audit would mean that greater emphasis is placed on the internal auditor's role in mitigating risks. While focusing on effective risk management and controls, in addition to appropriate transaction testing, the risk-based internal audit would not only offer suggestions for mitigating current risks but also anticipate areas of potential risks and play an important role in protecting the bank from various risks.

Under risk-based internal audit, the focus will shift from the present system of full-scale transaction testing to risk identification, prioritization of audit areas and allocation of audit resources in accordance with the risk assessment. Banks will, therefore, need to develop a well defined policy, duly approved by the Board, for undertaking risk-based internal audit. The policy should include the risk assessment methodology for identifying the risk areas based on which the audit plan would be formulated.

Understanding the concept of risk is of utmost importance.

Risk is vulnerability, a threat, an uncertainty or unpredictability of outcome which affects the achievement of laid down goals & objectives. Risk is a function of probability or likelihood of the event happening and the impact or the significance. This can be mapped to a matrix based on 3 point scale of High, Medium or Low or a 5 point scale of Critical, High, Medium, Low and Remote.

The risk assessment would, as an independent activity, cover risks at various levels (corporate and branch; portfolio and individual transactions. as also processes in place to identify, measure, monitor and control the risks. The internal audit department should devise the risk assessment methodology, with the approval of the Board of Directors, keeping in view the size and complexity of the business undertaken.

The risk assessment process should, include:-

- Identification of inherent business risks in various activities undertaken by the bank.
- Evaluation of the effectiveness of the control systems for monitoring the inherent risks of the business activities ('Control risk').
- Drawing up a risk-matrix taking into account inherent business risks and control risks.

The risk assessment methodology should include, following parameters:

- Previous internal audit reports and compliance
- Proposed changes in business lines or change in focus
- Significant change in management / key personnel
- Results of latest regulatory examination report
- Reports of external auditors
- Industry trends and other environmental factors
- Time elapsed since last audit
- Volume of business and complexity of activities
- Substantial performance variations from the budget

The annual audit plan, approved by the Board, should include schedule and rationale for audit work planned. It should also include all risk areas and their prioritisation based on the level and direction of risk. The primary focus of risk-based internal audit is to provide reasonable assurance to the Board and top management about the adequacy and effectiveness of the risk management and control framework in the banks' operations. While examining the effectiveness of control framework, the risk-based internal audit should report on proper recording and reporting of major exceptions and excesses. Transaction testing would continue to remain an essential aspect of risk-based internal audit. The extent of transaction testing will have to be determined based on the risk assessment

At the minimum, it must review/report on:-

- Process by which risks are identified and managed in various areas;
- Control environment in various areas;
- Gaps, if any, in control mechanism leading to frauds, identification of fraud prone areas;
- Data integrity, reliability and integrity of MIS;
- Internal, regulatory and statutory compliance;
- Budgetary control and performance reviews;
- Transaction testing/verification of assets to the extent considered necessary
- Monitoring compliance with the risk-based internal audit report
- Variation, if any, in assessment of risks under audit plan vis-à-vis risk-based internal audit.

The Internal Audit Department should be provided with appropriate resources and staff to achieve its objectives under the risk-based internal audit system. The staff possessing the requisite skills should be assigned the job of undertaking risk-based internal audit. They should also be trained periodically to enable them to understand the bank's business activities, operating procedures, risk management and control systems, MIS, etc.

Banks outsource the audit function to external firms of Chartered Accountants.Before entering into an outsourcing arrangement for risk-based internal audit, the bank should perform due diligence to satisfy itself that the outsourcing vendor has the necessary expertise to undertake the contracted work. The contract, in writing, should at the minimum, specify the following:

- o Scope and frequency of work to be performed
- o Manner and frequency of reporting, manner of determining cost of damages arising from errors, omissions and negligence
- o Arrangements for incorporation of changes in the terms of contract,
- o Locations where the work papers will be stored
- o Internal audit reports are the property of the bank and all work papers are to be provided to the bank when required
- o Employees authorized by the bank are to have reasonable and timely access to work papers
- o Supervisors are to be granted immediate and full access to related work papers

Management to continue to satisfy itself that outsourced activity is competently managed.

All work done to be documented and reported to the top management through internal audit.

To avoid significant operational risk arising due to sudden termination of outsourcing arrangement, banks to have a contingency plan to mitigate discontinuity in audit coverage.

Some of the risks which a bank is exposed are –

1) Credit risk
2) Market Risk
3) Operational risk
4) Liquidity & solvency risk
5) Reputational risk
6) Regulatory risk
7) Settlement risk
8) Counterparty risk
9) Concentration risk
10) Technology risk

All the risks will have a financial impact.

The basic role of the audit will be to ensure that the bank has properly identified the risks either in a Risk Register, Risk Universe or in a Risk Library. The Risks have to be properly classified into a 3 point scale of High, Medium or Low. Alternatively a 5 point scale can also be used.

Risk prioritization will mean tackling the urgent & important high risk first or an immediate basis depending upon the severity or criticality of impact.

Auditor will have to be evaluate the design of controls in place to mitigate or reduce the risks and manage it an optimum level. These will have to be tested whether they are operating effectively and serving the purpose for which they were setup. In case the controls are not strong enough, these will need strengthening or additional controls will need to be designed and implemented to reduce or minimize the risk.

There will always exist an inherent or gross risk. The controls will minimize the gross or inherent risk to a level called residual risk which has to be within the Risk appetite of the organization.

All risks have a positive upside of opportunity or reward if managed well and audit will have to provide the assurance that risks are being managed at an optimum level.

Audit will need to be aligned to organizational objective & priority. It will have to be aligned with the speed of risk. The risk based audit plan will have to be nimble and agile to change with business urgencies & priorities.

Adaptability has to be the buzzword.

Audit will have to be conducted in accordance with the Standards of audit & the COSO framework. Audit has to add value. It should ensure that the findings are implemented and should follow up for closure of the open issues. Focus will have to be on the root cause of the issue, so that the root cause is addressed to ensure that the error does not occur again.

Audit will be process based identifying redundant process for removal or suggesting improvements in existing processes or suggesting new processes.

Focus will not only be on costs and compliance but on effectiveness of controls to manage risks.

Audit has to move from Hindsight to a Insight and a Foresight Function.

It has to ensure that the vast amount of data is translated in to Information which adds to Knowledge & Wisdom.

Audit will have to be a forward looking function not just being fault finding to a solution providing role.

The Institute of Internal auditors has defined internal audit to include an Consultative role also.

Relevancy & usefulness of the recommendations made by audit should be a key for value addition. Is audit making an impact and is contributing positively to strengthening the risk management function. Is it making findings that should have the top management worried and ensure they act immediately.

Some of the new concepts in audit are –

1) Continuous Control Monitoring
2) Governance, risks & controls

3) 3 lines of defence
4) Audit of effectiveness of Board
5) Audit of ethics & organizational culture
6) Audit of Corporate Communications
7) Audit of strategy

Skills needed by an internal auditor can be summed up as -

1) Effective communication
2) Ability to Simplify information
3) Critical / Strategic thinking
4) Ability to Identify key issues & problem solving
5) Functioning well under pressure
6) Generating new ideas & scenarios
7) Learning – Unlearning – Relearning -
8) Team player & adaptive
9) Analytical & orientation for details
10) Ethical , Responsive & Insightful

Auditors will have to be tech savvy and good communicators to obtain a buy in for their issues. Change is the only constant in the future and there will be a continuous learning, unlearning and relearning process.

The internal audit methodology can be stated as under -

Internal audit will initially have a meeting with the Senior Management to discuss the Risks faced by the Organization. Based on the risks identified by the business, a broad audit scope or expectations from the audit will be laid down. **Business, Operational, Regulatory, Financial, Reputational, Regulatory** or any other types of risks faced by the business would be duly considered. The **risk of Fraud** will also be duly considered.

**The essential purpose of the audit is to give an assurance to the management of the effectiveness of the controls in place to mitigate the risks faced by the business in the achievement of their objectives.**

To opine on the Control assurance toward Risk mitigation, audit will focus on the **Design of controls in place & their implementation.**

Audit will conduct a detailed **walk-through** to review the existing processes, policies & procedures in place in the organization to evaluate the effectiveness in mitigating the risk – ie the Threat or the Vulnerability.

In the course of the walk through or in the conduct of the actual audit there could possibly be identification of new risks which would be brought out & discussed with the management.

Audit will review the existing **Risk classification** conducted by the business in to **High, Medium & Low** duly considering the **Probability & the Impact** & evaluate the adequacy of the current controls whether **Manual or Automated – Detective or Preventive or Deterrent.** Based on the review audit will suggest **strengthening of existing controls, incorporating new controls or removal of redundant controls.**

Based on these preliminary workings, a Risk based audit plan will be broadly drawn up to address the key risks. The audit plan would have the necessary flexibility to cover additional areas based on identification during course of the audit or new events / regulations impacting the business from time to time. The focus will be to pay attention & use audit resources in areas where the risks are significantly high.

**A detailed sample work plan would be as under:**

1. Identification of the Audit team members including the supervisor duly noting the seniority of the team & their experience in conducting similar audits and briefing them about the detailed scope of audit

2. Obtain a listing of the **Organization** Chart & the accounts, records, policies maintained.

3. Prepare a detailed audit schedule and annual work plan for review of activities / sub-activities in the processes – Transactional reviews including compliance checks, **snap & spot checks, surprise & special audits.**

4. Communicate the same to the Management of the company & obtain the Go-ahead.

5. Initiate the audit as per Schedule

   A. Gain the detailed understanding of the business functions to be audited

   B. Understanding the existing systems and controls in place to address the risks

   C. Prepare a **Risk Matrix** based on financial, non-financial and other parameters to determine the areas where risk is significantly higher & needs **immediate & urgent attention.**

   D. Following general objectives to be achieved by process of Internal Control which may be preventive / detective – Manual or Automated :

      - Execution of orderly, ethical, economical, efficient and effective operations;
      - Fulfilling of accountability obligations;
      - Compliance with applicable laws and regulations;
      - Safeguarding resources against loss, misuse and damage

6. Test of Controls:

   A. Evaluate the effectiveness of Internal Control System followed in each of the areas selected in a particular reporting period by doing a process walk through with focus on key risk areas through compliance and substantive testing,

   B. Give Recommendations after assessment of controls whether operation of internal control is satisfactory or needs improvement or is to be designed

7. Deal with critical issues identified during audit and recommend probable solution for gaps noticed;

8. Preparing draft audit report and discussing with the person responsible for the specific area and obtain their response which will be incorporated in the audit report.

9. If Issue noted is serious needing immediate & urgent attention, then the same would be escalated on the spot to the management irrespective of the reporting deadlines.

10. Based on the management responses and corrective actions initiated, prepare a final report and submit to the management with an Executive Summary within agreed timelines. The report will clearly identify the Root cause of the issue and give recommendations to mitigate the same. The type of the risk and the classification of the risk into High, Medium or Low or other parameters / scale as discussed with the Management will be stated. The Report will incorporate Management Responses and Closure Date.

11. Open issues to be tracked and reported in the next audit report. Submitting a summary of the effectiveness of the controls at the start of the audit engagement – after 6 months of the audit & after a year of the audit to indicate the improvements in the control process as a result of the audit.

**Ultimate success of audit will be that it will eventually make itself redundant and be a validating function.**

# CONDUCTING BRANCH AUDIT IN CBS ENVIRONMENT

**Introduction**

Over the past few years we have experienced core banking solution in almost all banks. The CBS as it is popularly called has changed the manner in which banking activity happens. The delivery channels have expanded from branch banking to net banking to mobile banking and now even to social media channels. Electronic medium of transaction and communication has become the base of all banking activities. Coupled with this situation is the trend of banks to centralize operations either at one location or at regional hubs. These hubs handle significant back office operations and control activities. Some of them are housed in cities away from where the central or regional offices are located and rely heavily on electronic transmission of data. There is also a proliferation of using out sourced agencies for support activities. RBI has guidelines on which activities can be out sourced. The common thread to all this out sourcing is once again the reliance on electronics – computers and data transmission equipments and the software that resides in each of them.

As auditors our challenge lies in executing our tasks in this new environment with the same high standards expected of our profession. Bank branch audits have been a significant segment of a chartered accountant's audit practice. The profession has kept pace with changing business and technologies practices across a spectrum of industries and hence, the changes that have happened in the banking industry should not be a stumbling block to us auditors.

Considering the timelines that are given for a bank branch audit, it is necessary that we achieve what the auditing standards expect of us to achieve within the same timelines. To that extent we can reinvent ourselves and use the technology to meet our audit objectives.

Normally, the appointment of a bank branch audit is received in the latter half of March. And the audit of the branch is expected to be completed within the first week of April. Hence, in general there are about ten to twelve working days available within which the auditor is required to familiarize himself with the control environment of the bank, comprehend the business processes, understand the technology deployed, do the substantive and compliance verification and then form an audit opinion.

However, it is my opinion all the above can be achieved without compromising on any of the requirements of professional standards and conducting procedures of "Auditing Through the Computer" and "Auditing Around the Computer". In the ensuing paragraphs I have attempted to elaborate the key processes that an auditor can do once he is appointed to conduct the audit of a bank branch. The ICAI's Guidance Notes on Audit of Banks gives detailed guidance of auditing in a computerized environment. There are certain checklists which are included in the Guidance Note; these can be used in the conduct of audit. Arising from that checklist are few suggested audit procedures for us to adopt.

**First few steps**

As soon as the audit is accepted and all due processes completed, schedule a meeting with the manager of the branch that is to be audited. Request that in this meeting the person in charge of systems at the branch is also present. It may be that there would not be a designated system executive; but there would most certainly be an official who will be responsible for the functioning of the information system facilities in the branch. In a CBS system such a person has a limited role of trouble shooting in the Bank as well as the main liaison man with the Data Centre.

We need to list out the following for our reference and work

a) What is the CBS environment? This will have to be summarized by the response received and any interface permitted with the DC.
b) Which software is implemented across the bank? This should be visible in the screens of the application.
c) Whether the software is bought out or customized?
d) Whether any steps are necessary to be taken at the branch when the software is modified / updated centrally?
e) Details of the hardware installed at the branch
f) How is the network managed? Does the branch have any role to play in the same?
g) What are the other softwares in the branch?
h) Does the CBS have any interface with these softwares? If there is interface then the quality of this interface needs to be judged on the basis of ensuring non duplication of loading into the main application, inclusion of all records etc.
i) Whether the branch has been subjected to system audit during the year?
j) What are the findings? Findings will permit you to evaluate the weak areas.

In case the branch has migrated into a CBS environment during the year or there has been a version change then we need to get the following information:-

a) Whether a migration / version change audit was done at the branch?
b) If so, peruse the audit report and get satisfied that all the balances have been duly carried forward and there are no issues which would affect the database in the new environment
c) If not, ask whether the migration / version audit was done at an organizational level and whether the findings of that audit are available at the branch?
d) If no audits were done, how has the bank / branch satisfied itself that all the data, balances etc have seamlessly migrated into the CBS environment?

The CIA Principle is fundamental to any computerization.

C = Confidentiality

I = Integrity

A = Availability.

The auditor needs to get comfort that the system is designed as implemented and there have been no incidents whereby the data is adversely affected vis-à-vis the CIA principle then it would be reasonable to place reliance on the records produced from the CBS environment for audit.

In addition to all the above first steps we need to peruse the internal audit, concurrent audit and system audit reports on the branch. We need to be satisfied that all matters that have arisen out of these reports are adequately addressed to by the bank by implementing suitable mitigating controls.

**Next Steps**

We should request for a read alone access to the CBS. This is akin to a request for the ledger in a non-computerized environment. The read alone access will enable us to peruse the transactions, accounts at our pace and style. To do this, we would, of course be a need for us to gain an orientation on how the CBS is configured. Since it is not possible for us to gain complete knowledge of how the CBS works and the various menus built into it, it will be necessary of us to request that the SE or some other knowledgeable person to accompany us while we navigate through the system. With the help of this designated bank officialwe can run queries of various situations on the branch data. The queries could be of such nature that would help us accomplish our audit objectives. These include:-

a) Identification of NPAs based on defaults in excess of 90 days The application will generate some report that displays default on basis of time for Loans as well as Cash Credit accounts
b) Identification of potential NPAs by focusing on year end transactions as also transactions that happened at the beginning of next year
c) Application of correct interest rates, both for advances &deposits needs to be verified on basis of either circulars or specific changes to any account under instructions from higher office
d) Application of interest rate modifications should be verified to ensure the change is made effective from the desired date
e) Accuracy of interest computations at least on test check should be done per facility
f) Accuracy of mandates given by customers such as auto-sweep, recurring deposits etc.
g) Accuracy of charges for non-funded facilities
h) Accuracy of other service charges such as number of withdrawals, note counting etc.
i) Existence of serial control over recording of transactions needs to be ensured by noting the vouchers carry the serial number is manually written

The output of these queries will reveal transactions of exceptional nature. From the information so generated we can select our samples for further substantive verification dovetailing with the source documents, their authorization and the appropriate capturing of the transaction in the books of account.

We need to test the adequacy of the interfaces by taking a sample of few cases where the data moves from CBS to the other software and vice-versa. There would be different softwares for uploading transactions into CBS from ATM, Net Banking, Mobile Banking etc.

If the CBS does not by itself apply IRAC norms and generate a NPA statement then there would be another software which does this analysis. It will be our task to be satisfied that the data that has flown into this other software is also accurate and from the CBS itself. This can be done by requesting the SE to run queries on both the softwares, (the transaction processing software CBS and the data analysis software) and matching the result so obtained. Over the past few years public sector banks have been advised to configure the CBS in a manner that IRAC norms and NPA statements are generated without any manual interventions. Hence, it is necessary for us to obtain an understanding of this configuration of the CBS.

As auditors we have immense experience of banking transactions. We should use this experience for conceptualizing various situations and then requesting the SE to run queries for them. The results of these queries will enable us to assess the performance of the branch vis-à-vis controls and adequacy of the CBS database. This will enhance our confidence in forming our audit opinion on the financial statements of the branch.

All our observations, findings, reservations arising out of the above steps will have to be discussed with the branch head. Based on his reactions and our audit findings appropriate remarks will have to be given in the LFAR.

# PLANNING OF BANK BRANCH AUDIT

Banking is a dynamic activity which has constantly been undergoing change. The recent past has witnessed banking industry becoming focus of attention towards its capital requirement and growing number of non-performing assets. Being backbone of economy, it is essential that the banking industry remains healthy and robust. Auditing within its scope of work contributes actively by ensuring proper financial reporting and disclosure aspects of banking industry.

Audit based on sound knowledge of business of the auditee is essential. The auditors of banks should familarise themselves thoroughly with the changes in operations of banks. One must keep themselves abreast with the latest developments in the banking sector including activities of regulator RBI.

Considering the computerization in Banking Industry, Auditors must plan their audit in systematic way to understand and discharge the duties of auditors in the available time frame.

**<u>Need to Plan</u>**

**"Failing to plan is planning to Fail".**

**"Prior Planning Prevents Problems".**

**<u>Objective of Audit Planning</u>**

a. Compliance with RBI / ICAI Guidelines
b. Compliance with Banks internal guidelines / manual of instructions
c. Compliance with terms of appointment
d. Compliance with Accounting Standards
e. Compliance with Standards on Auditing.
f. Cover all types of allied responsibilities during the audit, such as:
   - ✓ Requirements of Long Form Audit Report.
   - ✓ Requirements of Tax Audit Report.
   - ✓ Requirements for Ghosh & Jilani Committee Reports.
   - ✓ Other certification work as required by bank.
   - ✓ Compliance with BASEL I & II Guidelines framework
g. Reporting should be effective.
h. Completion of the audit in time.
i. Compliance with Peer Review / Quality Review Requirements

**<u>Characteristics, which distinguish Banks from other Commercial Enterprises</u>**

a. As they have custody of large volumes of monetary items, which needs to be stored and transferred, they are vulnerable to misappropriation and fraud.
b. As they have large volume and variety of transaction in both numbers and value, they require complex accounting and internal control systems.
c. Normally operates through wide network of branches requiring decentralization of authority and delegation of power.
d. Wide range of services offered such as ATM, net/phone banking, etc.
e. As they often assume significant commitments without any transfer of funds, these "off balance sheet items" may not involve accounting entries and consequently, the failure to record such items may be difficult to detect.

Special audit consideration arises because of the nature of risks associated with Banking transactions, the scale of operations, the effect of statutory and regulated requirements and the continuing development of new services and banking practices. The basic audit planning activities are divided in to three segments namely Off Site Preparations and On Site Preparation and Audit Executions.

**SEGMENT – I    OFF SITE PREPARATIONS**

✓ Audit under Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970.

- ✓ Coordination with branch
- ✓ Appointment Letter received from the Bank.
- ✓ Acceptance Letter to be sent to Bank, if unable to accept the audit, state reasons.
- ✓ Other letters, declarations, like letter of fidelity and secrecy, not indebted to bank, etc.
- ✓ Intimation to the Previous Auditor for no objection from them.
- ✓ Obtaining Basic Information from Appointment Letter.
- ✓ Issue Audit Engagement Letter
- ✓ Obtaining information about branch.
- ✓ Send Draft representation letter in Advance
- ✓ SA 310 – Knowledge of Business
- ✓ Study Latest RBI circulars to understand regulatory requirements.
- ✓ Study Latest updated Guidance Note on Bank Audit Issued by ICAI
- ✓ Study applicable Accounting Standards at the Branch Level
- ✓ Study applicable Standards on Auditing
- ✓ SA 200 – Basic Principles Governing Audit
- ✓ SA 230 – Audit Documentation
- ✓ SA 500 – Audit Evidence
- ✓ SA 400 – Risk Assessment and Internal Control
- ✓ SA 300 – Audit Planning
- ✓ SA 220 – Quality Control for Audit Work
- ✓ Understanding and defining concept of materiality to audit team
- ✓ Knowledge about CAAT tools
- ✓ Basic documentation requirements for Peer Review / Quality Review

Have a *"Birds Eye View"*:

- ✓ Knowledge of Economy
- ✓ Knowledge of Banking Industry, the Bank and its branch.
- ✓ Knowledge of Government Policies
- ✓ Knowledge of Rules & Regulations applicable
- ✓ Knowledge of the organisational structure of the Bank
- ✓ Knowledge of complexity of products handled by Bank
- ✓ Knowledge of FEDAI Guidelines
- ✓ Knowledge of Accounting Standards

Familiarity with Third Schedule of Banking Regulation Act, 1949 for the form of Balance Sheet and Profit & Loss Account.

**SEGMENT – II ON SITE PREPARATIONS**

- ✓ Obtaining the list of books maintained by the branch.
- ✓ Understand the computer software (basic operational knowledge)
- ✓ Obtain latest audit reports; i.e., external auditors and internal inspection reports.
- ✓ Obtain monthly average of advances and deposits.
- ✓ Review accounting policies and auditors report of the bank for the preceding year.
- ✓ Understanding Internal Controls at branch
- ✓ Obtain H.O. circulars/guidelines of CSAs.
- ✓ SA 200 – Objectives & General Principles
- ✓ SA 210 – Terms of Audit Engagement
- ✓ SA 220 – Quality Control for Audit work
- ✓ SA 230 – Audit Documentation
- ✓ SA 300 – Planning an Audit of Financial Statements

- ✓ SA 320 – Audit Materiality
- ✓ SA 401 – Auditing in Computerised Environment
- ✓ SA 500 – Audit Evidence
- ✓ SA 510 – Initial Engagements
- ✓ SA 520 – Analytical Procedures
- ✓ SA 530 – Audit Sampling
- ✓ SA 610 – Relying on work of Internal Auditor
- ✓ SA 710 – Comparatives
- ✓ SA 720 – Auditors Responsibility in relation to other information in documents containing Audited Financial Statements
- ✓ Audit Review
- ✓ Meetings with Branch Officials and maintaining minutes of important points discussed.
- ✓ Choosing appropriate CAAT tool to assist in audit under computerized environment
- ✓ Comparative Ratio Analysis with previous year figures.

<u>Check whether the branch is a specialised branch like</u>

- ✓ Housing finance branch
- ✓ Agricultural finance branch
- ✓ NRI branch
- ✓ Personal banking branch, etc.

<u>Preparation of Audit program and execution</u>

a. Define broadly the scope of Audit. Identify thrust areas.

b. Define the Audit Team with clearly defined scope of work

c. Once the requirements for the Audit and the weaknesses of the internal control are known, the thrust areas can be identified.

d. Set materiality level standards for each area of checking.

e. Lay down an over all time schedule.

f. Ensure that the Audit staff is satisfactorily trained and there is sufficient skill and competence for specialised areas.

g. Keep flexibility in the Audit plan for giving extra focus to weak areas, identified during the course of audit.

h. The Audit program should cover all areas under liabilities, assets, income, expenditure and off Balance Sheet items. However there should be special emphasis on verification of advances, income recognition and provisions to be made. The broad areas which the branch auditors should verify are:

   - ✓ Physical verification of cash, security papers, valuable securities etc.
   - ✓ Deposits.
   - ✓ Advances.
   - ✓ Sundry Assets/Suspense Accounts.
   - ✓ Sundry Liabilities.
   - ✓ Inter Branch Reconciliation.
   - ✓ Frauds discovered
   - ✓ Fixed Assets.
   - ✓ Contingent Liabilities.
   - ✓ Income Heads.
   - ✓ Expenditure Heads.
   - ✓ Ratio Analysis

i. Go through the Accounting Manual and the Procedures Manual of the bank wherever required.

j. <u>Areas generally not to be considered at branch, as they will be considered by HO are:</u>

   - ✓ Provision for Gratuity.
   - ✓ Provision for Taxation.
   - ✓ Provision for Audit fees
   - ✓ Depreciation on Assets

- ✓ Provision for pension and other retirement funds.
- ✓ Transfers to reserves.
- ✓ Dividends.

k. Obtain Audit evidence and Management representation letter from the branch.

l. Analytical review – compare current year's financial information with previous year's information as well as with the budgets setup. Calculate significant ratios to understand the business and identify areas where there is a potential of misstatement of financial information.

m. Compliance review – review compliance with banks, internal policies, RBI circulars and Accounting Standards.

**SEGMENT – III AUDIT EXECUTION**

**Evaluation of Internal Control Systems**

a. While evaluating the internal control the main concern of the auditor is to see the following objectives:
   - ✓ Executions of transactions are in accordance with authorisations.
   - ✓ Recording of transactions are of the correct amount in the appropriate account and the accounting period.
   - ✓ Safeguarding of assets from unauthorised access.
   - ✓ Physical verification of assets undertaken at reasonable intervals compared with book records and appropriate action taken for differences, if any.
   - ✓ Most important requirements is to verify the controls in software being used at the branch

b. Review various audit / inspection reports at the branch such as:
   - ✓ Previous Year's Statutory Audit Report and LFAR
   - ✓ Internal Inspection Report
   - ✓ RBI Inspection Report
   - ✓ Concurrent Audit Reports
   - ✓ IS Audit Report
   - ✓ Charge Handover Report

   Most important to verify compliance with these reports by branch.

c. Evaluate the strength, effectiveness and weakness of the control systems. In areas where deficiencies have been noticed in the earlier Audit reports; actual transactions can be tested by the Auditor.
   - ✓ Apply Audit Procedures.
   - ✓ Documentation — SA 200.
   - ✓ Materiality — SA 320.
   - ✓ Memorandum of changes to be given with explanations, justification and clarity.
   - ✓ In case of NIL MOC, issue a NIL MOC Statement and do not write audit report subject to MOC
   - ✓ Independence of main report and LFAR — No Referencing of each other, independent qualification/adverse remarks.
   - ✓ Discuss the draft reports — reservation, major observation, qualifications with branch management prior to finalisation of reports.
   - ✓ Qualifications to be given in bold/italics
   - ✓ To quantify the qualification and also quantify the total effect of all the qualifications put together separately in the main report.
   - ✓ Issue of final reports in time.

**Revenue Leakage**

**Parameters for Audit of Income Expenditure**

- ✓ The Income earned or expenses incurred should be on account of the carrying business of the bank.
- ✓ The element of personal expenses should not be present
- ✓ Amount mentioned in books of account should be supported by documentary evidences
- ✓ There exists proper authentication for all the transactions as per delegated authority
- ✓ There exists proper internal control at the branch
- ✓ Arithmetical accuracy for rate, quantity etc. is verified.

**Major Threats**

- ✓ Repetitive Transactions
- ✓ Large Number of Transactions
- ✓ Availability of time for audit
- ✓ Weak internal controls at the branch
- ✓ Lack of awareness about computerized environment

**Methodology**

<u>Computerized Records</u>

- ✓ Review procedures for Application of Interest / Other charges
- ✓ Review internal controls established in the system
- ✓ Verify the calculation of interest on test check basis
- ✓ Accounting Entries
- ✓ Verification of Change Reports – Tracking Changes in Rate of Interest, effective date

**Manual Records**

- ✓ Review procedures for Application of Interest / Other charges
- ✓ Review internal controls established in the system (Duel control / Maker Checker)
- ✓ Verify the calculation of interest on test check basis
- ✓ Accounting Entries
- ✓ Ratio Analysis – Total Advances / Deposits to Total Interest Received / Paid

**Income**

**Interest on Advances**

The Interest on Advances is accounted on monthly rests, on accrual basis except interest on NPA accounts, which is accounted on realization.

<u>Auditors should:</u>

1. Study the procedures for calculation of interest.
2. Check the existence of proper internal controls exists.
3. Check the Head Office circular for change of rates on advances.
4. Check the correct date from which the rate has been changed.
5. Check the interest on test check basis in each type of advance accounts.
6. Check whether any advance account is upgraded or downgraded.

Revenue Leakage

- ✓ Rate of Interest charged is different than the actual sanctioned rate.
- ✓ Change in Interest Rate (PLR) whether recorded correctly in the system.
- ✓ The NPA account upgraded during the year, interest is not charged for the year.
- ✓ The advance account classified as NPA during the year, Interest serviced during the year is also reversed as unrealized interest.

**Interest / Income on Investments**

Investment Department is generally audited by Statutory Central Auditors and the procedures followed for verification of interest on investments are similar to that followed in case of Interest on Advances.

In case of Investments held at the branch on behalf of Investments Department

<u>Auditors should:</u>

1. Understand the nature of Investments held by the branch.

2. Check the existence of proper internal controls exists.
3. Check the interest on test check basis in each type of investments
4. Ascertain the reasonableness of the figure of interest eared on respective investments during the year

Revenue Leakage

- ✓ Cheque for Interest / Dividend / Coupon as on 31.03.2010 not accounted on accrual basis
- ✓ Interest / Dividend not received for the full year

**Other Income**

Other Income includes income by way of:

- ✓ Commission
- ✓ Exchange & Brokerage
- ✓ Profit / Loss on Sale of Investments / Other Assets
- ✓ Profit / Loss on Revaluation of Investments / Other Assets
- ✓ Profit / Loss on Foreign Exchange Transactions
- ✓ Miscellaneous Income

Auditors should:

1. Check the existence of proper internal controls exists.
2. Check the rate of commission on test check basis in each type (Guarantees / Letter of Credits / Demand Drafts / Pay Orders / MTs / TTs / Travellers Cheques / Gift Cheques etc.)
3. Check whether the Change of various rates and the record date for the same, as per the Head Office Circular are recorded properly in the system. Check value date.

**Revenue Leakage**

- ✓ Check the rate of commission for DD / PO / TT / MT for Cash Transaction which is generally 1.5 times of the charges for regular account holders of the bank.
- ✓ Check the date of issue and expiry of guarantees and letter of credits as the commission is charged on per quarter basis.
- ✓ Processing fees on Advances not recorded.
- ✓ Previous year income received in advance not accounted during the year (Bank Guarantee commission)
- ✓ Circular for change in rates received by the branch after the date from which the same was changed.

**Head Office Interest (Transfer Price Mechanism)**

Though the Profit and Loss account at the branch includes HO Interest in the Revenue side, it is the internal matter of the Bank considered globally.

Auditors should:

1. Verify the calculation of HO interest as per the HO Guidelines.
2. Check the arithmetical accuracy of the Interest as per the formula given.

Revenue Leakage

- ✓ Whether the amount of deposits / advances / other business at the branch is correctly taken in the statement.

As the HO interest is internal to the bank and compensating at the Head Office of the Bank, it is suggested that the MOC need not be passed for the same.

If the amount of difference is material, the auditors can qualify their report stating that the Profit / Loss for the year at the branch is overstated / understated by Rs.______/-.

**Expenses**

**Interest on Deposits**

The Interest on Advances is accounted on monthly rests, on accrual basis except interest on NPA accounts, which is accounted on realization.

Auditors should:

1. Study the procedures for calculation of interest.
2. Check the existence of proper internal controls exists.
3. Check the Head Office circular for change of rates on advances.
4. Check the correct date from which the rate has been changed.
5. Check the interest on test check basis in each type of advance accounts.
6. Check whether any advance account is upgraded or downgraded.

Revenue Leakage

- ✓ Rate of Interest charged is different than the actual sanctioned rate.
- ✓ Change in Interest Rate (PLR) whether recorded correctly in the system.
- ✓ The NPA account upgraded during the year, interest is not charged for the year.
- ✓ The advance account classified as NPA during the year, Interest serviced during the year is also reversed as unrealized interest.

**Interest on borrowings from RBI and Inter bank Borrowings**

Generally not applicable at the branch.

In case if there are borrowings with RBI or other banks, the Branch Auditors should verify the interest applied as per the terms of sanction and respective changes in the rate if any.

**Operating Expenses**

- ✓ Payment to and provisions for employees
- ✓ Rant Taxes and lighting
- ✓ Printing and stationery
- ✓ Advertisement and publicity
- ✓ Depreciation on Bank’s property
- ✓ Directors’ Fees, allowances and expenses
- ✓ Auditors’ Fees and expenses
- ✓ Law Charges
- ✓ Postage, Telegrams, Telephones etc.
- ✓ Repairs and maintenance
- ✓ Insurance
- ✓ Other Expenditure

Auditors should:

1. Check the existence of proper internal controls exists.
2. Verify that the entries are supported with documentary evidence
3. Twelve months transaction / expenses are debited

Revenue Leakage

- ✓ Current Years provisions not made / Previous years provisions not reversed
- ✓ Items in Sundry Assets / Suspense Accounts not accounted for.
- ✓ Expenses to be recovered from the borrowers / other branches / HO

## SEGMENT – IV AUDIT REPORTING

### Memorandum of Changes (MOC)

Memorandum of Changes (MOC) is a mechanism by which the Branch Auditors record the changes to be effected in the Financial Statements of the Branch at the yearend. The Statutory Audit of Bank is a huge exercise carried out by the bank and the various stages involved in the Statutory Audit are summaried below:

- ✓ Annual Closing at all the branches / departments
- ✓ Preparation of Financial Statements at the Branch
- ✓ Unaudited results submitted to respective Regional Offices / Controlling Offices
- ✓ Commencement of Branch Statutory Audit / Departments Statutory Audit
- ✓ Consolidation of Branch Results at Regional Level
- ✓ Consolidation of Regional Office Results at the Head Office Level
- ✓ Finalisation of Statutory Audit of Bank by the Statutory Central Auditors of the Bank
- ✓ Publication of Audited Financial Statements of the Bank

The un-audited Closing Statements, Financial Statements are sent to the respective regional offices and subsequently the Branch Auditors start their audit exercise for the same. During the Audit carried out the branch / departments, any discrepancy, error, misstatements is observed by the branch manager or suggested by the branch auditor, it is not practically possible for the branch to correct / rectify the said changes in all the sets of statements.

Memorandum of Changes (MOC) provide for a facility to record such changes in a systematic format provided by the bank.

The Branch Auditors should verify the previous year's MOC and check that the accounting entries for the same are passed during the year under audit.

During the course of audit the auditors observe any discrepancy, error, misstatement, which need immediate rectification at the branch, the materiality of such transaction has to be considered before passing MOC for the same.

All the MOC should be discussed with the branch manager in detail and necessary supporting / working / documentary evidences should be attached with the same.

If the auditors feel that the MOC's given by them amount to material misstatement and affects the true and fair view of the financial statements, suitable qualification can be given in the main report.

MOC's of the various branches are consolidated at the Controlling / Regional Office and the summary of the Region is sent to Head Office for Consolidation. After the Audited Financial Statements are published, the Controlling / Regional Office sends the MOC pertaining to each branch and the necessary entries are passed at the branch level by giving effect in "Head Office Closing Adjustment Account"

### Preparation and Submission of Audit Report

a. All issues should be discussed with the Branch Manager.
b. Changes should be made through the MOC.
c. Qualification to be made in main report and not in LFAR.
d. Concept of materiality should be observed while reporting.
e. The reports & observations should be in clear & unambiguous language.
f. Quantification should be made wherever possible.
g. Discuss with CSA or Controlling authorities at Bank, wherever required.
h. Record the extent of check carried out in all areas
i. Minute the major discussions held with the branch manager.
j. Main report should be a self-contained document, no reference to the LFAR.
k. Submit all reports simultaneously.
l. Obtain the Management Representation Letter.

## Long Form Audit Report in Case of Bank Branches

The Long Form Audit Report [LFAR] is an effective tool to the auditors to keep the Bank informed about the important matters arising out of the statutory audit exercise. The Institute of Chartered Accountants of India [ICAI] has issued guidelines to its members for conducting the statutory bank audit. In the current format, the question answer format is retained for the branches however for regional offices and head office the same has been made in a narrative format. There is also an Annexure to be given along with the LFAR, which is applicable for branches having large/irregular/ critical advance accounts having large limits.

The Branch is responsible for compiling the information / statements required for LFAR and the auditors should verify the same. Auditors should ensure that the documentation of files is adequate and the records and working papers are planned and filed systematically in respect of matters included in the LFAR.

Regional Office / Zonal Office / Head Office / Statutory Central Auditors / External Auditors / RBI auditors etc are the various users of the LFAR

Aagainst each question in LFAR the branch auditors are expected to comment upon their observations during the course of audit. Where the auditors have any reservations or adverse remarks with regard to any of the matters to be dealt with in their LFARs, they may give the reasons for the same. Also, where relevant, instances of situations giving rise to their observations or adverse remarks may also be given. Where any of the comments made by the auditors in their LFAR are adverse, they should consider whether a qualification in their main report is also necessary. It should not however, be assumed that every adverse comment in the LFAR would necessarily result in a qualification in the main report. In deciding whether a qualification in the main report is necessary the auditors should use their discretion in the facts and circumstances of each case.

Auditors should avoid writing answers to LFAR as Yes, No or Not Applicable, instead a detailed answer about the observations against the question is expected. Any observations which require adjustment in books of accounts should be reported in LFAR along with reporting as MOC in Statutory Audit Report.

If the branch covered by specialised questionnaire are mentioned below then appropriate questionnaire of LFAR must be reported:

a. Branches dealing in Foreign Exchange
b. Branches having large advances, excess of Rs. 100 Crores.
c. Branches dealing in NPA like Asset Recovery Branches
d. Branches dealing in Clearing House Operations

For Large / Irregular / Critical Accounts of Advances having outstanding of Rs. 2 crores or 5% of total advances at branch must be reported through Annexure to LFAR. The information must be compiled by Branches and Auditors must verify the correctness of the information.

## Other Certificates

Audit Report is a reasonable assurance however Certificate is an absolute assurance. Hence great attention is expected while verifying and issuing any certificate during the bank branch audit process.

Types of certificates generally issued in bank branch audit:

a. Branch Returns (BS PL Other Schedules)
b. Audit Report
c. Memorandum of Changes
d. LFAR
e. Tax Audit Report
f. Jilani & Ghosh Certificate
g. Capital Adequacy – BASEL I II III
h. DICGC Claims
i. Prime Ministers Rojgar Yojana
j. Service Tax
k. Cash Balance on 12 Odd Dates
l. Sectorwise Advances

m. Bucket of Maturity for Deposits /Advances
n. Interest subvention
o. Exposure in Foreign Currency
p. Exposure of Intra Group transactions
q. IRAC / NPA Certificates
r. Restructured Advances
s. Foreign Currency Assets & Liabilities

The above list is illustrative and for each bank the same is provided in closing circular. Auditors are expected to include requirements and audit process for verification of these various certificates and execute the same during audit.

# TECHNIQUE FOR CONDUCTING BRANCH AUDIT OF BANKS

The Nationalised Banks appoint the Statutory Branch Auditors from the eligible list of Chartered Accountant firms forwarded by the Institute of Chartered Accountants of India and approved by Reserve Bank of India. It is a well know fact that statutory branch audit of Banks is a special type of assignment and bulk of our members get opportunity of such assignment only once in a year and that too the audit has to be completed within the stipulated time. Therefore, in order to complete the audit in efficient manner within the time frame, in addition to make an "Audit Plan" well in advance [based on Standard on Auditing (SA) 300 (Revised)], one has to familiarised with the latest guidelines issued by Reserve Bank of India on "Income Reorganisation, Asset Classification and Provisioning Norms" on 1 st of July, 2015, Banking Regulation Act 1949 and other relevant matters associated with Statutory Branch Audit. I am making an attempt to summarise the steps to be taken for conducting statutory branch audit in effective manner within the time frame allotted by the respective banks.

**1) On receipt of the appointment letter:**

- Communication with the previous auditor for obtaining "No objection" letter from the said audit firm.
- On getting the "No objection" letter from the previous auditors, issuance of the acceptance letter to the appointing bank along with Statement of Fidelity, Confidentiality etc.
- Obtain the Closing Circular/ Accounting Guideline issued by the Head Office of the appointing bank.
- Issuance of the "Engagement Letter"
- Download the "Significant Accounting Policies" & "Notes on Accounts" of the previous year ended 31/03/2015 of the appointing Bank.
- Formation of an in-house "Audit Team" well in advance, to be deputed for branch audit. The team should be constituted preferably by members having experience of Bank Audit.
- If possible, collect the Audit Report, Copy of MOC, Long Form Audit Report (LFAR), Tax Audit Report, System Audit Report etc of the previous year.
- Visit the branch prior to commencement of audit with prior intimation of the branch in charge and go through the Concurrent Audit Report (if available), Inspection Report, RBI Inspection Report (if any), stock audit reports, list of top ten NPA borrowers, top 10 borrowers including the borrowers enjoying consortium advance with the name of the banks in the consortium and leader bank. , list of stressed Accounts with potential NPA, list of borrower accounts upgraded to standard from NPA etc.
- Study the files of large borrowers accounts of the branch and the periodical reports send by the branch to the higher authorities in respect of the stressed Accounts.
- Based on the study of Guidelines issued by Reserve Bank of India on "Income Reorganisation, Asset Classification and Provisioning Norms" Significant Accounting Policies" & "Notes on Accounts of previous year, Closing Circular & Accounting Instructions, Inspection Reports, Concurrent Audit Reports, Last year Statutory Audit Report & LFAR etc, draw an "Audit Program".
- Make separate file, if the appointment received for more than one branch. Put the copy of the Audit Program in each of such files along with the copy of previous year audit report, LFAR and response of the branch against the adverse comment, if any, in previous year's LFAR.
- Due care should be taken in drafting the Audit Program, so that the same cover the relevant questionnaire appearing in the LFAR.
- As per Para (5) of LFAR, large advances are those in respect of which the outstanding amount is in excess of 5% of the aggregate advances of the branch or Rs.2 Crore, whichever is less. For review of such large advances, the Branch is suppose to provide details of Large/ Irregular / Critical Advances, which is placed as "Annexure" to the LFAR. In some bank it is called as LFAR-II. Such LFAR-II contains several information about the borrowers including the **Limits sanctioned, Outstanding Balance, Security (both primary & collateral security), relevant financial data as per audited statement of accounts of the borrower, current year's provisional figures, future projection given by the borrower etc.** The said "Annexure" to LFAR also have space for comment of the Branch Auditors in respect of each large borrower accounts. **As such, before commencement of the audit, the branch should be asked to provide the LFAR-II**, so that the branch auditor can put his comment there.
- Please do not forget to carry letter head of the firm, seal and introduction letter addressed to the branch containing name of the team members and leader of the team. The letter should be issued under signature of the partner or proprietor of the firm.

## 2) On commencement of audit in the branch

(A) I suggest that instead of completing the LFAR after completion of the audit in the branch, attempt should be made to carry the work simultaneously covering the areas, comments against which have to be given in respect of the various questionnaire of the LFAR. In order to do that, following steps should be taken on commencement of the audit:

- Physical verification of Cash, Stamp, Stationery etc. Examination of the cash book of the branch to ascertain in how many occasion the balance of the branch has exceeded the cash retention limit fixed by the higher authorities of the bank.
- Obtain the signed Trial Balance, Profit & Loss A/C and Balance Sheet with schedules of the branch for the year ended 31 st March, 2016.
- Study whether the branch is maintaining any account with other banks and call for the statement of that bank with the reconciliation of balance, if any.
- Check the Profit & Loss Account of the branch from the relevant data/ records including variation of income and expenditure in comparison to Last year.
- In CBS, interest is calculated by the system. Therefore, on sample basis check the parameter set in the system for calculation of interest.
- Check the Deposits including FD/RD/TOD/Matured FD etc. Emphasis to be given to overdue/ matured deposits and interest provision on those matured deposits has been made as per policy/ instruction of the respective bank.

(B) Checking of Advances:

In the LFAR, the branch auditors have to give their comment in respect of **(a) Credit Appraisal, (b) Sanctioning/ Disbursement, (c) Documentation (d) Review/Monitoring/Supervision (e) Guarantees and Letters of Credit etc.**

In order to verify the advances and give comments, the branch auditors need to familiarise the team with the following guidelines issued by RBI in respect of "Asset Classification"/"Identification of NPA":

i. Interest and/ or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.

ii. The account remains **'out of order'** in respect of an Overdraft/Cash Credit (OD/CC).

An account should be treated as "Out of Order" if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. 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'.

iii. The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.

iv. The instalment of principal or interest thereon remains overdue for two crop seasons for short duration crops,

v. The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.

Example of Short Term & Long Term Crops Short duration crops:

Onion 60 to 65 days

Pulse crops around 90 days.

Medium duration crops : ( around a year)

Example: sugarcane.

Long duration crops:

Mango, Lichhi, sapota etc (yielding from 4th Year to 25 and/or more years).

For identification of Short Term Crops or Long Term Crops, please refer to hand book published by Indian Council of Agricultural Research (ICAR)

vi. The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitisation dated February 1, 2006 issued by RBI.

vii. In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Based on the aforesaid guidelines issued by Reserve Bank of India for identification of advances, checking of advances to be conducted in respect of Term Loan, Cash Credit & Overdraft, Bill Discounted, Agricultural Loan (short duration & long duration crop), House Building loan etc.

**In addition to the above, special emphasis has to be given on the following areas of checking:**

**1) Review of RESTUCTURED ACCOUNT**

The provision for diminution in the fair value of restructured accounts should continue to be maintained by banks as per the existing instructions. In addition, the banks are required to disclose:

- Details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable);
- Provisions made on restructured accounts under various categories; and
- Details of movement of restructured accounts.

Accordingly, banks should disclose in their published Annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances as per the format given by RBI.

**2) Review of the NPA A/C and Provisioning there of**

**For review of the NPA Accounts, following matters should be kept in mind:**

- On identification of NPA Account as per the guidelines stated above, interest should be reversed by debiting interest account and crediting Advance Account of the borrower. To check "Interest not collected A/C" how has been kept in the system.
- In term of **clause 4.2.5 of Master Circular issued by RBI, "If the arrears of Interest and Principal are paid by the NPA borrower, the account should be upgraded to standard**". Therefore, in case up gradation of NPA A/C to Standard, it is necessary to check whether arrear interest and principal have been paid by the borrower. That is why it is necessary to check "Interest not collected A/C" how has been kept in the system.
- On sample basis outstanding balance of NPA, date of NPA, Security value and provision in the NPA A/Cs should be compared with the corresponding data for the quarter ended December'2015.
- To check whether the system automatically flag the **ab-initio** (unsecured exposure) NPA A/Cs and such sub-standard NPA A/Cs, provision has been made @ 25% in place of normal sub-standard A/C where the provision required for 15%.
- What is policy of the bank in respect of recovery of NPA A/C, whether interest would first recognise or the outstanding principal?
- What is the basis of allocation of security value in case of NPA borrower having more than one facility availed from the bank. **This is particularly important in view of the following guidelines issued by RBI in para 4.2.9 of the Master Circular:**
  a) If the erosion in the value of security is less than 50% of the value assessed by the bank or accepted by RBI at the last inspection, then such NPA should straightway classified under doubtful category and provision should be made as applicable to doubtful asset, which is 100% of the unsecured portion of advance and 25% (up to one year) of the secured portion, 40% of secured portion (One to three years) and 100% of secured portion (more than 3 years)
  b) If the realisable value of security by Bank/ Approved Valuers less than 10% off the outstanding balance, then the account should be straightway classified as" Loss" and 100% provision should be made.

  **Beside checking of Advances in the manner stated above, checking of the following areas are also required to give the comments against the various questionnaire of LFAR:**
- Review of the L.C Devolved and Bank Guarantee invoked.
- Inter Branch transaction adjustment account.
- Debit balance in current A/C, Saving Bank A/C. Review of the exception report of 30 th & 31 St March to find out major adjustments made by the branch on the last day.
- Checking of Contingent Liability.
- Fraud, if any, in the branch and its present status. Whether the matter has been reported to higher authority. What is the policy of the bank for making provision against "Fraud", whether at the branch level or centrally at Head Office, based on the information obtained from the branches?

- Checking of "Other Assets" like **a) Stationery and stamps (b) Suspense Accounts / Sundry Assets etc.**
- Checking of **Liabilities**, which includes checking of "Deposits" (Fixed Deposit & other Term Deposits, Current Account Deposits, Saving Bank Deposits etc).
- Checking of **Other Liabilities**, which includes checking Bills Payable, Sundry Deposits etc.
- Checking of the items of Profit & Loss A/C of the branch including checking of depreciation on fixed assets, Scrutiny of the "Other Advances" to identify whether advances against the Capital/Revenue items have been adjusted on completion of the purpose for which the advance has been given. For example advance has been given to contractor for modification of counters of the branch. The work has been completed and the counters are in use but still the advance is appearing in the branch.
- Checking of Inter Branch Accounts and Other matters of Critical Importance.

For other areas not cover above, please refer to the "Guidance Notes on Bank Audit" issued by Institute of Chartered Accountants of India.

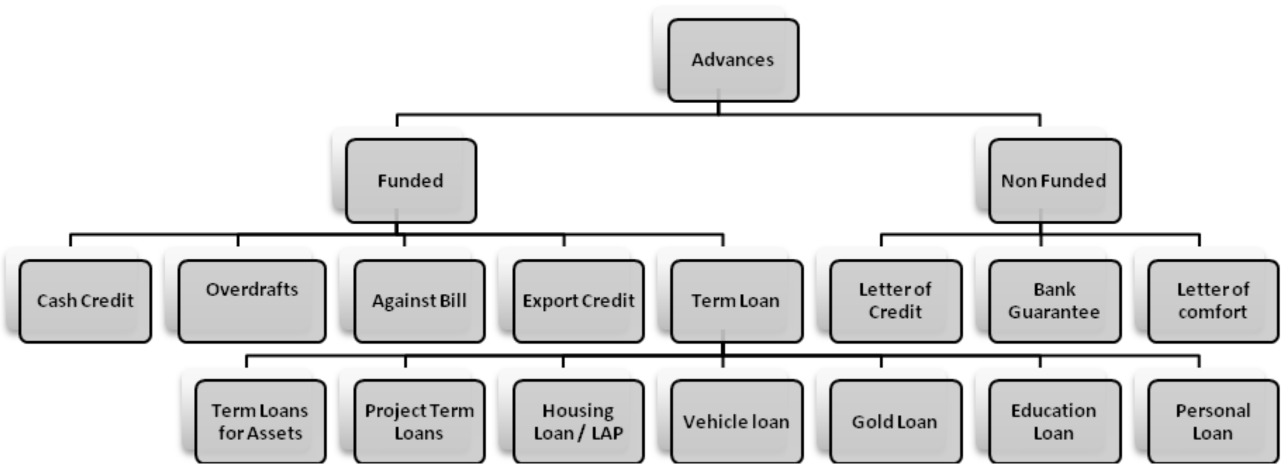
# VERIFICTAION OF ADVANCES FUNDED – NON-FUNDED

**I. Introduction and Overview**

Primarily the banks are in business of lending money i.e. Advances, that's the main source of bank's earning. Interest, commission and other income earned from advances constitute major income of the banks. Bank receives fund in the form of various deposits at specified interest rate and after adding the sufficienet margin it lends the same money to borrower in the form of adances. Out of total deposits received the bank is supposed to maintain CRR / SLR margins for liquidity and safety and balance money is allowed to be gven as loans and advances.

**a) TYPE OF LOANS**

The banks have been granting various types of advances which are clasifed as Fund based and Non-fund based. Type of advances under fund based and non fund based category are as under:




**(i) FUND BASED**

Fund based advances are the one wherein the actual movement of funds from bank is certain

**1. Cash Credit**

Cash credit facility is provided mainly to individuals or enterprises engaged in manufacturing and trading activities to enable them to meet the gap in their working capital requirements and are repayable on demand. The amount of cash credit facility to be sanctioned to a unit is need-based and is worked out as per well-defined parameters in each bank; the guidelines of the RBI may also affect the quantum of the facility in some cases. The cash credit facility is generally granted against the security of stocks of goods, standing crops, bills / book debts representing genuine sales – all belonging to the borrower. These assets are 'primary' security for the advance and are hypothecated to Bank. Although borrower is sanctioned particular amount of loan , he would be allowed to withdraw maximum up to the drawing power which is calculated based on the value of security and after reduction of margin and unpaid creditors. Drawing power may be less than the sanctioned limit , if there is a reduction in level of security after the sanction.

**2. Overdrafts**

Overdraft facility may be secured or unsecured and generally does not carry a specific repayment schedule. Most common form of security offered are fixed deposit receipts with same branch, LIC policies, Shares, NSC receipts etc.Under the arrangement, the customer can draw upto an agreed sum in addition to his credit balance in the account. The overdraft facility may be either secured or clean (I.e. without security) and does not generally carry a repayment schedule. Mode of operations is same as cash credits. Like cash credit, in case of overdraft account, borrower is allowed to withdraw maximum upto the drawing power which is calculated based on the value of security less margin.

**3. Bills**

While the cash credit finance against stocks is intended to be used for financing the pre-sales stages, i.e., procurement of raw materials, their processing and conversion into finished goods to bring them into saleable condition as well as to carry reasonable quantities of these goods lying in various stages, the finance against bills is meant to finance the actual sale transactions. The finance against bills can be in any of the below mentioned form:

Purchase of bills by the bank if these are payable 'on demand'.

Discounting of bills by the bank if these are usance (or time) bills.

Advance against bills under collection from the drawees, whether sent for realisation through the bank or sent directly by the drawer to the drawees.

**4. Term Loan**

Loans are repayable in instalments spread over a period of time. Loans with repayment periods beyond 36 months are usually called 'Term Loans' whereas loans with repayment period up to 36 months are called short term loans However both are similar in many respects: both have pre-determined repayment schedule. The basic difference between the two is that term loans are for acquisition of capital assets, which then becomes the security for the loan, i.e., end use of funds is fixed. There are various types of terms loans as depicted in flow chart above. Various loans are given with different objective however nature of operations will be same such as one time disbursement and repayment through instalment with interest may be EMI.

**5. Foreign Currency Loans**

Banks are authorized to lend in foreign currency. These loans are given as per the EXIM policy and guidelines issued by Reserve Bank of India from time to time. Foreign currency loans may be in nature of term loans or working capital loans

**6. Export Credit**

Exporters are also granted facilities in the form of cash credit and bills only but, being of a special nature, require a separate mention here.

**a) Pre-shipment credit**

In pre-shipment credit all advances required to finance the production cycle – from procurement of raw materials to bringing them to the port for despatch. The exporter usually adjusts the account by drawing bills of exchange on the foreign buyer, which are discounted by the bank under the letter of credit and the proceeds collected from the foreign bank. This also can be in foreign currency more popularly known as PCFC.

**b) Post-shipment credit**

The post-shipment credit relates to financing of bills raised on the overseas buyer upon shipment of goods/ services**.**

**(ii) NON FUND BASED**

**1. Letter of Credit(LC)**

Letter of credit is an undertaking by the bank to the payee (supplier of goods and services), on behalf of the buyer as per the terms of the LC.

**2. Bank Guarantee**

A Bank guarantee is a contract between the bank and the beneficiary of the guarantee which is independent of the contract between the bank and its customer on whose behalf the guarantee is issued by the bank. This implies that in case the beneficiary makes a demand of any money under the guarantees, the bank is obliged to unconditionally pay the sum so demanded, within the amount guaranteed.

**3. Letter of Comfort**

Banks issue a letter normally to their correspondence to confirm that they have created charges on securities of the correspondent's borrowers, on the strength of which the said correspondent releases financial assistance to the borrower. Such letters are called 'letters of comfort'.

**b) TYPE OF SECURITIES:**

**i) Primary and Collateral Securities**

The term 'primary security' refers to the security acquired by the borrower with bank finance or the one against which credit has been extended by the bank. Primary security is the principal security for an advance. A collateral security, on the other hand, is additional security, which provides a cushion to the bank in case of need. Banks accept various types of assets as collateral security.

**ii) Personal Security of Guarantor**

The personal security of guarantor comprises a guarantee by a third party for payment of outstandings in the event of default by the borrower. No charge is created on the guarantor's movable or immovable assets. The personal security of guarantor can be enforced only through the competent Court of law.

**iii) Fixed and Floating Charges**

A fixed charge (also called 'specific charge') is a charge on some specific and ascertained assets. The creator of the charge (i.e., the borrower) cannot deal with the asset without the specific consent of the holder of the charge (i.e., the lender). A floating charge, on the other hand, is an equitable charge on the assets, present as well as future. A floating charge attaches to assets whose condition varies from time to time in the ordinary course of business (e.g., work-in-process). A floating charge crystallises (i.e., becomes a fixed charge) when money becomes repayable and the holder of the charge (i.e., lender) takes necessary steps for the enforcement of the security

**c) NATURE OF BORROWING ARRANGEMENTS**

**i) Sole Banking**

In this arrangement, the borrower obtains credit from a single bank. This is the simplest form of tie-up and is operationally convenient for both the lender and the borrower.

**ii) Consortium Arrangement**

In this type of arrangement, the number of lending banks is more than one. The lending banks form a formal consortium. Salient features of the arrangement are:

- The consortium has a formal leader, called the 'lead bank' (normally, the bank with the largest exposure).
- There is a common set of loan documents, which is obtained by the lead bank on behalf of other participating banks also.
- The lead bank is responsible for overall monitoring.
- The member banks of the consortium have rights over the security in an agreed proportion.
- The borrower maintains direct business relationship with all member banks of the consortium.

**iii) Multiple Banking**

In this type of arrangement, there is no formal arrangement amongst the lending banks. Each of them has its set of loan documents, securities and mode of lending, independent of other lending banks. The borrower has to deal with each of the banks separately.

## II. Verification of Advances:

Following paragraphs narrates the audit evidence which auditor needs to obtain ,how to obtain the evidence and overall approach for verification of advance:

**1. Obtain appropriate audit evidence about the following:**

- Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- Advances represent amount due to the bank.
- Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- There are no unrecorded advances.

- The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
- The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

**2. How to obtain appropriate audit evidence ?:**

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.

**3. Evaluation of Internal Control:**

Auditor need to examine following important aspects for evaluation of internal control,

- Existence of clearly laid down delegation of authority.
- Existence of clearly laid down eligibility criteria for loans.
- Existence of system of communicating the terms of sanction to the borrower.
- Existence of system of execution of documents before disbursement.
- Existence of system of post disbursement monitoring and reporting irregularity.
- Existence of system for implementation of IRAC Norms.
- Adequate control on changing of interest etc in CBS environment.

**4. Extent of Verification:**

- Due to the large volume of accounts ,its not possible for auditors to verify all the accounts of advances and therefore auditors may select samples on following basis.
- All large advances whose year-end balance is in excess of Rs.2 crore or 5% of the aggregate year-end advances of the branch, whichever is less (All large advances are required to be commented in LFAR and therefore all large advances need to be verified)
- Advances which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc.
- Advances which are sanctioned during theyear
- The accounts identified to be problem accounts . Such accounts can be identified from control returns which are sent periodically to controlling offices.
- Other small advances on a selective basis

**5. Stages of Verification:**

Broadly the areas of verification of advance can be divided in to four stages as under:

**i. Pre sanction – Credit appraisals etc.**

Before sanctioning a loan, bank has to ascertain various aspects like credit worthiness of borrower, viability of the project/business for which the loan is proposed to be sanctioned, review of project report, future projections ,realisability of amount ,quality of securities offered etc. Verification of all these important aspects is known as credit appraisal. Officer of the bank who does credit appraisal need to have sound knowledge of credit and related aspects.

Some of the important aspects which need to be verified by auditor to ensure that appraisal is done properly are:

- Whether prescribed Application Form has been received from the borrower for fresh or renewal proposal
- KYC Compliance has been done as Per RBI Requirements
- Evaluation of latest audited financial statements is done by the officer who does appraisal
- Review of Project Report Projected Profit & Loss Account, Balance Sheet & Cash Flow – Whether realistic? This can be done by comparison with the standards of particular industry, past performance via vis future projections etc.
- Verify that important Financial ratios are satisfactory such as
  - Debt Equity ratio
  - Debt service Coverage ratio and other ratios
- Board Resolution for the availment of the facility being obtained
- Availability of relevant statutory documents like industrial license, registration with pollution control board, Sales Tax Authorities etc.
- Latest Income Tax Returns of Borrower
- Details of associates and sister concerns
- Latest Income Tax and wealth tax returns of guarantor and their net worth statement.
- In case borrower is shifting his account from one bank to another then Confidential report and NOC from the existing banker should be obtained.
- CIBIL Report to ensure that prospective borrower has not defaulted in the past, Title clearance report & valuation report in respect of property being mortgaged.
- Confirm the adequacy of security cover
- Verify whether Exposure limit (including derivative instruments) is within the limits fixed by Bank-group wise, Industry wise & policy of Bank
- Whether Appraisal done by Competent person

**ii. Sanction, Documentation and disbursement:**

**a) Sanction:**

After the appraisal ,if the account is found suitable for disbursement of loan then the loan would be sanctioned. But the loan would be sanctioned depending on the amount of loan sanctioned. Sanctioning authority could be the Branch Manager or it could be the Board. Some of the important aspects which need to be verified are:

- Proposal has been routed through appropriate authorisation levels and recommendations are properly documented and noted
- Limits sanctioned are within the discretionary powers of the sanctioning authority
- In case where the sanctions are beyond the discretionary powers, the same has been reported to appropriate authorities and ratified within specified period
- Any change in the terms of sanction is ratified by appropriate authority

**b) Documentation:**

This is one of the important aspect of verification of advances. If documents are not executed properly then it could create a difficult situation for bank in case of litigation. Some of the important aspects of verification of documentation are:

- All loan documents, as required by the sanction letter and loan policy have been executed (e g. DP Note, loan Agreement, Letter of guarantee, hypothecation Agreement, etc). Each bank has its own set of rules regarding the documents to be obtained from various types of borrowers and in respect of different kinds of facilities.
- Whether loan documents are complete in all respects. Many a times it is observed that officers have tendency of keeping documents blank and some times it is filled by more than two persons at different point of time resulting in change in handwriting. This may create legal complication and therefore auditor need to report on this aspect.

- Loan documents are properly executed and approved by legal department or advocates on panel of bank. This again is very important aspect especially in case of large advances. Auditor is not supposed to be an expert in verifying whether documents are adequately stamped etc. Therefore it is very important that documents are approved by legal experts.
- Fresh loan documents are obtained on change in limit, change in the constitution of the borrower
- Original agreement, share certificate, title deeds, title clearance certificate valuation report are held on record
- Charge on securities offered have been registered with registrar of companies/ appropriate authority
- Lien marking in case of loan against fixed deposit
- In case negative lien is marked in case of a property then NOC of housing society should be on record.
- In case of consortium advance original documents are kept by the lead Bank. The member bank must have copy of these documents .
- Some of the banks have now started system of maintaining documents at a centralized location and therefore documents may not be available at the branch for verification. Auditor in such situation would be required to visit such location and verify document or get them at the branch.
- Some banks also execute documents in local language i.e documents are not executed in English language. Therefore if auditor does not know that language ,it would be difficult for him to verify the validity of documents. In such situation he may have to insist for translation or confirmation of validity of such documents by an expert.
- Verify that documents are not time barred

**c) Disbursement:**

It must be ensured that disbursement is not done without execution of documents. Some of the other aspects which need to be verified in respect of disbursement are:

- Pre disbursement unit inspection has been carried out & report held on record
- Acceptance of the borrower confirming the terms & conditions of sanction is obtained
- Verify that Disbursement done only after compliance of all terms of Sanction terms and conditions

**iii. Monitoring/Supervision**

Post disbursement ,monitoring of an account is of paramount importance and if an account is monitored properly it may turn NPA. Therefore auditors need to verify that the account is properly monitored by the concerned official of the bank and following important aspects need to be checked by auditors and offer their comments.

- Critically review operations in account, specially at month end, quarter end. Whether turnover in account is healthy? If there are accounts of group companies in the same branch then auditor may verify whether there are many transactions with such group companies. Because of paucity of time it may not be possible for auditor to verify all the accounts but only critical accounts which are perpetually overdrawn.
- Fund disbursement has been utilised towards the object for which limit was sanctioned i.e. Not diverted to group companies / associates or used to pay of existing overdues
- Regular QIS, Stock & Debtors statements are submitted by borrowers and scrutinised by concerned officer to identify non moving stock and old debtors and eliminate such assets while calculating drawing power. Also verify that drawing power is calculated as per guidelines of the bank
- Periodic review of irregular/ overdue/ NPA accounts has been done at the appropriate level
- Whether physical inspection of units and stock verification is done by bank as per its policy and discrepancies noticed on such visits have been properly addressed.
- Whether all the assets hypothecated/mortgaged have been adequately insured with Bankers' clause
- Whether penal interest is charged if there is delay in submission of stock statement, account is continuously overdrawn etc.
- Verify annual audited financial statement of the borrower with the monthly stock statement for the last month of the year
- In case stock audit/inspection is done by an independent firm of Chartered Accountant. Whether discrepancies pointed out by them have been properly clarified by borrower.

iv. **Review/Renewal / Enhancement.**

All the limits which are sanctioned by bank have to be reviewed/renewed at the end of each year. This exercise is done with a view to review general performance of the account of the borrower and whether necessary credit discipline is maintained by him. In case borrower fails to achieve the projections given by him or does not maintain necessary discipline, at times bank may reduce the limit or recall the advance also. Similarly a borrower may need additional facility due to expansion of business .For such enhancement also review of accounts is done. As per prudential norms ,if banks don't review accounts within 180 days from the due date ,they are liable to become NPA. Therefore banks have become very conscious for review /renewal of accounts. Auditors need to verify that accounts have been reviewed as per due dates and they need to verify on test check basis that review is properly done.

Besides the above guidance ,Checklist for verification of various types of advances are given below:

| Sl. No. | Aspects to be checked | Checked by |
|---|---|---|
| | **Checklist on Loan and advances** | |
| 1 | Check the individual balance in each loan ledger with the trial balance book / Advance Sanctioned Register | |
| 2 | Verify the head office / appropriate authority, sanction /renewal for each advances with various circulars / guidelines issued by Bank / RBI. | |
| 3 | Verify that advances have been properly classified into Standard, Sub-standard, doubtful and Loss assets as per NPA norms issued by RBI | |
| 4 | See that margins are maintained in respect of secured advances | |
| 5 | Advances are classified in such a way that information required in schedule 9 of banking regulation act, 1949 can be gathered. Advances are classified in the balance sheet of banks in three ways- Classification based on nature of advance, classification based on nature and extent of security, classification based on place of making advances | |
| 6 | Ascertain whether Credit Scoring system has been accessed by the banks to assess the credit worthiness and capacity of a borrower to repay his loan and advances and also discharge his other obligations in respect of credit facility availed or to be availed by him particularly in view of Credit Information Companies (Regulation) Act, 2005 (CICRA). | |
| 7 | The auditor should examine that any advance made by a banking company otherwise than in the course of banking business, such as, prepaid expenses, is not included under the head 'advances' but is included under 'other assets' | |
| 8 | Examine that the operation of each advance is reviewed at least once in a year | |
| 9 | Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet | |
| 10 | 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 | |
| 11 | All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made | |
| | **Advances against Stock / Debtors** | |
| 1 | Examine the stock / debtors statements and ascertain that the loans availed is within the drawing power/limits sanctioned | |
| 2 | Verify the fire insurance policy and ascertain that polices are alive as at 31st March 20XX | |
| 3 | Verify that letter of hypothecation has been executed in favour of bank | |
| 4 | See that name board of the bank with mention of pledge /hypothecation has been properly displayed at a conspicuous place in borrower's godown | |
| 5 | Verify that charge is duly registered with ROC in case of loan on hypothecation to limited company | |
| 6 | Banks should have a system in place to ensure that the borrower does not avail the advantage double financing on same stock, i.e., financing from bank for the portion of stock not paid to the creditors | |
| 7 | Stock registers are maintained by the godown keepers of the lending bank in respect of goods pledged with the bank. The godowns are regularly inspected by the inspectors and other officers of the bank | |
| | **Loan on deposits (fixed deposits)** | |
| 1 | See that deposit receipts /pass books/ cash certificates have been duly discharged in favor of bank at the time of discharge | |

| | | |
|---|---|---|
| 2 | See that bank's lien have been marked on deposit receipts as in their respective ledger folio | |
| 3 | See that deposit receipts /pass books/ cash certificates have been duly discharged in favor of bank at the time of discharge | |
| 4 | Stock registers are maintained by the godown keepers of the lending bank in respect of goods pledged with the bank. The godowns are regularly inspected by the inspectors and other officers of the bank | |
| 5 | See that no advance is granted against duplicate receipt without proper verification | |
| 6 | In case of advances against deposit receipts of other branches ,to verify the intimation to that branch to mark the lien and to see that the same has been acknowledged by other branch | |
| | **Vehicle advance** | |
| 1 | Verify the copies of registration certificate with RTO Authority. | |
| 2 | Test check the original certificate and ascertain that endorsement is made in favor of bank | |
| 3 | See that vehicle has been comprehensively insured and verify the banker's clause in insurance policy | |
| | **Advance against immovable property** | |
| 1 | Go through the legal opinion of bank's lawyer about title of property to the borrower | |
| 2 | Verify the latest tax receipts towards the payment of property tax and verify the encumbrance certificate till the date of deposit of title deed | |
| 3 | Verify the engineer's valuation / Valuers' Valuation Certificate | |
| 4 | Verify whether building has been properly insured and policy has been taken in the joint name of bank and the mortgagor | |
| | **Advances against LIC** | |
| 1 | Scrutinise the insurance policy and ascertain the surrender value from LIC | |
| 2 | The surrender value of the policies is taken as the basis of valuation | |
| 3 | If surrender value is subject to payment of certain premium the amount of such premium has been deducted from the surrender value. | |
| 4 | Verify the latest premium receipts | |
| 5 | Satisfy that sufficient margin is kept | |
| 6 | Verify whether policies have been duly assigned by the insured in favour of bank and assignment is noted by LIC | |
| | **Advances against shares** | |
| 1 | Shares are accompanied by blank transfer deeds duly signed by the person (normally the borrower) in whose name they are registered | |
| 2 | In case of shares held in de materialised form, authorisation slips should be obtained from the borrower and kept by the banker | |
| 3 | Bankers' lien should be noted in de materialised account of the client | |
| 4 | If the person in whose name the securities are registered is other than the borrower, the bank satisfy itself that the person has a good title to the security. The bank also obtains a letter of renunciation from the person in whose name the securities are registered. | |
| 5 | When shares offered as security are under promoters' quota, banks require the promoters to provide an undertaking not to dispose of these shares during the tenure of the loan | |
| 6 | Banks insist that borrowers issue 'mandates' in their favour for collection of dividends, etc. | |
| | **Advances against bills purchased and discounted** | |
| 1 | All the outstanding bills have been taken in the balance sheet; | |
| 2 | All the details, including the nature of the bills and documents, are mentioned in the register and that the bills have been correctly classified | |
| 3 | The bills purchased or discounted from different parties are in accordance with the agreements with them and the total of outstanding bills of each party is not in excess of the sanctioned limit | |
| 4 | The bills are not overdue. If there are any overdue bills, the auditors should ascertain the reasons for the delay and the action taken by the bank | |

Note : Readers are advised to refer latest Guidance Note issued by ICAI. Latest Copy of the guidance note is available onICAI website : www.icai.org

# ADVANCES - IRAC NORMS

**BACKGROUND:**

In case of Banks, especially Public Sector Bank branches, Advances is generallythe largest item on the asset side of the balance sheet. In view of the recent news on sharp spike in loan write offs and increasing bad loans in the portfolio of Banks, the meaningful audit of advances has become most importantpart of Bank audit. In case an advance account is not servicing properly and becomes a Non-Performing Asset(NPA), primary responsibility of correct classification and making adequate provision for diminution in value of advance is that of the Bank'smanagement. However, these financial statements are also audited bythe statutory auditors and hence it is imperative for the statutory auditors to have thorough knowledge of"Prudential norms onincome recognition, asset classification and provisioning pertaining to advances" (IRAC Norms) as prescribed by the Reserve Bank of India(RBI).

The RBI has formulated standard prudential norms on income recognition and asset classification which are applicable to all the Banks in specific sector. Master circulars are also published every year in the month of July which is a compilation all the circulars related to the subject issued during the year.

The latest Master Circular No. DBR.No. BP.BC.2/21.04.048/2015-16 dated July 1, 2015 issued by RBI contains IRAC norms which are applicable for the statutory audit of banks for the year ending 31st March 2016. For the first time, RBI has introduced new frame work for Revitalisation of distressed assets in the above circular.

After issuance of above Circular, there are two more circulars issued by the RBI which are given below and can be referred to since there were published after the Master circular:

1. Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances – Credit Card Accounts dated July 26, 2015

2. Review of Prudential Guidelines - Revitalising Stressed Assets in the Economy dated February 25, 2016

Audit of NPA would basically involve identification of the account as NPA, its correct classification by the respective Branch, income recognition(reversal of unpaid interest charged), provisioning, if an account is restructured, compliance of various conditions as enumerated in the Master Circular etc.

Important aspects of the audit of NPA have been describedbelow:

**I. Identification of Account as NPA**

| Credit Facility | Basis for treating a Credit Facility as NPA | Remarks |
|---|---|---|
| **Term Loans** | Interest or principal instalment remains overdue for a period of more than 90days.As per para 2.1.3 of the master circular in case of interest payments, ifinterest due and not charged during quarter is not fully paid within 90 days from the end of the quarter, the account would become NPA<br><br>**Agricultural Advances:** Inrespect of agricultural advance, if interest and/or instalment of principal remains overdue for a period of more thantwo crop seasons for short duration crops and one crop season for long duration crops, the advance should be treated as NPA. | **Overdue:** An amount due to the bank under any credit facility is 'Overdue' if it is not paid on the due date fixed by thebank |
| **Cash Credits & Overdrafts** | The account remains continuously "out of order" for a period of more than 90 days i.e. Outstanding balance remains continuously in excess of the sanctioned limit/ drawing power or there are nocredits continuously for a period of 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period. | Banks may not classify an accountmerely due to existence of some temporary deficiencies, such as non- submission of stock statements and non-renewal of the limits on the due date,etc.<br><br>Outstanding in an account based on stock statements older than three months would be deemed irregular. Such account will |

| Credit Facility | Basis for treating a Credit Facility as NPA | Remarks |
|---|---|---|
| | | become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.<br><br>Further, an account where the regular/ adhoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of adhoc sanction respectively, will be treated asNPA |
| **Bills Purchased & Discounted** | The bills purchased/discounted remains overdue for a period of more than 90 days. | Overdue interest should not be charged and taken to income account in respect of overdue bills unless it is realised. |
| **Derivative Transactions** | Overdue receivables representing positive mark to market value of a derivative contract remaining unpaid for a period of 90 days from specified due date. | |
| **Liquidity Facility** | Remains outstanding for more than 90 days in respect of Securitisationtransaction | |
| **Credit Card Account** | Minimum amount due, as mentioned in the statement, is not paid fully within 90 days from the due date mentioned in the statement. | |
| **Government guaranteed advances** | State Government guaranteed advance would attract asset classification and provisioning norms, if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days. | Credit facilities backed by guarantee of Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. However, income shall not be recognised if the interest or instalment has remained overdue or the account has remained continuously out of order or the bills or any other facility has remained overdue for a period of more than 90 days. |

Notes:

1. On account turning NPA, interest already charged and not recovered should be immediately reversed by debiting Profit & Loss account and stop further accrual of Interest.

2. Once an account has been classified as NPA, all the facilities granted to the borrower will be treated as NPA except in respect of Primary Agricultural Credit Societies (PACS) IFarmers Service Societies (FSS). Also, in respect of additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, provision may be made after a period of one year from the date of disbursement in respect of additional facilities sanctioned under the rehabilitation package. The original facilities granted would however continue to be classified as sub-standard/ doubtful, as the case may be.

2. Advances against term deposits, NSCs eligible for surrender, IVPs, KVPs and Life policies need not be treated as NPA. However, income on such advances can be recognised subject to availability of margin. Advances against gold ornaments, government securities and all other securities are not covered by this exemption

3. Till the time the account is identified as NPA, income is recognised irrespective of whether realised or not. Where an account is identified as NPA during the year, unrealised income should not be recognised for the year. In respect of NPAs with the balance of Rs. 5.00 crores and above, bank needs to formulate policy for annual stock audit by external agencies & in respect of immovable properties, valuation should be carried out at least once in three years by approved valuer.

4. If the accounts of the borrowers have been regularised before the balance sheet date by repayment of overdue amounts, the same should be verified carefully and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.

5. Advance under rehabilitation programme approved by BIFR/Institutions, Provision should be continued to be made on existing facilities.

6. No provision is required to be made on additional facilities for a period of one year.

8. In case of advances guaranteed by CGTSI/ECGC, Provision should be made only for balance in excess of the amount guaranteed by these corporations.

9. In absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries of NPAs, banks should adopt an accounting principle and exercise the right of appropriation of recoveries in a uniform and consistent manner. Thus in case of recoveries in NPAs, auditor should verify that appropriation between interest and/or principal is done as per its consistent accounting policy of the Bank.

**II. Guidelines for classification of projects under implementation is as under**

| | **Before commencement of commercial operation** | **Fails to commence commercial operation within two years (IS)/ one year (NIS) from** | **Restructuring due to court cases (refer notee)** | **Restructuring due to other reasons (Refer notee)** |
|---|---|---|---|---|
| Infrastructure Sector(IS) | Classify as NPA if interest / instalment is 90 daysoverdue | Classify as NPA even if it is regular as per record of recovery unless restructured and eligible to be classified as Standard | a) Can be retained as Standard if restructured within two years from original DCCO<br>b) DCCO can be extended up to 4 years beyond the original DCCO | a) Can be retained as Standard, if restructured within two years from original DCCO<br>b) DCCO can be extended up to 3 years beyond the original DCCO |
| Non Infrastructure Sector(NIS) | Classify as NPA if interest / instalment is 90 daysoverdue | Classify as NPA even if it is regular as per record of recovery unless restructured and eligible to be classified as Standard | Not applicable | a) Can be retained as Standard, if restructured within one year from original DCCO.<br>b) DCCO can be extended up to another one year (beyond the existing extended period of 2 years i.e. total extension of 3 years) |

**Note:**

a) For all projects financed by the FIs, banks after **28th May, 2002**, the date of completion of the project should be clearly spelt out at the time of financial closure of the project.

b) 'Project Loan' would mean any term loan which has been extended for the purpose of setting up of an economic venture. Banks should fix a Date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan financial closure.

c) The above asset classification norms would apply to the project loans before commencement of commercial operations.

d) The benefits of retention under standard category upon restructuring as above would not be applicable to commercial real estate sector.

e) The above guidelines would not be applicable for restructuring of advances which are dealt with different sets of guidelines.

f) Any change in the repayment schedule of a project loan would not be treated as restructuring if:

   i) The increase in scope and size of the project takes place before commencement of commercial operations of the existing project.

   ii) The rise in cost excluding any cost-overrun in respect of the original project is 25% or more of the original outlay.

   iii) The bank re-assesses the viability of the project before approving the enhancement of scope and fixing a fresh DCCP.

   iv) On re-rating, (if already rated) the new rating is not below the previous rating by more than one notch.

**III. ASSET PROVISIONING NORMS:**

| Category | Conditions to be satisfied | Provision Amount | Remarks |
|---|---|---|---|
| **Standard Assets** | Does not disclose any problem and which does not carry any more than normal risks attached to business | General Provision on standard assets is as under :<br>• Direct advances to Agricultural and SME sector 0.25%<br>• Commercial Real Estate (CRE)-1% Residential Housing Sector (RH). 75%<br>• Others. 0.40%<br>• Housing Loans at teaser rates 2% for one year then, .40% when the rates are reset at higher rates.<br>• Project Loans (refer paras 12 and 14 of Master Circular of July 1, 2014)<br>• RestructuredA/Cs<br>31-3-2014 3.5%<br>31-3-2015 4.25%<br>31-3-2016 5.00% | Such an asset is not a NPA |
| **Sub-Standard Assets** | • Classified as NPA for a period less than or equal to 12 months<br>• Classification of an asset should not be upgraded merely as a result of rescheduling, unless there is satisfactory compliance of the required conditions at least for one year | • A general provision of 15% of total outstanding<br>• Anunsecured exposure which is identified as 'sub standard' would attract an additional provision of 10%. i.e. total of 25% of total outstanding balance | In respect of accounts where there are potential threats of recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent for banksto first classify them as sub-standard and then as doubtful after expiry of twelve months from the date the account has become NPA. Such accounts should be straightaway classified as doubtful asset (when realisable value of security is less than 50% of the total value of security) or loss asset (when realisable value of security is less than 10% of the value of security), as appropriate, irrespective of the period for which it has remained as NPA. |

| Category | Conditions to be satisfied | Provision Amount | Remarks |
|---|---|---|---|
| **Doubtful Assets** | • Remained NPA for a period exceeding 12 months | • 100% on unsecuredportion<br>• Over and above the aforesaid, depending upon the period for which the asset has remained doubtful, provision on the secured portion to be made on the following basis:<br>Upto 1 year 25%<br>1 to 3 years 40%<br>Over 3 years 100% | |
| **Loss Assets** | • Loss asset is one where loss has been identified by bank, external or internal auditors or RBI inspectors, but amount has not been written off (wholly or partly) | • 100% of the outstanding should be provided for/ written off | If the assessed realisable value of the security is less than 10 per cent of the outstanding amount, the existence of security should be ignored and the asset should be straightaway classified as loss asset |

**IV. PRUDENTIAL GUIDELINES ON RESTRUCTURING OF ADVANCES BY BANKS**

There is a different set of guidelines for classification of advances under restructuring in Part B of the Master Circular of Reserve Bank ofIndia.

1. Guidelines are extended to following four category of advances:

   (i) Advances to industrialunits

   (ii) Industrial units under the Corporate Debt Restructuring(CDR) Mechanism.

   (iii) Advances extended to SmallandMedium Enterprises(SME).

   (iv) Restructuringofallotheradvances.

2. Eligibility Criteria :

   a) Banks may restructure the accounts classified under ‘standard’, ‘substandard’ and ‘doubtful’ categories.

   b) Banks cannot reschedule / restructure / renegotiate borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue toapply.

   c) The process of restructuring can be initiated by the bank in deserving cases subject to customer agreeing to the terms and conditions.No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package.

   d) The borrowers indulging in frauds and malfeasance are ineligible for restructuring.However in old cases where the manner of classification of a borrower as a wilful defaulter was not transparent and bank satisfies itself that the borrower is in a position to rectify the wilful default, the restructuring of such cases may be done with Board’s approval and for accounts the restructuring under the CDR Mechanism may be carried out with the approval of the Core Group

   e) BIFR cases are eligible for restructuring after their express approval and ensuring that all the formalities in seeking the approval from BIFR are completed before implementing thepackage.

**3. Asset Classification Norms**

a) The restructuring/rescheduling/ renegotiation of the terms of loan agreement could takeplace:

   i. Before commencement of commercial operations;

   ii. After commencementof commercial operations but before the asset has been classified assub-standard;

   iii. After commencementof commercial operations and after the asset has been classified assub-standard.

b) Upon restructuring, the accounts classified as 'standard assets' would get reclassified as 'sub- standard assets' and account which is already NPA would continue to have the same classificationand slip in to further lower asset classification as perthe extant asset classificationnorms

c) Any additional finance may be treated as 'standard asset', up to a period of one year after thefirst interest/ princ1ipal payment, whichever is earlier, falls due under the approved restructuringpackage.

All restructured accounts which have been classified as NPA upon restructuring, would be eligible for upgradation to the 'standard' category after observation of 'satisfactory performance' during the specified period. Specified period means a period of one year from the commencement of the first payment of interest or principal whichever is later, on the credit facility with longest period of moratorium under the terms of restructuring package.

d) However accounts of borrower can continue to be classified in existing asset classification category subject to fulfilment of conditions enumerated in para 5 below.

**4. Provisioning Norms:**

a) The total provisions required against an account under restructuring would benormal provisions in addition to provisions fordiminution in the fair value of the advances.

b) Normal provision is discussed in paraIII.

c) Diminution in fair value of the advance is difference between fair value of advance before and after restructuring. Fair value of advance before/after restructuring is computed as the present value of cash flows representing the interest at the existing rate/revisedrate charged on the advance before/ after restructuring and discounted atanappropriate rate. The difference between two fair values would be the diminution in value of advance which would be provided for.

d) The diminution in the fair value would berequired tobere- computed on each balance sheet date till satisfactory completion of all repayment obligations and full repayment of the outstanding in the account. Consequently, banks would be required to provide for the shortfall in provision or reverse the amount of excess provision.

e) As an alternative to the methodology prescribed above for computing the amount of diminution in the fair value, banks will have the option of notionally computing the amount of diminution in the fair value and providing therefore, at five per cent of the total exposure, inrespect ofall restructured accounts where the total dues to bank are less than rupees one crore.

f) Restructured advances classified as standard or classified as NPA but subsequently upgraded would attract higherprovision.

**5. Special Regulatory Treatment for Asset Classification**

Reserve Bank of India has stipulated special regulatory framework for asset classification, in modification to guidelines as enumerated in para 6 above. This special treatment will be available to the borrowers engaged in important business activities, subject to compliance with certain conditions as enumerated herein and is not extended to the following categories ofadvances:

i. Consumer and personaladvances;

ii. Advances classified as Capitalmarketexposures;

iii. Advances classified as commercial real estateexposures

Thus benefit of special regulatory frame work would be available subject to compliance of conditions stipulated in the paragraph 5.1 below. If these conditions are not complied, then guidelines as discussed in para 4 would apply to restructured accounts.

**Elements of special regulatory framework**

The special regulatory treatment has the following two components:

**(i) Incentive for quick implementation of the restructuring package.**

As an incentive for quick implementation ofthe package, ifthe approved package is implemented by the bank as per the following time schedule, the asset classification status may be restored to the position which existed when the reference was made to the CDRCell,or when the restructuring application was received by thebank.

(a) Within 120 days fromthe date of approval under the CDR Mechanism.

(b) Within 120 days from the date of receipt of application by the bank in othercases

**(ii) Retention of the asset classification of the restructured account in the pre-restructuring asset classification category.**

Subject to the compliance with the undernoted conditions in addition to the adherence to the prudential framework laid down in para 6above,

(a) An existing 'standard asset' will not be downgraded to the sub-standard category uponrestructuring.

(b) During the specified period, the asset classification of the sub-standard/doubtful accounts will not deteriorate upon restructuring, ifsatisfactory performance is demonstrated during the specifiedperiod.

These benefits will be available subject to compliance of the followingconditions:

i) The dues to the bank are 'fully secured' by tangible assets except in the following cases:

a) SSI borrowers, where the outstanding is up to Rs. 25 lakh.

b) Infrastructure projects, provided the cash flows generated from these projects are adequate for repayment of the advance, the financing bank(s) have in place an appropriate mechanism to escrow the cash flows, and also have a clear and legal first claim on these cash flows.

ii) The unit becomes viable in 8 years, if it is engaged in infrastructure activities, and in 5 years in the case of other activities.

(ii) The repayment period of the restructured advance including the moratorium, if any, does not exceed 15 years in the case of infrastructure advances and 10 years in the case of other advances. The aforesaid ceiling of 10 years would not be applicable for restructured home loans; in these cases the Board of Director of the banks should prescribe the maximum period for restructured advance keeping in view the safety and soundness of theadvances.

iv) Promoters' sacrifice and additional funds brought by them should be a minimum of 20% of banks' sacrifice or 2% of restructured debt whichever is higher. The term 'bank's sacrifice' means the amount of "erosion in the fair value of the advance". The additional funds required to be brought in by the promoter should be brought up front and not be phased over a period of time.

v) Promoter'scontributionneed not necessarily be brought in cash and can be brought in the form of de-rating of equity, conversion of unsecured loan brought by the promoter into equity and interest freeloans.

vi) The restructuring under consideration is not a 'repeatedrestructuring'.

vii) Promoter's personal guarantee should be obtained in all cases of restructuring. Corporate guarantee cannot be accepted as a substitute for personal guarantee. However,the same can be acceptedincases where promoters of a company are notindividuals.

**V. Framework for Revitalisation of Distressed Assets**

This is the new framework introduced by the RBI and is given as part C of the Master Circular. The purpose of this frame work is to ensure that the banking system recognises financial distress in borrower account early, takes prompt steps to resolve it and ensures fair recovery for lenders and investors. Some of the key aspects are discussed in brief hereunder:

i) Banks are required to identify incipient stress in the account by creating three sub category under the Special Mention account.

| SMA Sub categories | Basis for classification |
|---|---|
| SMA-0 | Principal or interest payment not overdue for more than 30 days but account showing signs of incipientstress |
| SMA-1 | Principal or interest payment overdue between 31-60days |
| SMA-2 | Principal or interest payment overdue between 61-90days |

ii) Banks are required toreport SMA accounts as per prescribed limit of exposure toCentral Repository of Information on Large Credits (CRILC) of RBI.

iii) As soon as an account is reported as SMA2, Banks have to form a committee called Joint Lender's Forum (JLF). The JLF in turn would decide corrective Action Plan (CAP) which would be either rectification or restructuring or recovery.

iv) While a restructuring proposal is under consideration by the JLF/CDR, the usual asset classification norm would continue to apply.

v) As a measure to impose disincentives on borrowers not maintaining credit discipline, accelerated provisioning norms are prescribed (Refer para 26 of the Master Circular).

vi) As per para 27 of the Master Circular, banks would be required to identify directors whose name appear more than once in the list of willful defaulters as also non cooperative borrowers. The provisioning for such cases will be at the rate of 5% if it is a standard account and accelerated provision as per para 31, if it is NPA.

**CONCLUSION:**

To summarize the above discussion and as a general guidance, following can be kept in mind:

1) Apart from the ledger of the borrower which show disbursement, application of interest/charges and repayment of credit facility, Banks generally have a separate system to maintain other financial and non-financial data such as value of security, periodicity of stock verification/audit, classification of account, provision, drawing power, date of inspection, date of review of account etc., It is very important to check such other data also for all major accounts since a lot of important information for the compilation of notes to financial statements may flow from such system and there is a possibility of wrong information submission due to incorrect input.

2) Some of the critical areas in CC/OD accounts which auditor need to verify are determination of correct drawing power, temporary deficiencies, fresh sanction to regularize an account, regularization of account near about the balance sheet date through genuine sources etc.

3) Post April 1, 2015 all the standard accounts subject to restructuring would be classified as NPA with exception to change in DCCO for infrastructure and non-infrastructure project loans.

4) SDR (Strategic Debt Restructuring) as specified in the Master Circular of RBI would not be treated as restructuring of advance and the existing classification of the account as on the reference date (the date of JLF's decision to undertake SDR) would continue for 18 months from the reference date.

5) Reversal of unrealized interest on classification of an account as NPA and non-recognition of income subsequently.

6) Accounting and recognition of income in NPA accounts on recovery as per the Bank's accounting policy.

5) If an account is classified as NPA, all the other facilities of the borrower be classified as NPA including investments, if any.

6) Upgradation of accounts from NPA to Standard if any and whether the same is in accordance with the guidelines given in the Master Circular.

7) Verification of secured and unsecured portion and provisioning. Many a times valuation report of securities are not available. In such cases, auditor will have to be careful in evaluating the value of securities and take an appropriate view.

8) If the debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as part of the borrower's principal operating account to identify the out of order status for the purpose of prudential norms on income recognition, asset classification and provisioning.

9) If an account is restructured, ensure that guidelines as prescribed in the Master Circular are followed.

The above covers important aspects from the perspective of audit of Advances. Auditor should refer to the Master Circular dated 1st July, 2015 of RBI for better understanding of the subject.

# HOUSEKEEPING AND SENSITIVE ACCOUNTS

The Bank plays a very important role in functioning oforganized financial sector of the economy. A well-organized and efficient banking system is a prerequisite for economic growth of the country. The banking system is developing not only geographically but also operationally. It is no more an institution, which used to collect deposits to lend money. Anti-money laundering measures guidelines, submission of different returns of information about excess cash withdrawal, obtaining PAN for certain high value transactions, TDS on interest on Bank deposits and submission of returns, etc. reveal that the Government is thinking of using banking system to streamline and strengthen the economy.

The volume of operations and the geographical spread of banks are increasing in India. The Core Banking Solutions reduces the time lag between different the initiation of the transactions and conclusion of the transaction. The country has witnessed the use and abuse of the banking system. Therefore, the Auditing Function gained importance to protect the banking system from abusing the same. The responsibility of the auditor is increasing from time to time considering the expectations of the people from the Audit.

The starting point of good banking operations is good housekeeping. Therefore the auditor can not ignore the aspect of understanding of the importance of good housekeeping at the branch under audit and the efficiency at which it is implemented at the branch.

**Housekeeping**

Chambers Twentieth Century Dictionary states that 'housekeeping' means keeping or management of a house or of domestic affairs.

The system at the branch is designed to have smooth banking operations in a controlled environment. These smooth operations are ensured if the housekeeping at the branch is proper. Good housekeeping system has to be maintained by the branch management and the auditor has to get himself satisfied about the same. It gives a good comfort level. The housekeeping at the branch could be from different areas such as…

1. Levels of managements along with their authorities and responsibilities.
2. Human resources and management of human resources.
3. Discipline and customer services.
4. Compliance with central office guidelines and other statutory authorities.
5. Maintenance and upkeep of assets.
6 Security system.
7. Quality and safety of records maintained.
8. MIS and filing of returns to central office or to Reserve Bank of India.
9. Reconciliation of accounts.

The above could be an illustrative list. In short, it starts from the name board of the branch and goes up to the quality of annual audited returns submitted by the branch.

The auditor has to examine the following aspects in housekeeping of the branch and satisfy himself about the quality of housekeeping and its weak links. This will helphim to understand the internal control at the branch. Accordingly the audit programme could be designed.

**A. Operational Manuals**

The bank prepares operational manuals for different functions, for e.g. Deposit Manual, Advances Manual, and Foreign Exchange TransactionsManual, etc. These manuals giveideas about how the branch shouldoperate for the given function.Apart from such manuals, thebranch gets circulars and guidelinesfrom its central office about anychanges—additions, alterations,amendments to the matters stated inthe manual. The branch should followthese manuals and the guidelinesor circulars. The branch auditorshould get himself acquaintedwith the banking system in use andfind out whether the same is asexpected by the control office.

## B. Organization Chart

The organization chart at thebranch explains the manpowerwith its authorities and responsibilities.The officials at the branchshould function within their authorities. The duties should bedischarged as per the job profile ofa person. There should be properchannels of communication. Theauditor should obtain an organizationchart specifying the authoritiesand responsibilities of the officials/ employees at the branch. Heshould study the organization chartand ascertain whether the employeesare functioning within the parameters of their authorities and responsibilities, whether theduties are discharged properly or not. While executing the functionswhether there is a case of jumpingof authority? In such case an explanationmay be demanded.

Similarly the system of rotationof the job at the branch needs tobe seen. A leave record of the staffcould be seen to see the behavior of absenteeism. In case of computerized environment the employeeID in different areas could be studied.The branch should have effectiveuse of concept of makercheckerat the branch.

## C. Employee Relationship

The employees at the branch are themembers of the team and theBranch Manager is the captain ofthe team. Therefore, the teamworkis most important. The role of a captainis vital in having smoothemployee relationship and highmorale. During the course of thestay at the branch the auditor shouldkeep eyes and ears open to sense theemployee relations and teamworkat the branch. Good teamwork andhigh employee morale will lead tozero pendency as far as work is concerned.The branch managershould ensure that the work at thebranch is completed in timely manner and there is no backlog of work.

## D. Discipline and CustomerService

Nothing succeeded without discipline.The branch personnel shouldfollow proper discipline to ensureproper conduct of the business.The norms of customer serviceneed to be followed to ensure thegrowth in the business in the bank.The auditor should see the punctualityof the staff, the work behavior of the employee and thebehavior with the customer. Theauditor should take a note ofunusual behavior and think aboutits impact on the operations at thebranch.

## E. Maintenance and upkeepof Assets

Usually the advances given areconsidered as assets in the balancesheet of the branch. There are specificguidelines about classificationof assets and provisioningnorms. Apart from the same, thebranch is also having fixed assets,such as dead stock, furniture, equipments, etc. These assets needto be maintained properly. Usuallythe insurance for such assets istaken at head offices level. Theexpenditure on maintenance ofsuch assets also needs to be authorized by the head office.

Similarly, the branch shouldmaintain proper record by way offixed asset register, depreciationcalculation, etc. The depreciationshould be calculated as per therates specified. The method ofcharging depreciation should be inaccordance with the accountingpolicy of the bank.

## F. Security System

Effective security system in thebranch will ensure stoppages ofpossible loss. The bank handles notonly cash but also the securities ofthe customer, which are pledgedwith it. Hence responsibility ofsuch items gains more importance.Thus, there should be proper securitysystem. The exit doors shouldnot be kept open during the bankinghours. There should be properarmedguard and license of the gunshould be renewed timely. The cartridgeof the gun should bereplaced after the expiry. The firedrill should be done at least once ina year. The alarm system should bewell tested at appropriate periodicity.An attention to these aspectswill ensure proper security system.

## G. Quality and safety ofRecords maintained

The Books and other recordsshould be kept in good condition.There should be a system of timelyretrieval of records wherever thesame is required. The custody ofthe record should be maintainedproperly. Propercontrol over the issue and stock ofFixed Deposit receipts, DemandDrafts, Traveler’s cheques, etc. should be maintained. Incase of computerized environmentthe auditor should verify whetherthe hard copies of the accountshave been printed regularly. Theauditor should check whether thereexists a proper security system thatensures stoppage from unauthorized use of the system. The auditor should also verify different checks like physical checks, logical access controls, input controls, output controls, processing controls, etc.

## H. MIS and Control Returns

Management Information System(MIS) returns and returns prescribedby the Head Office forstatutory and other requirementsshould be filed as per the scheduleprescribed. These returns have tobe scrutinized and explanation forthe unusual items should be askedfor. A comparative analysis ofreturns for different periods shouldbe made in order to get properinsight of the operations at thebranch.

**Reconciliation**

The word 'reconciliation' is thebuzzword in the banking industry.The inter-branch entries are routedthrough Head Office account. TheHead Office passes necessary entryat their end under the intimation torespective branches. These intimationsneed to be responded by thebranches immediately. Therefore,the time element in receipt of intimationand passing of entry or givingresponse to such entry shouldbe minimum. The pending entrieswill reduce substantially in such situation. The auditor should verifythe entries in Head Office Accountant keeping in mind thefollowing aspects: -

- Whether daily extracts are preparedaccording to the prescribedinstructions and arebeing dispatched promptly?
- Whether office distinctive numberis being stamped on dailyextracts/interbranch remittance?
- Review of pending correspondenceand the manner of its disposalneeds to be reviewed thoroughly.
- The HO closing balance as perdaily extract and as per balancesheet at the end of accountingperiod should be tallied.
- The adjustment of high valueentries (Rs. 2,00,000 and above)should be done within thirtydays.
- Abnormal entries should bereported.

**Sensitive Accounts**

In the books of the branch there arecertain accounts, which need to beseen properly. These accounts areso sensitive that they can createhavoc if they are ignored. Preciselythese accounts need to be monitoredwith great care. They arefraud prone accounts. The sensitiveaccounts normally include: -

- Suspense Account
- Sundry deposit Account
- Current Deposit Miscellaneous Account
- Demand draft payable Account
- Pay slip payable Account
- Clearing Adjustment Account

The Auditor should review the system of operation of sensitive account – Passing of entry into such accounts and squaring of entries in the same accounts, the authority under which such entries are passed, etc. Similarly, a process of reconciliation and reasons for entries remaining pending in the reconciliation need to be reviewed. The Auditor needs to look into the following aspects while scrutinizing sensitive accounts.

- The outstanding in sundry deposits and suspense account should be taken down monthly and checked by the Manager.
- All debits in the suspense account should be passed by the Manager himself or by any other authorized person.
- There should be a proper register for such entries, which are passed and squared off.
- The records such as vouchers, supporting should be maintained.
- The auditor should take a list of outstanding entries and review them whether there exists any long outstanding entry.
- The auditor should also verify whether there exists any unusual entry in these accounts. An explanation for such entries should be asked and verified with the records at the branch.
- The clearing adjustment account is reconciled up to date and balancing as per ledger is tallied with the balance as per general ledger/statement received.
- The old entries in clearing suspense account, which are unreconciled need to be reviewed, and reasons for pendency should be understood. A follow up action of the branch should also be reviewed.
- The pending entries in drafts payable and pay slip payable should be scrutinized with a stress on reasons for pendency and follow up done by the bank.
- The entries in the stale drafts and pay orders should be transferred to inoperative ledger.
- The branches where the advices are in default on persistent basis should be reported. The entries in such sensitive accounts have to be seen for entire audit period. The auditor should not restrict himself to the pending entries. In fact, the adjustment entries passed in last two months in such sensitive accounts need to be seen with more care.

**Conclusion**

No doubt the advances portfolio of the bank is the income generating assets of the bank and the deposits are the sources of the fund. Therefore the usual concentration for audit may be on the areas of deposit and advances as well as on provisioning norms. It is also important to give proper attention to the housekeeping and analysis of sensitive accounts. This helps to understand the overall control and environment at the branch which helps to measure the risk in the audit. The auditor faces risk when the housekeeping at the branch is not to the mark. In such situation he has to modify his audit program and enhance his test check. So that he can form his opinion about the true and fair view on the financial statements.

# AUDIT REPORTS AND CERTIFICATES

With the intentions of financial inclusions, the banks have started spreading their wings of operations geographically. Presently the audit of bank in India is governed by pyramid approach. The branches are at the base, the zonal offices, regional offices in the middle and the Head office at the top. Therefore the process of audit is also designed in the similar fashion. The consolidation of accounts gets started from the branch account and ends with the bank as a whole accounts at the Head Office. Even the process of statutory audit also starts from the bank branch audit and ends at the Central Statutory Auditors(CSA) signing the consolidated Financial Statements at the Central Office.

We all are aware that the deliverable product of the auditor is AUDIT REPORT. The preparation of the financial statements is the responsibility of the management of the bank. The auditors of the bank should express its opinion. Therefore at the end of the audit, the auditor issues the report. In case of the bank branch audit, he issues the report on the accounts and operations at the branch.

The financial statements consist of certain disclosure to be given. These disclosures could be as prescribed by the Reserve Bank of India through its master circular on disclosure and disclosures as required by the Accounting standards issued by the Institute of Chartered Accountants of India (ICAI) or by the prescribed authorities. In order to give these disclosures the bank compiles the data from the branch operations. Hence the branch auditors have to issue certain certificates which in turn facilitate the CSA to issue the certificate for the bank as a whole.

The final deliverables from the branch auditors include the following

1. The audit report as prescribed by the Banking Regulation Act
2. Long Form Audit Report (LFAR)
3. Certificates as prescribed by the appointment letter.
4. Memorandum of Changes (MOC), if any,

In this article we are going to deal with the audit report and the certificates as the other topics are dealt by the other articles in the background material for the bank branch audit

**Bank Branch Audit Report**

The Branch statutory audit report is also sometimes referred to as the One-page audit report. The revised SA-700 issued by ICAI is to be borne in mind while issuing the Branch Audit report. Certain important aspects to be borne in mind while drafting the audit report are asfollows:

1. Usually the audit report is addressed to the members of an entity or the appointingauthority if not the members. At a branch the audit report may be generically worded without addressing it to any specificperson that is tosay, "Independent auditors report – ABCBranch of XYZ Bank Ltd.".

2. Branch audit report is an independent report and all the critical issues arising during the audit need to be addressed in this report. This is a standalone report and hence matters reported here should not give a reference to some other report or other document. The audit report should stand out on itself.

3. The Banks usually provide a standard format of the branch audit report. However, in order to include all observations and qualifications of the auditor, the auditor should independently draft the report instead of directly signing on the pre-printedformat.

4. The auditor should bear inmind the amendments made byICAI dated 3rd January 2014 in the "Auditor's Responsibility" Paragraph included inthe Independent Auditor's Report under SA-700. These amendments are available at http://220.227.161.86/32150aasb22246-3.pdf. Certain clarifications have also been issued by ICAI on 22nd August 2013 contemplating situations where in statutory provisions requiredifferent/ additional reporting in the auditreportsand how the auditors should incorporate such matters in the audit report. Recent changes in the reporting, if any, required bythe Companies Act 2013 also need to be considered. The format of report is also given in the Guidance Note issued by the Institute of Chartered Accountants of India (ICAI).

5. For the ready reference of members carrying out audit of banks/bank branches, the auditing and assurance standards board of the ICAI has developed relevant audit report formats specifically for Bank Branch audit reports in line with the requirements of the revised SA- 700. These are available on the ICAI website as well as in the latest edition of the Guidance Note on audit of Banks released in February 2016.

6. As regards the MOCs issued by auditors, the RBI has advised ICAI that the total number and amount of debits/ credits arising pursuant to the Memorandum of Changes submitted by them, should be given under the heading "Other Matters Paragraph" on the face of the bank branch audit report issued by them. Auditors should keep this communication in mind while reporting the effect of MOCs in the auditreports.

7. In certain cases, it may so happen that certain documents / returns etc. pertaining to a branch are not available at the branch. In such cases, the auditor should highlight this fact in the audit report under the section modification of opinion or disclaimer of opinion as the case may be if in his judgment; his opinion is expected to be vitiated due to non-availability of thedocuments. In extreme cases, where the Auditor has not been able to carry out the audit satisfactorily or no or inadequate records have been produced to him or there are major inconsistencies in the records, etc. making it difficult for the Auditor to give an unqualified report, the Auditor should issue a qualified report regarding the "true and fair view" of the accounts under audit. However, in such an event, it is imperative on the Auditor to substantiate the facts and reasons for giving a qualified report under the section modification of opinion or disclaimer of opinion as the case maybe.

8. Practically in every Bank, certain provisions / effects are provided for only on a consolidated level at the HO viz: Provisions for NPAs, Gratuity, Pension, Provision for tax etc. To that extent, the Branch financial results are understated and may not show a true andfair view of the Branch financial statements. To cover such scenarios, theAuditor should incorporate suitable comment in the "Modification of Opinion" Paragraph. It is also possible that certain accounting standards are not complied with at the branches viz: cash flow statement may not be prepared, the effects of exchange fluctuations especially on derivative transactions may not be provided for under AS-11, segment reporting may not be drawn up etc. the auditor should suitable clarify these facts in the audit report while reporting about compliance with AccountingStandards.

**Certification by Branch statutory Auditors**

In addition to the audit report, there are various certificates to be issued by the Branch Statutory Auditor. A few of those important certificates and the aspects to be considered while issuing them are given herewith:

1. Certificate on DICGC claims - This aspect may include three types of certificates to be issued- whether appropriate claims have been lodged with DICGC, whether the claims received are appropriated to the respective accounts and whether in recovered account, proportionate claims have been refunded to DICGC. Over the years in most of the Banks, this aspect has been discontinued and generally no amounts are claimed or received. In such case, the auditor should give a NIL certificate. In some Banks, consolidated claims may be lodged from the HO in which case also the Branch auditors would provide a NIL certificate. In case there are claims lodged or amounts received, the auditor should call for all the individual accounts in which the claims have been lodged. Actual claim letters in the relevant format and the dates of submission should be verified from the forms at the Branch. Where amounts have been received from DICGC, the auditor should check the statements of claims settled received from DICGC and further check if the amount is appropriated to the respective savings/current accounts. Yearwise break up of outstanding claims can be asked fromthemanagement for determining the recoverability of the same. In respect of recoveries in claim received accounts, the auditor should call for representation from the management about such items and check whether the claims received are proportionately refunded by a debit to the customer's account and fund transfer to DICGC.

2. Certificate on claim of PMRY subsidy - In this regard, the verification of related items would be similar to the procedure under DICGC claims. The auditor should go through the circular on PMRY and certify that the subsidy claimed is correct.

3. Certificate pertaining to Cash and Bank Balances – This certificate is required to be furnished in order to arrive at the CRR / SLR position of the entire Bank and its compliance with the same. Usually the Bank / Central Statutory Auditors would call for these details from the Branch auditors, especially for 26 non-reporting Fridays in the whole year. Now-a-days, after core banking has been introduced, Banks where all branches are on CBS, this certification may not be required. Wherever it is to be given, auditors should be careful while certifying the amounts of Cash and Bank balance. Cash balance also includes connected ATM balance if any. Bank balances where reconciliation items have not been accounted for should be considered inthe Bank balance and suitable MOCsshould bepassed.

4. Certificate of investments held - This certificate may be required in case any investments are held by the Branches on behalf of HO. The auditor should cross-check the relevant GL head in which such investments are reflected and verify the amount and details included in the certificate are correct. The auditor should also physically verify the investments held, either in certificate form or in Dematmode. Valuation, provisioning on such investments, should also be verified and reported if required.

5. Certificate on risk weighted assets for BASEL- II CRAR – This certificate is issued by the Branch auditors to enable the Central Statutory Auditors to certify the whole bank CRAR. The branch auditors should be well versed with the relevant RBI circulars on CRAR. At the Branch level, the certificate usually includes pre-printed risk weights against the relevant GL items and the GL amounts are reported against each of the items. Auditors should take precaution that not only the GL amounts reported are correct, but the risk weights printed are alsoin accordance with the latest RBI circular. If not, the auditor should include the correct risk weights in the certificate. Additional precaution is required while certifying the risk weighted assets for off-balance items as to their nature. With the phased introduction of BASEL III norms, some Banks may also require the branch auditors to give limited certificates related to these aspects.

6. Certificate of NPAs at the Branch - The auditor should be conversant with the RBI circular on NPA classification. In case the auditor has identified additional NPAs than those reported by the Branch, he should adequately bring out that fact in the certificate issued. Suitable MOCs should also be passed to classify such advances asNPA.

7. **Certificate of Statutory Auditor w.r.t. compliance of Ghosh &Jilani Committee Recommendations:**

   A Committee under Chairmanship of Mr. Rashid Jilani, former CMD of PNB was formed to review the effectiveness of Internal Control, Inspection and Audit System in Banks. Jilani Committee made various recommendations for strengthening Internal Control, Inspection and Audit System in Banks under three broad categories based on areas of operations in Banks:

   a. EDP Environment in Banks.
   b. Inspection/ Internal Audit in Banks.
   c. Other Miscellaneous matters.

The Branch Management is required to prepare this report on implementation of Jilani Committee Recommendations (25 Questions to be answered in Implemented/ Not implemented Format) and The Auditor is supposed to verify the answers given by the Branch. Some of the Recommendations of Jilani Committee are to be implemented at Branch Level and some of them at RO/ZO Level. Central Statutory Auditors have time and again observed that the reports received from branches on Ghosh and Jilani Committee are not properly verified by the auditors and they are a mere replica of previous reports. The Auditor is supposed to verify the correctness of the reports prepared by the Branch. In case of negligence, the auditor may be held accountable under ICAI disciplinary process.

Few key recommendations of the Jilani are Committee are given below:

| Sr. No. | Recommen-dation No. | Nature of Recommendation | Implementation Status at Branch |
|---|---|---|---|
| 1 | 39 | Follow up on major/serious irregularities detected during concurrent audit immediately taken up with the HO. A time bound action programme for rectification to be drawn up and closely monitored. Fraudulent transactions to be reported to Vigilance / Chief of Inspection / Audit etc. | |
| 2 | 44 | Auditors to get majority of irregularities rectified during their stay at the branches concerned and guide them as well. | |
| 3 | 45 | Immediate action to be taken to plug gaps in serious irregularities/revenue leakage's which have surfaced due to loopholes in existing procedures, abnormal deviations from laid down procedures/ norms in consultation with the departments concerned by issue of fresh guidelines. | |
| 4 | 53 | Appropriate control measures should be devised and documented to prevent the computer system from attacks of unscrupulous elements. All aspects of security, reliability, and accessibility are ensured before introduction of EDP application in place of manual system by having pilot parallel runs. | |
| 5 | 54 | Various tests to be carried out to ensure that EDP applications have resulted in consistent and reliable system for inputting, processing and generation of output of data. | |

A committee under the Chairmanship of Mr.A. Ghosh, past Dy.governer of RBI was formed to review the causes of frauds and mal-practices in Banks and give recommendations on minimizing the same. The Branch Management is required to prepare this report on implementation of Ghosh Committee Recommendations (in "YES" or "NO" Format) and the Branch Auditor is required to verify the answers given. The main objective of this report is to ensure Existence of Proper Systems in Banks to ensure –

a. Safety of assets,
b. Compliance of laid down procedures,

c. Accuracy and completeness of accounting and other records,

d. Proper segregation and rotation of duties and responsibilities of staff and,

e. Measures for the prevention of frauds.

f. Timely detection of frauds and malpractices and taking corrective actions

Usually the auditors do not pay much attention to the aspect highlighted in the report. They tend to postpone the verification of these items to the last day of audit and then face shortage of time to verify the compliance reported. As a result they end up blindly certifying the compliance. Instead this report should be verified on day one of the audit. After the computerisation of major operations of the Banks, certain items of the Ghosh report have become redundant viz: safe custody and transportation of cheques between bank and clearing house. This aspect has slowly lost importance after introduction of CTS mechanism. The auditor should identify the items which have become redundant and state so in his certificate. There might be certain items which are not carried out at the branches and therefore are not applicable. Suitable comments should be given where items are not applicable. For other applicable items the auditor should test check a suitable sample and certify the compliance accordingly. Lastly, he should make amply clear in his certificate that it is only on the basis of sample verification and 100% verification is not possible.

A sample of important items of the Ghosh committee recommendations is given below:

| Sr. No. | Recommen-dation No. | Nature of Recommendation | Implementation Status at Branch |
|---|---|---|---|
| **GROUP A PART I** | | | |
| 1 | 3.3 | Joint custody and dual responsibility of cash and other valuables. | |
| 2 | 3.4. | Transactions in the currency chest to be reported to RBI on the same day | |
| 3 | 3.5 | Adhering to the prescribed norms and safeguards issued by RBI on issue and payment of high value drafts, depositing large amounts in new accounts without verifying antecedents, opening of benami accounts, etc. to prevent misuse of banking channel. | |
| 4 | 8. 10 | a. System of exclusive scrutiny of credit portfolio with focus on larger advances and group exposures.<br>b. Special scrutiny of high value accounts shifted to the bank along with executives and account transferred from other branches along with officials. The observations of RBI Inspections should be promptly and effectively followed up by banks. | |
| 5 | 8.14 | Monthly certificate on inspection of associated units and on stocks pledge / hypothecated to bank. | |
| 6 | 9.9 | Adoption of preventive measures of vigilance in letter and spirit as enumerated. | |
| 7 | 11.4 | Rotation of staff / duties and transfer covering all categories of staff, including dealing room / securities department staff etc. | |
| 8 | 11.9 | Desk cards for staff to be prepared, banks to designate one of the senior officers as a Compliance officer. | |
| **GROUP A PART II** | | | |
| 9 | 1.1 | Precautions in handling cash and valuables - restriction of entry to cash cabin, dual custody of cash / valuables, surprise verification at regular intervals, etc. | |
| 10 | 1.2 | Precautions against theft of cash - staff should not indulge in conversations / answering queries, but direct such persons to Enquiry Counter only. | |
| 11 | 1.3 | Precautions against shortage in cash reported by Cashier - Introduction of surprise checking at frequent intervals. | |
| 12 | 1.4 | Precautions against misappropriation of cash by member of staff in the guise of customer service. Only authorised personnel should accept cash / issue counterfoils in cash departments. Cashier should not be allowed to made entries in Pass Book. | |
| 13 | 1.5 | Proper systems should be evolved in respect of cash balances, insurance and prompt reporting of inter-branch and inter bank remittances of cash. | |
| 14 | 1.6 | Banks should evolve proper systems of adequate security and custody of cash in dacoit / terrorist attack-prone areas. | |
| 15 | 1.7 | Precaution against misusing banking channels for tax evasion. Pos/ TCs in excess of Rs.50,000/- should be by way of debit to constituents account and not by cash. Doubtful cases should be reported to higher authorities. | |

| Sr. No. | Recommen-dation No. | Nature of Recommendation | Implementation Status at Branch |
|---|---|---|---|
| 16 | 1.8 | Periodical reporting of deposits / withdrawals from currency chest to issue Department of RBI. | |
| 17 | 1. 10 | Exercise of caution at the time of opening of new deposit accounts of all types. | |
| 18 | 1.11 | Customers to be educated about implications of introducing an account without knowing the party. | |
| 19 | 1.13 | Close watch on the operations in the new accounts should be kept. | |
| 20 | 1.14 | Issue of fresh cheque book should be only against requisition slip from previous check books and other precautions to be taken in respect of cheque books. | |
| 21 | 1.15 | Precautions in payment of cheques - verification of signature, custody of specimen signatures, custody and control of bank cheque books, etc. | |
| 22 | 1.16 | Balancing of ledgers periodically by staff other than ledger keepers, scrutiny of unauthorized entries / corrections, and other precautions in respect of ledgers. | |
| 23 | 1.17 | In operative accounts to be kept in separate ledger, specimen signature to be in custody of Manager and other precautions. | |
| 24 | 1.18 | Safe custody of / access to vouchers through written orders of Manager - records to be maintained of those who have accessed such records. | |
| 25 | 1.19 | Safe custody of specimen signature cards and verification of instructions in respect of operations of the account. | |
| 26 | 1.21 | Blank draft and mail transfer forms to be treated as security items and usual precautions should be taken in respect of their issue and safe custody. | |
| 27 | 1.23 | Precautions in writing of drafts/ mail transfer - use of pin point typewriters or reverse carbon. | |
| 28 | 1.26 | Way in which telegraphic / telex messages for telegraphic remittances should be sent - use of codes and accessibility to top most officers of branch, etc. | |
| 29 | 1.28 | Precautions against frauds perpetrated by employee - effective supervision, timely receipt of control returns and scrutiny thereof, rotation /transfer of staff etc. Strict watch on clearing operations, housekeeping, and reconciliation of inter bank / branch accounts. | |
| 30 | 1.29 | Precaution against frauds perpetrated by staff in clearing - checking of Branch Clearing General a/c, dispatch of statement, verification of instruments with relative schedules, etc. | |
| 31 | 1. 30 | Safe transit of cheques and instruments between the branches / clearing house. | |
| 32 | 1.31 | Precautions to be taken to prevent fraud through entries in suspense account - periodical balancing and checking, signing of debit voucher by Manager/Officer authorised by him, sending periodical statement specifying reasons for non adjustment of large &long outstanding entries etc. | |
| 33 | 1.32 | Mechanisation of operations relating to inter branch reconciliation. All branches to clear outstanding entries above Rs.2 lacs and not allow them to remain outstanding for more than a month, etc. | |
| 34 | 2.3 | Post- disbursement safeguards to be followed - critical assessment of all advances periodically, review of sticky advances and look into staff side of case when there is shift in health code status of account. | |
| 35 | 2.7 | Observance of laid down rules / guidelines / safeguards by bank officials - credit appraisal, pre sanction visit to borrowers premises / godown, proper monitoring of end use of funds by allowing payment to parties connected with borrowers line of business and not allowing transfer of large amount to sister concerns etc. | |
| 36 | 2.8 | Check list of guidelines to avoid misuse of hypothecation / pledge facilities - verification of borrowers tittle top pledged, safety of godowns, obtention of stock statement, etc. | |
| 37 | 2.13 | Safeguards against frauds through Kite Flying operations in cheques - limits against clearing cheques only for prime customers, limited drawings, spare use of discretionary powers, etc. | |

| Sr. No. | Recommen-dation No. | Nature of Recommendation | Implementation Status at Branch |
|---|---|---|---|
| 38 | 2.15 | Precaution against frauds in bill portfolios - to ensure bills represent genuine trade transactions, insistence on submission of all related documents, ascertaining credit worthiness of borrowers and drawees, lorry receipts of approved transporters, etc. | |
| 39 | 3.4 | Precautions for averting frauds in the areas of letter of credit, issue of guarantees and co-acceptance facilities. | |
| 40 | 3.7 | Bank guarantees/ LCs to be issued in security forms serially numbered, under two signatures above certain cut off point in triplicate, binding on beneficiary to seek conformation of Controlling Office (incorporation of suitable condition in the document). etc. | |
| 41 | 3.8 | One of two authorised signatures on LCs may be from controlling office. | |
| 42 | 3.9 | Bill Discounting facility under LCs, co-acceptance should be extended only to customers having regular sanctioned limits. | |
| 43 | 4.4 | Precaution relating to deals in item's like furniture and fixtures, stationary, - proper system of receiving quotations, delegation of authority, proper inventory management and periodical checking etc. | |
| 44 | 5.2 | Devising standards for suitable internal control in computerised environment. | |
| 45 | 5.5. | Micro Filming of record, vouchers, books. | |
| 46 | 5.6 | Evolving standards for fully computerised branches. | |
| 47 | 5.8 | Screening / selection of employee in EDP Cells, Computer areas. | |
| 48 | 5.9 | Replacement of unwilling workers in computer area. | |
| **Group B Part II** | | | |
| 49 | 1.22 | Paper use for cheques / drafts should be such that any use of chemicals for making material alteration in the instrument should be visible to the named eye. | |
| **Group C Part I** | | | |
| 50 | 9. 10 | Fraud cases upto Rs.25,000/- having involvement of an insider should not be reported to Police when recovery is not doubtful. | |
| **Group D Part II** | | | |
| 51 | 1.12 | Obtaining photographs of depositors at the time of opening accounts. | |

Based on the work done ,the auditor should assess whether any information obtained during the verification indicates that any of the recommendations of the Ghosh and Jilani Committee have not been implemented either in full or in part. The auditor may consider expressing either disclaimer or appropriate comments. Auditor may refer page V.40 of the Guidance Note on Audit of Banks ,2016 Edition for the illustrative format of certificate with respect to compliance of Ghosh and Jilani Committee recommendations.

Lastly, one must bear in mind seemingly petty matters, but of upmost importance while issuingany audit report or any certificate. The audit report or certificate should be printed on the letterhead of the auditor firm. It should not be dated earlier than the date on which the financial statements or certificates are signed by the Branch Manager. The audit report or certificate should be signed in the personal name of the partner and on behalf of the firm. Firm registration number of ICAI should be invariably mentioned in the audit report along with the firm's seal.

The audit report should be correct and clear on facts and the opinion of the auditor should be expressed in the said audit report. Such reports do help the CSA to take the point of branch auditor further and in issuing his report for the bank as a whole. Therefore while issuing the audit reports the branch auditors should remember five Cs viz. Compliance, Correctness, Clarity, Conciseness and Completeness. Such audit reports will be helpful for the CSA to compile his final audit report and it will serve the desired purpose of the branch audit reports or certificates.

# AUDIT OF PROFIT & LOSS ACCOUNT

The format of Profit and Loss Account is set out in Form B of Third Schedule of the Banking Regulation Act, 1949. Nowadays, almost all the bank branches are computerized and the accounting entries are passed in the system. Major revenue items such as interest on loans and deposits, accrual of interest on investments, weighted average cost of investments for the purpose of calculation of gain/loss on sale of investments etc., are computed by the system based on the programmed parameters set up. If the system parameters and programming are correct then the levy of interest and charges is correct. However, every auditor is may not be an expert in computer programming.Therefore, he may have to use certain techniques of auditing to satisfy that there is no revenue leakage at the branch under audit. These techniques may be sampling, test check, verification, checking of audit trail, depth check,etc. These can be done after understandingthe computerized accounting system at the branch. Nowadays, most of the banks are on Core Banking Solutions (CBS).

The Auditor should carefully go through the Accounting policy of the Bank for recognition of revenue. Atthe same time, the circulars about the rate of interest (both the deposits and advances), service charges, penal interest, etc. These things will give a better background about accounting of income or expenditure. The auditor can decide his audit methodologyaccordingly.

In case of CBS, the parameters are set at data centre level (i. e. centrally). Therefore, the auditor should concentrate more on the parameters set in the system, the logic of programming, etc. He should concentrate more on the master data entered and validated at the branch. In such a scenario, how the parameters are changed and the person who is authorized to change these parameters needs to be understood and the compliance should be verified. Unauthorized change or input of wrong parameters may lead to wrong calculation of income orexpenses.

The auditor should be more careful when the parameters are changed and also when the concessions are given. Auditor should have process- wise detailed checklist to improve accuracyduring the auditprocess.

Another important thing to check is the concurrent audit reports of the respective branch under audit. This would help auditor to understand the types of discrepancies noticed in the Branch and a broad idea about the level of comfort for the sample selected based on the audit plan.

The Auditor may look into the followingareas-

**A. INCOME**

1. Correct application of interest on all types of loans. The auditor should see the fagged accounts where interest is not charged from the exception report.
2. Appropriateness of Rate of interest- Correct Rate of interest as per sanctioned terms. Especially, in case of advance against Fixed Deposit of third party, the interest should be changed additionally.
3. Debit Freeze: The auditor should verify that, in case if there is debit freeze activated in loan account, the interest is run at the Back-end and is reflecting under interest accrualaccount.
4. Concessions given to the borrower in the rate of interest on loans should be seen. Whenever rates are revised, the impact thereof on the concessions needs to be seen morecarefully.
5. In case of NPA accounts, the interestis to be recognized as income only on realizable basis. It should be realized out of fresh and genuine credits and not from fresh sanction ofloans. This can be checked by verifying ledgers of the new NPAs identified during the period under audit.
6. Penal interest should be verified. The penal interest is on account various reasons such as delay in submission of stock statements, non- compliance of the terms of sanction, incomplete documentation, nonrenewal of facilities after due date,etc.
7. Manual intervention:The auditor should strictly verify the income and expense accounts where there is human intervention
8. Loan Processing charges: The auditor should confirm that the Bank has charged Loan Processing fees on pro-rata basis
9. New Products may not be Leakage free: Auditors should thoroughly verify the newly introduced asset products which may be prone to errors resulting into revenueleakage.

10. Fraudsters toleverage technology: Auditor should verify the leakages relating to weaknesses in a process of identifying a fraud concerning operational and accountingissues.

11. Commission and exchange should be checked-
    - DD/TT/MT
    - Balance Certificatecharges
    - Solvency certificatecharges

**B. EXPENSES**

For expenses, it is not enough to have appropriate account debited but the amount debited should also beproper. For all expenses, the auditor should see the sanction by appropriate authority, proper documentation and correctness in accounting. The auditor may also have a proprietary angle which he may usejudiciously.

The areas covered could be the following-

1. Interest paid on different types of deposits and Borrowings: Auditor should ensure that interest paid on deposits are as per the stipulated card rates in case of Term deposits and fixed rate in case of Saving account as per Banks policy andasperdealticketincaseofborrowings.
2. Reversal of interests paid or interest on premature deposits: Auditor should ensure the genuineness of reversal of interest on premature deposits.
3. Tagging of accounts: Auditor should ensure proper tagging of deposit accounts especially in case of current accounts and deposits from Bank which may result in paying interest on current account and paying additional premium for Bankdeposits.
4. Provisions and Payments to employees: Auditor should ensure that there are no ghost employees in thebranch.
5. Billing, Duplication &Reconciliation: Auditor should verify non entry/data entry errors, transactions which are of voluminous nature with the vendors to ensure proper billing and avoiding duplication of sameexpense.
6. Spot checks and revenue leakage on mail acceptance: Auditor by way of personal interviews should ensure whether there are any cases of spot checks or sharing of password with others which may help to authorize the undueexpenses.
7. Sensitive Stationaries: Auditor should verify the stationary and ensure the genuineness of the use of old cheque books, Demand drafts, etc.
8. Inoperative accounts: Auditor should thoroughly verify the process of activating the inoperative accounts.
9. Timely renewal of agreements: Auditor should verify that all the warranty/service related agreements are timely renewed, failure of which may lead to burden of extra cot to bank.
10. Establishment expenses
11. Rent forpremises
12. Service tax payments and payment of other taxes
13. Professional fees, legal fees, etc.
14. Printing and Stationeryexpenses
15. General chargesaccount

The audit for above areas should be done on test check basis. The sampling should be done logically. Selection of transaction should be such that it should cover all types of transactions. In such situation, as mentioned earlier the other techniques like ratio analysis, comparisons etc. should be used. In case of any divergence the matter needs to be checked thoroughly so that there is no detection risk in audit. The auditor should also see that the provisions for all expenses have been made and the application of interest is calculated and applied to all the accounts. The auditor should scrutinize the ledger account to see that there is no abnormal entry in thebooks.

**Conclusion:**

Proper audit of Profit & Loss account of the Branch is a very important aspect since it has a direct impact on the revenue/profitability of the bank. Though in today's environment, most of the Banks have computerized the accounting and hence manual intervention is reduced to a large extent, the chances of error due to incorrect input such as wrong rate of interest, penal interest, commission etc., are always there.

To summarize the discussion, following needs to be kept in mind while auditing Profit & Loss account:

1. Analytical review: Comparison with the previous period would indicate the major differences in specific areas which may be looked into if reasons given for large variances by the Branch management are not convincing

2. Exception report: Review of the exception report or debits in income account and credits in expenditure account head indicates error and requires explanation for such entries and detailed verification.

3. Input of correct rate of interest: It is very important that for all the new advances/deposit accounts and in case of reviewed accounts, the interest rate is correctly put up in the system as per the appropriate sanction letter. The incorrect rate would result in excess/under recovery of interest. Samples can be selected for major accounts and verified. Also in irregular accounts, the correct levy of penal interest should be checked.

4. Review of concurrent audit report: Review of concurrent audit report would help a great extent in audit of above area.

# ACCOUNTING STANDARDS APPLICABLE TO BANK BRANCHES

The Indian Banking industry is regulated by policies and regulations of the Reserve Bank of India (RBI). These guidelines offer limited flexibility in terms of policy decision to Scheduled Commercial Banks pertaining to a specific subject. Scheduled Commercial Banks are Companies as per the Companies Act, and follow the relevant provisions of the Companies Act wherever these are not consistent with the provisions of the Banking Regulation Act.

An important aspect of preparation of accounts and financial statements of a Bank is compliance with Accounting Standards (AS). Since the time AS issued by ICAI is in force, Banks are mandatorily required to comply with these standards. However, owing to the peculiar nature of a Bank's business, compliance with certain standards was a difficult proposition.

RBI therefore had constituted a Working Group Committee under the Chairmanship of Shree N D Gupta, Former President of ICAI to recommend steps to eliminate / reduce gaps in compliance by banks with AS issued by ICAI. The Working Group gave certain recommendations with respect to compliance with AS for Banks and observed that out of AS, already in force then i.e. in 2003 viz AS 1-22, Banks in India were generally complying with most AS except for AS5, AS9, AS11, AS15, AS17, AS18, AS21, AS22, leading to qualification in the financial statements. RBI Circular - DBOD.No.BP.BC 89 / 21.04.018/2002-03 dated 29th March,2003 stated that compliance with specific AS be complied from year ended 31st March,2003. Circular No. DBOD No.BP.BC.82/21.04.018/2003-04 dated 30th April, 2005 dealing with AS24, AS26 and AS28 further supplemented the earlier circular. All other AS prescribed by ICAI are applicable in their entirety; only the ones highlighted in these circulars are applicable in the manner prescribed therein.

Every year RBI comes out with a Master circular on Disclosure in the notes to accounts by Banks which include the relevant disclosures under the aforementioned AS.

**Indian Accounting Standards Ind-AS:** The Ministry of Finance vide notification dated February, 16th 2015 stated the applicability of Ind- AS mandatorily from periods commencing from 1st April 2016 with comparatives for accounting period ended on 31st March, 2016.

Insurance, banking & NBFC are however not required to comply with IND AS:

However RBI vide circular dated 11th February 2016 made the applicability of IND-As to Banks from periods commencing from 1st April 2018 with comparatives for period ending on 31st March 2018 and not earlier.

Banks shall assess the impact of the Ind AS implementation on their financial position including the adequacy of capital, taking into account Basel III capital requirements and place quarterly progress reports to their Boards. Banks also need to be in preparedness to submit proforma Ind AS financial statements to the RBI from half-year ended September 30, 2016, onwards.

Banks shall disclose in the Annual Report, the strategy for Ind AS implementation, including the progress made in this regard from the financial year 2016-17 until implementation.

Some key Accounting Standards (AS) are discussed below -

- **AS 5 Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies**

The standard

A) prescribes classification and disclosure of items in the Profit and loss account to be prepared and presented on a uniform basis.

B) requires classification and disclosure of extraordinary and prior period items, and disclosure of certain items within profit or loss separately from ordinary activities.

Banks do not disclose the details of such items separately in the relevant year's profit & loss account since the profit & loss account format for Banks is prescribed under Form B of the Third Schedule to the Banking Regulation Act, 1949 which does not have any matching item head for such disclosure.

RBI has clarified vide Circular DBOD No.BP. BC. 89/21.04.018/2002-03, that such disclosures, wherever warranted, be made in the Notes on Accounts to the Balance sheet of banks.

AS-5 specifies the accounting treatment for changes in accounting estimates and disclosures to be made in the financial statements regarding changes in accounting policies. These disclosures are in addition to any other disclosures required by other AS.

**Branch applicability -** In case of Prior Period items, the Branch Statutory auditor should ensure that they are separately disclosed. If any Accounting Policy / Accounting estimate is changed at the Branch level in the current year as compared to last year, the same should be specifically intimated to the Central Statutory Auditor. A MOC (Memorandum of Change) could be passed rectifying the change and giving effect to the entry as per the policy/ estimate adopted last year

- **AS 6 Depreciation Accounting**

a) Depreciation on assets is to be charged on Written Down Value at rates that depreciate 95% of the historical cost over the useful life of the asset (i.e. Book value at the end of the useful life of the asset shall be lesser than 5% of the historical cost), except in case of computers where it is calculated on the Straight Line Method, at rates prescribed by RBI.

b) In respect of additions, depreciation shall be provided for the full year, irrespective of the date on which the assets were put to use and no depreciation is to be provided in the year of sale/disposal of an asset.

c) Depreciation on the revalued portion of assets should be adjusted against the Revaluation Reserve.

d) Where the cost of land and building cannot be separately ascertained, depreciation should be provided on the composite cost, at the rate applicable to buildings.

e) Premium paid on leasehold land is amortized over the period of lease.

f) Useful life of asset shall not be longer than the useful life as prescribed in Part C of Schedule II of Companies Act 2013.

A company adopting a useful life or using a residual value different from limits specified in Schedule II of Companies Act 2013, shall disclose such deviation.

- **AS 9 Revenue Recognition**

a) Income/Expenditure should be recognized on accrual basis, unless otherwise stated.

b) Interest income should be recognized on time proportion basis except Interest on Non-Performing Assets recognized on realization, as per RBI guidelines.

c) Commission on issue of Bank Guarantee (BG) and Letter of Credit (LC) is accrued over the tenure of BG/LC.

d) All other Commission and Exchange, Brokerage, Fees and other charges are recognized as income on realization.

e) Income (other than interest) on investments in “Held to Maturity” category acquired at a discount to the face value, is recognized -

   1. At the time of sale/ redemption, on interest bearing securities &
   2. Accounted over the balance tenor of the security on a constant yield basis for Zero-coupon securities,

f) Profit or loss on sale of investments is recognized in the Profit and Loss account. In case of profit on sale of investments under ‘Held to Maturity’ category, an equivalent amount, net of taxes and amount is transferred to Statutory Reserves and appropriated to ‘Capital Reserve Account’.

g) Dividend is recognized when the right to receive the dividend is established.

h) Interest on Income-tax refund is recognized in the year of passing of the assessment order.

i) Recoveries made from NPA accounts are generally appropriated first towards unrealized interest, expenditure/out of pocket expenses incurred, and then lastly towards principal. However, banks may also choose to appropriate it first towards principal and then to interest.

In either case, the policy has to be consistently followed and disclosed.

- **AS 10 Accounting for Fixed Assets**

a) Fixed assets are stated at historic cost, except for revalued assets which are stated at revalued amounts. The appreciation on revaluation is credited to Revaluation Reserve.

b) Cost includes cost of purchase and all expenditure such as site preparation, installation costs, professional fees etc. incurred on the asset before it is put to use. Subsequent expenditure incurred on assets put to use is capitalized only if it increases the future benefits from such assets or their functioning capability.

c) Cost of premises shall include cost of land, both freehold and leasehold.

- **AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003),**

If foreign branches are submitting data for Indian Group Reporting, they need to follow AS issued by ICAI and RBI guidelines.

**A. Translation in respect of Integral Foreign operations:**

Foreign currency transactions of Indian branches are classified as integral foreign operations and foreign currency transactions of such operations are translated as under:

a. Foreign currency transactions are initially recorded on initial recognition in the reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency on the daily closing rate as notified.
b. Foreign currency monetary items are reported using the Foreign Exchange Dealers Association of India (FEDAI) closing spot rates.
c. Foreign currency non-monetary items, carried at historical cost, are reported using exchange rates at the date of the transaction.
d. Contingent liabilities denominated in foreign currency are reported at FEDAI closing spot rates.
e. Outstanding foreign exchange spot and forward contracts held for trading are revalued at the exchange rates notified by FEDAI for specified maturities, and the resulting profit or loss is recognized in the Profit and Loss account.
f. Outstanding Foreign exchange forward contracts not intended for trading are valued at closing spot rate as advised by FEDAI. The premium or discount arising at the inception of such a forward exchange contract is amortized as expense or income over the life of the contract.
g. Exchange differences arising on the settlement of monetary items at rates different from those at which they are initially recorded are recognized as income or expense in the period in which they arise.
h. Gains/Losses on account of changes in exchange rates of open position in currency futures trades are settled with the exchange clearing house on daily basis and such gains/losses are recognized in the Profit and Loss account.

**B. Translation in respect of Non-Integral Foreign operations:**

Transactions and balances of foreign branches are classified as non-integral foreign operations and their financial statements are translated as -

i) Assets and Liabilities (monetary, non-monetary and contingent liabilities) are translated at closing rates notified by FEDAI.
ii) Income and expenses are translated at quarterly average closing rates notified by FEDAI.
iii) All resulting exchange differences are parked in a separate account 'Foreign Currency Translation Reserve' till the disposal of the net investments by the bank in the respective foreign branches.
iv) Assets and Liabilities of foreign offices in foreign currency (other than local currency of the foreign offices are translated into local currency using spot rates applicable to that country.

- **AS 13 Accounting for Investments**

a) Transactions in Government Securities are recognized on Settlement Date and all other investments are recognized on trade date.

b) Investments are categorized under 'Held to Maturity', 'Held for Trading' and 'Available for Sale' categories as per RBI guidelines. For the purpose of disclosure of investments in India, these are classified, in accordance with RBI guidelines & Banking Regulation Act 1949, under six-classification viz. Government Securities, Other Approved Securities, Shares, Debentures and Bonds, Investment in Subsidiaries and Associates and Others. In respect of investments outside India, these are classified, in accordance with RBI guidelines, under three categories viz. Government Securities (including local authorities), Subsidiaries/Joint Ventures abroad and Other Investments.

   a) Basis of categorization –

   Categorization of an investment is done at the time of its acquisition as under:-

   1. **Held to Maturity:** Investments that the Bank intends to hold till maturity. Investments in subsidiaries, joint ventures and associates are categorized under Held to Maturity.
   2. Held for Trading: Investments acquired with the intention to trade by taking advantage of short term price/interest rate movements and intended to be traded within 90 days from the date of purchase.

3. Available for Sale: Investments which do not fall under in "Held to Maturity" or "Held for Trading" classification.

b) Acquisition Cost of Investment

1. Brokerage, commission, securities transaction tax etc. paid on acquisition of equity investments are included in cost.
2. Brokerage, commission, broken period interest paid/received on debt investments is treated as income/ expense and is excluded from cost/sale consideration.
3. Brokerage and Commission received on subscription of investments is credited to Profit and Loss Account.
4. Cost of investments is determined at weighted average cost method.
5. Discounted instruments such as T-Bills are valued at carrying cost.

c) Transfer of Securities between Categories

Transfer of securities between categories is done at the least of acquisition cost / book value /market value on the date of transfer. Depreciation, if any, on such transfer is fully provided for.

d) Non performing Investments (NPIs) and valuation thereof

1. Investments are classified as performing and nonperforming, based on guidelines issued by the RBI in case of domestic offices and respective regulators in case of foreign offices.
2. In respect of non performing investments, income is not recognized and provision is made for depreciation in value of such securities as per RBI guidelines.

e) Repo / Reverse Repo

Securities sold and purchased under Repo/ Reverse repo are accounted as Collateralized Lending and Borrowing transactions. Securities are transferred as in case of normal outright sale/ purchase transactions and such movement of securities is reflected using the Repo/ Reverse Repo Accounts and Contra entries. The entries are reversed on date of maturity.

Costs and revenues are accounted as interest expenditure/income, as the case may be.

Balance in Repo Account is classified as a Borrowing.

Balance in Reverse Repo account is classified as Balance with Banks and Money at Call & Short Notice.

- AS 15 Employee Benefits (revised 2005)

i. **Short Term Employee Benefit:** The undiscounted amount of short-term employee benefits, such as medical benefits etc. expected to be paid in exchange for the services rendered by employees are recognized during the period when the employee renders the service.

ii. **Post-Employment Benefit:**

A. <u>Defined Benefit Plan:</u>

a) **Gratuity:** Banks provide gratuity to all eligible employees. The benefit is in the form of lump sum payments to vested employees on retirement, on death while in employment, or on termination of employment, for an amount equivalent to 15 days' basic salary payable for each completed year of service, subject to a maximum prescribed as per The Payment of Gratuity Act 1972 whichever is higher. Vesting occurs upon completion of five years of service.

b) **Pension:** Banks may provide pension to all eligible employees. The benefit is in the form of monthly payments as per rules and payments to vested employees on retirement, on death while in employment, or on termination of employment. Vesting occurs at different stages as per rules. Banks generally make monthly contribution to the pension fund at 10% of pay. The pension liability is reckoned based on an independent actuarial valuation carried out annually and Bank makes such additional contributions periodically to the Fund as may be required to secure payment of the benefits under pension regulations.

B. Defined Contribution Plan:

a) **Provident Fund:** Banks may operate a recognized Provident Fund scheme. All eligible employees are entitled to receive benefits under the Bank's Provident Fund scheme. Banks contribute monthly at a determined rate which is remitted to a trust established for this purpose and charged to Profit and Loss Account. Banks recognize such annual contributions as an expense in the year to which it relates. If the interest declared by EPFO is higher than the interest earned by the trust than the bank has to make good the shortfall since it has to match the interest declared by EPFO. Alternatively, Banks may have a defined contribution plan and contribute to Recognized Provident Fund (RPF) directly in which case whatever is paid has to b recognized in the Profit and loss account

b) **Pension:** Banks also contribute monthly at a predetermined rate to the said pension scheme. Banks recognize the contribution to such scheme as expenses in the year to which it relates. The contributions are remitted to National Pension System Trust. Bank's obligation is limited to such predetermined contribution.

iii. **Other Long Term Employee Benefit:**

a) Leave encashment benefit is a defined benefit obligation and is provided based on actuarial valuation.

b) Other employee benefits like Leave Fare Concession, Milestone award, resettlement benefits etc. which are defined benefit obligations are also provided based on actuarial valuation.

- **AS 19 Accounting for Leases**

This Standard prescribes appropriate accounting policies and disclosures in relation to finance leases and operating leases for lessors/ lessees.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred.

A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

Lease payments under an operating lease are recognized as an expense in the statement of profit and loss on a Straight Line Basis over the lease term unless another systematic basis is more representative of the time pattern of the users' benefit.

- **AS 22 Accounting for Taxes on Income**

a) Income Tax comprises the current tax provision and net change in deferred tax assets or liabilities during the year. Deferred tax adjustments shall comprise of changes in the deferred tax assets or liabilities during the period.

b) Deferred Tax is recognized subject to consideration of prudence in respect of items of income and expenses those arise at one point of time and are capable of reversal in one or more subsequent years.

c) Deferred tax assets and liabilities are measured using tax rates and tax laws that are enacted or substantively enacted by the balance sheet date.

d) Deferred tax assets are recognized and reassessed at each reporting date, based upon management's judgment as to whether realization is considered reasonably certain. Deferred tax assets are recognized on carry forward of unabsorbed depreciation and tax losses, only if there is virtual certainty that such deferred tax assets can be realized against future profits.

- **AS 26 Intangible Assets**

This Standard prescribes accounting treatment for intangible assets not dealt with specifically in another AS. It requires an enterprise to recognize an intangible asset if, and only if, certain criteria are met. AS specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

The Standard is to be applied by all enterprises in accounting for intangible assets, except:

a. Intangible assets covered by other AS;

b. Financial assets

c. Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and

d. Intangible assets arising in insurance enterprises from contracts with policy holders.

This Standard does not apply to expenditure in respect of termination benefits and - .

(a) intangible assets held by an enterprise for sale in the ordinary course of business (AS 2, Valuation of Inventories, and AS 7, Construction Contracts);

(b) Deferred tax assets (AS 22, Accounting for Taxes on Income);

(c) Leases falling in the scope of AS 19, Leases; and

(d) Goodwill arising on an amalgamation (AS 14, Accounting for Amalgamations) and goodwill arising on consolidation ( AS 21, Consolidated Financial Statements).

- **AS 28 Impairment of Assets**

This standard prescribes procedure that a Bank should apply, to ensure that its assets are carried at more their recoverable amount. An asset is treated as carried at more than its recoverable amount, if its carrying amount exceeds the amount to be recovered through use or sale of the asset.

If this is not the case, the asset is described as impaired and the Bank has to recognize an impairment loss. Banks should assess at each balance sheet date whether there is any indication that an asset may be impaired. The impairment loss, if recognized, is debited in the profit and loss account provided no revaluation reserve exists at that date in relation to the asset, and if it exits, the loss is debited to revaluation reserve. After debiting the revaluation reserve, if still there is impairment loss then the same is debited to profit and loss account.

- **AS 29 Provisions, Contingent Liabilities and Contingent Assets**

Banks shall recognize provisions only when it has a present obligation as a result of a past event and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and when a reliable estimate of the amount of the obligation can be made.

Contingent liability is disclosed unless the possibility of an outflow of resources embodying economic benefit is remote.

Contingent Assets are not recognized in the financial statements since this may result in the recognition of income that may never be realized.

**Branch Applicability:** Both AS-28 & AS-29 are applicable at the Branch level and the Branch Statutory Auditor should ensure correct provisioning of liabilities and impairments is made in the books.

**Standards on Auditing**

One of the main objectives of the Auditing and Assurance Board of ICAI is to issue Auditing Standards. The Board issues Statements on Standard Auditing Practices and Auditing and assurance Standards under the authority of the Council.

Auditing standards represent a codification of the best practices of the profession, which are already in existence. Auditing standards help the members in proper and optimum discharge of their profession duties. Auditing standards also promote uniformity in practice as also comparability.

While discharging their attest functions, it is the duty of the members of the Institute to ensure that the auditing standards are followed in the audit of financial information covered by their audit reports. If for any reason the member is unable to perform an audit in accordance with the generally accepted auditing standards, his report should draw attention to any material departures there from, failing which he would be held guilty of professional misconduct under clause 9 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949.

**Certain Key Standards on Auditing are :**

- **SA 230 Audit Documentation**

It deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. It is to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The specific documentation requirements of other SAs do not limit the application of this SA. Laws or regulations may establish additional documentation requirements.

**Branch Applicability —** Branch auditor has to document things that are checked by him, the manner of checking and the outcome. Eg, If the auditor goes for Sample checks, he has to document that whether the Internal Controls are effective at all times during the audit period. Auditor also has to document whether the Internal Control System is sufficient enough due to which he has conducted his test checks.

The entire methodology of conducting the audit, right from the planning till the signing and certifying stage has to be documented properly.

- **SA 315 Identifying and Assessing Risk of Material Misstatement through Understanding the Entity and Its Environment**

It deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements through understanding the entity and its environment, including the Banks internal controls.

The auditor has to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the bank and its environment, including the internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

**Branch Applicability –** The branch auditor has to gain an understanding of the functions of the branch and base his audit procedures accordingly. The Internal Control System and Accounting System of the branch have to be reviewed to identify and assess the risk of material mis-statement. Special attention should be given to the process of Income Recognition & Asset Classification.

- **SA 530 Audit Sampling**

This standard applies when the auditor uses audit sampling in performing audit procedures. It deals with the auditor's use of statistical and non-statistical sampling in designing and selecting the audit sample, performing tests of controls and tests of details, evaluating the results from the sample. The objective of the auditor when using audit sampling is to provide a reasonable basis to draw conclusions about the population from which the sample is selected.

This SA complements SA 500, which deals with the auditor's responsibility to design and perform audit procedures, to obtain sufficient and appropriate audit evidence, and to be able to draw reasonable conclusions on which, to base the audit opinion. SA 500 provides guidance on the means available to the auditor for selecting items for testing, of which audit sampling is one means.

**Branch applicability-** The branch auditor shall see the nature and cause of any misstatement identified and their possible effect on the purpose of audit procedure and other areas of audit.

The auditor shall evaluate the sample result and whether use of sampling has provided a reasonable basis for his conclusion.

The extent and basis of sampling has to be specifically brought out in the Long Form Audit Report (LFAR)

- **SA 600 Using The work of Another Auditor**

"When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, such as in the case of the work of branch auditors appointed under the Companies Act, 2013 the auditor's report should expressly state the fact of such reliance."

SA 600 establishes standards to be applied in situations where a principal auditor, reporting on the financial information of an entity, uses the work of other auditor with respect to the financial information of one or more components included in the financial information of the entity. It also discusses the principal auditor's responsibility in relation to his use of the work of the other auditor.

**Branch Applicability:** The branch auditor might discuss with the previous auditor, the audit procedures applied or review a written summary of the auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. He may also wish to meet the previous auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the branch auditor's knowledge of the professional competence of the previous auditor. This knowledge is enhanced from the review of the previous audit work of the previous auditor.Alternatively, the branch auditor should also meet or communicate to the Central Statutory Auditor, issues which he feels are important to be brought to notice.

**List of Standards Not Applicable to Banks**

AS 2 Valuation of Inventories
AS 7 Construction Contracts (revised 2002)

**Sources:**

1. Annual Reports of various Banks
2. Bare Text of Accounting standards as issued by ICAI
3. Guidance Note on Audit of Banks (2016 Edition) by ICAI

# TAX AUDIT OF THE BRANCH OF THE BANK

1. As per section 44AB of the Income Tax Act, 1961, every person carrying on business whose total sales, turnover or gross receipts, as the case may be, in the business exceed or exceeds Rs. 1 crores in the previous year should get his accounts of such previous year audited by an accountant before the specified date and furnish by that date the report of such audit in the prescribed form, duly signed and verified by such accountant. The audit under section 44AB of the Income Tax Act, 1961 is commonly known as Tax Audit.

2. As far as the bank is concerned, it is operating through its branches. However, for Income Tax purpose the bank as a whole is an assessee. Hence the monetary limit of the turnover of Rs. 1 crores is considered in respect of the bank as a whole. Thus the bank is subject to tax audit. The operations of the bank are carried out through its branch network. Therefore the bank appoints its branch auditor as the tax auditor who is supposed to carry out the tax audit of the branch and report to the Head Office. At Head Office the branch tax audit reports are considered and a consolidated tax audit report is prepared. Thus the tax audit report of the branch plays supplementary role in the entire process of the tax audit of the bank.

3. The audit could be carried out by the accountant as defined in the explanation below sub-section (2) of section 288 of the Income Tax Act, 1961. According to this explanation a chartered accountant within the meaning of the Chartered Accountants Act, 1949 can sign the Tax Audit Report.

4. The details are required to be submitted in the prescribed form viz. Form 3CD. I have given the said Form 3CD by way of annexure to this article. I have also given the possible answers against every clause in the Form 3CD. These answers are the indicative answers and not necessarily the complete answers. The auditor should apply his mind for every clause and verify the answer given in the form

5. The prescribe format of Form 3CD does not have a place for the signature of the assessee. It provides the place for the signature of the Chartered Accountant. However it is advisable to take the signature of the Branch Manager on Form 3CD. It is presumed that the answers to the clauses in the form are compiled by the Branch Management and the auditor should verify them by applying suitable test checks as he may think appropriate.

6. Normally the bank prepares a format of Form 3CD. There are certain items for which the details are available at the head office of the bank. The branch may not have the details. Such items are specifically mentioned in the format given herein. For some of the clauses, there will be standard answers which are also stated in the said format. In some cases the details are to be given in a specific manner. In such cases the bank prepares the formats of the annexure to be attached to the Form 3CD and the same are attached along with the said format.

7. The auditor should verify the correctness and completeness of the details given in Form 3CD. In case the auditor is of the opinion that the details given by the branch are not correct or complete, he should bring this fact to the notice of the branch management and get it corrected. In case the branch management is not in agreement with the views of the auditor, the fact should be suitably disclosed and the reasoning should also be given.

8. The auditor should give the report in Form 3CA, as the audit of the branch is conducted under Banking Companies(Acquisition and Transfer of Undertaking) Act, 1980

9. While signing the audit report as well as Form 3CD, the auditor should mention his firm name, firm registration number, name of the member signing the report along with his/her membership number. The date and the place of execution of the report should also be mentioned.

10. While carrying out the tax audit, the tax auditor should also refer to the tax audit report of the earlier year. This will help him in understanding the expenses of the prior period, disallowances under section 43B, written down value of the assets as per Income Tax Act, TDS disallowances or allowances, etc,

11. Clause 347 of Form 3CD requires stating the details about tax deduction and its remittance to the government treasury. It is necessary to see the compliance of the provisions of Chapter XVII-B of the Income Tax Act, 1961. In case of violation of the provisions the matter should be reported. Additionally, it is necessary to pay attention to the following for aspects

    a. Tax deductible and not deducted at all – Where it is necessary to deduct the tax at source as per chapter XVII-B and the branch had not deducted the tax from such payments should be given. The auditor should verify the expenses while scrutinizing the profit and loss account and ascertain whether proper tax has been deducted or not. Where the tax is not deducted the amounts should be mentioned.

b. Shortfall on account of lesser deduction than required to be deducted- The rates of tax to be deducted are specified in the Act. The auditor should verify whether the tax is deducted at appropriate rate or not. In case the tax deducted is less than the amount works out at the prescribed rate, the instances with the amount of short fall should be mentioned. In case the tax deducted is more than the prescribed amount, the instances need not be mentioned.

c. Tax deducted late – The tax should be deducted at the prescribed time. Usually the tax is to be deducted at the time of credit or on payment whichever is earlier. However, in case the bank deducts the tax subsequently, it should be mentioned here as tax deducted late.

d. Tax deducted but not paid to the credit of the central government – The bank deducts the tax and the accounting entry is passed. The said amount remains as liability till the time it is paid to the government treasury. In case such tax which is deducted but not remitted to the government treasury, the auditor should enquire whether the amount is paid till the time of conclusion of the tax audit. However, in case, the amount is not remitted till the time of conclusion of the tax audit, it should be mentioned against this sub-clause.

e. The details of interest paid u/s 201 should also be mentioned. The auditor should also ask the branch management about the pending demands from the income tax site and if need be it should be mentioned in the contingent liabilities apart from considering it during the course of tax

While ascertaining the correctness of the details given under this clause one should remember that the non compliance of the provisions of chapter XVII-B has an impact on the allowability of the expenditure under section 40(a)(ia) of the Income Tax Act,1961

12. The auditor should obtain proper documentation from the branch to complete the working paper file. Wherever required, proper representation, in respect of certain points, may be obtained.

13. Tax audit is a specific appointment in the process of annual bank branch audit. Therefore the auditor should plan for the tax audit and design appropriate audit program to complete the tax audit effectively. In fact the auditor can enquire about the availability of well prepared Form 3CD along with its annexure. The checking of these details required for the tax audit can be done simultaneously while carrying out the scrutiny of the books of accounts. Where the accounts are maintained on computer, the auditor should enquire about the availability of the reports supporting the data required for the tax audit and use such reports as additional support to ascertain the correctness and completeness of the details given.

14. In order to complete tax audit effectively the auditor should not only be thorough with the audit, auditing techniques, Standards on Auditing, etc. but also be thorough with the provisions of the Income Tax Act, 1961. Understanding the provisions of Income Tax Act and using the audit techniques efficiently will make the tax audit more effective.

## FORM NO. 3CD

[See rule 6G(2)]

Statement of particulars required to be furnished under section 44AB of the Income tax Act, 1961

## PART - A

| | | |
|---|---|---|
| **1** | Name of the assessee | : *Name of the branch/office with C.O. Code Number* |
| **2** | Address | : *Address of the branch* |
| **3** | Permanent Account Number (PAN) | : *Specify the PAN of the bank* |
| **4** | Whether the assessee is liable to pay indirect tax like excise duty, service tax, sales tax, customs duty, etc. if yes, please furnish the registration number or any other identification number allotted for the same | : *Specify the relevant registration number of the bank* |
| **5** | Status | : *Domestic Company* |
| **6** | Previous year | : **01-Apr-2015 to 31-Mar-2016** |
| **7** | Assessment year | : **2016-17** |
| **8** | Indicate the relevant clause of section 44AB under which the audit has been conducted | : 44AB(a) |

| PART – B | | | |
|---|---|---|---|
| 9 | (a) | If firm or Association of Persons, indicate names of partners/members and their profit sharing ratios. | Not Applicable |
| | (b) | If there is any change in the partners or members or in their profit sharing ratio since the last date of the preceding year, the particulars of such change. | Not Applicable |
| 10 | (a) | Nature of business or profession (if more than one business or profession is carried on during the previous year, nature of every business or profession). | *Banking as per Section 6 of the Banking Regulation Act, 1949.* |
| | (b) | If there is any change in the nature of business or profession, the particulars of such change. | *There is no change in the nature of business.* |
| 11 | (a) | Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed. . | No |
| | (b) | List of books of account maintained and the address at which the books of accounts are kept.<br>(In case books of account are maintained in a computer system, mention the books of account generated by such computer system. If the books of accounts are not kept at one location, please furnish the addresses of locations along with the details of books of accounts maintained at each location.) | *As of 31.03.2016, the branch / office is computerized having Core Banking Solution Platform and the books of accounts are generated by computer system.* |
| | (c) | List of books of account and nature of relevant documents examined. | As above |
| 12 | | Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant sections (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB, Chapter XII-G, First Schedule or any other relevant section.) | No |
| 13 | (a) | Method of accounting employed in the previous year. | Mercantile system |
| | (b) | Whether there had been any change in the method of accounting employed vis-a-vis the method employed in the immediately preceding previous year. | *Dealt at Head Office* |
| | (c) | If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss. | *Dealt at Head Office* |
| | | Serial number Particulars Increase in profit (Rs.) Decrease in profit (Rs.) | |
| | (d) | Details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss. | *Dealt at Head Office* |
| 14 | (a) | Method of valuation of closing stock employed in the previous year. | Not Applicable |
| | (b) | In case of deviation from the method of valuation prescribed under section 145A, and the effect thereof on the profit or loss, please furnish: | Not Applicable |
| | | Serial number Particulars Increase in profit (Rs.) Decrease in profit (Rs.) | |
| 15 | | Give the following particulars of the capital asset converted into stock-in-trade: -<br>(a) Description of capital asset;<br>(b) Date of acquisition;<br>(c) Cost of acquisition;<br>(d) Amount at which the asset is converted into stock-in-trade. | Not Applicable |
| 16 | | Amounts not credited to the profit and loss account, being,- | |
| | (a) | the items falling within the scope of section 28; | Details to be given, if any |
| | (b) | the pro forma credits, drawbacks, refund of duty of customs or excise or service tax, or refund of sales tax or value added tax, where such credits, drawbacks or refunds are admitted as due by the authorities concerned; | Details to be given, if any |
| | (c) | escalation claims accepted during the previous year; | Details to be given, if any |
| | (d) | any other item of income; | Details to be given, if any |
| | (e) | capital receipt, if any. | Details to be given, if any |
| 17 | | Where any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, please furnish: | NIL |
| | | Details of property Consideration received or accrued Value adopted or assessed or assessable | |

| | | |
|---|---|---|
| 18 | Particulars of depreciation allowable as per the Income-tax Act, 1961 in respect of each asset or block of assets, as the case may be, in the following form :-<br>(a) Description of asset/block of assets.<br>(b) Rate of depreciation.<br>(c) Actual cost or written down value, as the case may be.<br>(d) Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of—<br>(i) Central Value Added Tax credits claimed and allowed under the Central Excise Rules,1944, in respect of assets acquired on or after 1st March, 1994,<br>(ii) change in rate of exchange of currency, and<br>(iii) subsidy or grant or reimbursement, by whatever name called.<br>(e) Depreciation allowable.<br>(f) Written down value at the end of the year. | *Dealt at Head Office* |
| 19 | Amounts admissible under sections-<br>(a) 32AC, (b) 33AB, (c) 33ABA, (d) 35(1)(i), (e) 35(1)(ii), (f) 35(1)(iia), (g) 35(1)(iii), (h) 35(1)(iv), (i) 35(2AA), (j) 35(2AB), (k) 35ABB, (l) 35AC, (m)35AD, (n)35CCA, (o)35CCB, (p)35CCC, (q) 35CCD, (r) 35D, (s) 35DD, (t)35DDA, (u)35E:<br>Amount debited to profit and loss account<br>Amounts admissible as per the provisions of the Income Tax Act, 1961 and also fulfils the conditions, if any specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules,1962 or any other guidelines, circular, etc., issued in this behalf. | *NIL* |
| 20 | (a) Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [Section 36(1)(ii)] | *NIL* |
| | (b) Details of contributions received from employees for various funds as referred to in section 36(1)(va):<br>Serial number \| Nature of fund \| Sum received from employees \| Due date for payment \| The actual Amount paid \| The actual date of payment to the concerned authorities | *NIL* |
| 21 | (a) Please furnish the details of amounts debited to the profit and loss account, being in the nature of<br>Capital expenditure<br>Personal expenditure<br>Advertisement expenditure in any souvenir, brochure, tract, pamphlet or the like, published by a political party<br>Expenditure incurred at clubs being entrance fees and subscriptions<br>Expenditure incurred at clubs being cost for club services and facilities used<br>Expenditure by way of penalty or fine for violation of any law for the time being force<br>Expenditure by way of any other penalty or fine not covered above<br>Expenditure incurred for any purpose which is an offence or which is prohibited by law | Details to be given, if any |
| | (b) Amounts inadmissible under section 40(a):-<br>(i) as payment to non-resident referred to in sub-clause (i)<br>(A) Details of payment on which tax is not deducted:<br>(I) date of payment<br>(II) amount of payment<br>(III) nature of payment<br>(IV) name and address of the payee | Details to be given, if any |
| | (B) Details of payment on which tax has been deducted but has not been paid during the previous year or in the subsequent year before the expiry of time prescribed under section 200(1)<br>(I) date of payment<br>(II) amount of payment<br>(III) nature of payment<br>(IV) name and address of the payee<br>(V) amount of tax deducted | Details to be given, if any |

| | | |
|---|---|---|
| | (ii) as payment referred to in sub-clause (ia)<br>(A) Details of payment on which tax is not deducted:<br>(I) date of payment<br>(II) amount of payment<br>(III) nature of payment<br>(IV) name and address of the payee | Details to be given, if any |
| | (B) Details of payment on which tax has been deducted but has not been paid on or before the due date specified in sub- section (1) of section 139.<br>(I) date of payment<br>(II) amount of payment<br>(III) nature of payment<br>(IV) name and address of the payer<br>(V) amount of tax deducted<br>(VI) amount out of (V) deposited, if any | Details to be given, if any |
| | (iii) under sub-clause (ic) [Wherever applicable] | NIL |
| | (iv) under sub-clause (iia) | NIL |
| | (v) under sub-clause (iib) | NIL |
| | (vi) under sub-clause (iii)<br>(A) date of payment<br>(B) amount of payment<br>(C) name and address of the payee | NIL |
| | (vii) under sub-clause (iv) | NIL |
| | (viii) under sub-clause (v) | NIL |
| | (c) Amounts debited to profit and loss account being, interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof; | Not Applicable |
| | (d) Disallowance/deemed income under section 40A(3): | |
| | (A) On the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, please furnish the details:<br>Serial number / Date of payment / Nature of payment / Amount / Name and Permanent Account Number of the payee, if available | Details to be given, if any |
| | (B) On the basis of the examination of books of account and other relevant documents/evidence, whether the payment referred to in section 40A(3A) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft If not, please furnish the details of amount deemed to be the profits and gains of business or profession under section 40A(3A);<br>Details to be given, if any<br>Serial number / Date of payment / Nature of payment / Amount / Name and Permanent Account Number of the payee, if available | Details to be given, if any |
| | (e) provision for payment of gratuity not allowable under section 40A(7); | NIL |
| | (f) any sum paid by the assessee as an employer not allowable under section 40A(9); | NIL |
| | (g) particulars of any liability of a contingent nature; | NIL |
| | (h) amount of deduction inadmissible in terms of section 14A in respect of the expenditure incurred in relation to income which does not form part of the total income; | NIL |
| | (i) amount inadmissible under the proviso to section 36(1)(iii) | NIL |
| 22 | Amount of interest inadmissible under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006. | Details to be given, if any |
| 23 | Particulars of payments made to persons specified under section40A (2)(b). | NIL |
| 24 | Amounts deemed to be profits and gains under section 32AC or 33AB or 33ABA or 33AC. | NIL |
| 25 | Any amount of profit chargeable to tax under section 41 and computation thereof. | NIL |

| | | |
|---|---|---|
| 26 | In respect of any sum referred to in clauses (a), (b), (c), (d), (e) or (f) of section 43B, the liability for which:-<br>(A) pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was<br>(a) paid during the previous year;<br>(b) not paid during the previous year.<br>(B) Was incurred in the previous year and was<br>(a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);<br>(b) not paid on or before the aforesaid date. | Details to be given, if any |
| | (State whether sales tax, customs duty, excise duty or any other indirect tax, levy, cess, impost, etc., is passed through the profit and loss account.) | Yes |
| 27 | (a) Amount of Central Value Added Tax credits availed of or utilised during the previous year and its treatment in the profit and loss account and treatment of outstanding Central Value Added Tax credits in the accounts. | Relevant details to be reported |
| | (b) Particulars of income or expenditure of prior period credited or debited to the profit and loss account. | NIL |
| 28 | Whether during the previous year the assessee has received any property, being share of a company not being a company in which the public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viia), if yes, please furnish the details of the same. | No |
| 29 | Whether during the previous year the assessee received any consideration for issue of shares which exceeds the fair market value of the shares as referred to in section 56(2)(viib), if yes, please furnish the details of the same. | No |
| 30 | Details of any amount borrowed on hundi or any amount due thereon (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque [Section 69D]. | NIL |
| 31 | *(a) Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year<br>(i) name, address and permanent account number (if available with the assessee) of the lender or depositor;<br>(ii) amount of loan or deposit taken or accepted;<br>(iii) whether the loan or deposit was squared up during the previous year;<br>(iv) maximum amount outstanding in the account at any time during the previous year;<br>(v) whether the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.<br>*(These particulars needs not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.) | Not Applicable |
| | (b) Particulars of each repayment of loan or deposit in an amount exceeding the limit specified in section 269T made during the previous year :—<br>(i) name, address and permanent account number (if available with the assessee) of the payee;<br>(ii) amount of the repayment;<br>(iii) maximum amount outstanding in the account at any time during the previous year;<br>(iv) whether the repayment was made otherwise than by account payee cheque or account payee bank draft. | Details to be given, if any |
| | (c) Whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents<br>Details to be given, if any<br>(The particulars (i) to (iv) at (b) and comment at (c) above need not be given in the case of a repayment of any loan or deposit taken or accepted from Government, Government company, banking company or a corporation established by a Central, State or Provincial Act) | Details to be given, if any |

| | | |
|---|---|---|
| 32 | (a) Details of brought forward loss or depreciation allowance, in the following manner, to the extent available:<br>Serial Number \| Assessment Year \| Nature of loss/ allowance (in rupees) \| Amount as returned (in rupees) \| Amount as assessed (give reference to relevant order) \| Remarks | NIL |
| | (b) Whether a change in shareholding of the company has taken place in the previous year due to which the losses incurred prior to the previous year cannot be allowed to be carried forward in terms of section 79 | No |
| | (c) Whether the assessee has incurred any speculation loss referred to in section 73 during the previous year, If yes, please furnish the details of the same. | NIL |
| | (d) Whether the assessee has incurred any loss referred to in section 73A in respect of any specified business during the previous year, if yes, please furnish details of the same. | NIL |
| | (e) In case of a company, please state that whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73, if yes, please furnish the details of speculation loss if any incurred during the previous year. | NA |
| 33 | Section-wise details of deductions, if any, admissible under Chapter VIA or Chapter III (Section 10A, Section 10AA). | Details to be given, if any |
| | Section under which deduction is claimed \| Amounts admissible as per the provision of the Income Tax Act, 1961 and fulfils the conditions, if any, specified under the relevant provisions of Income Tax Act, 1961 or Income Tax Rules,1962 or any other guidelines, circular, etc, issued in this behalf. | |
| 34 | (a) Whether the assessee is required to deduct or collect tax as per the provisions of Chapter XVII-B or Chapter XVII-BB, if yes please furnish:<br>1 Tax deduction and collection Account Number (TAN)<br>2 Section<br>3 Nature of payment<br>4 Total amount of payment or receipt of the nature specified in column (3)<br>5 Total amount on which tax was required to be deducted or collected out of (4)<br>6 Total amount on which tax was deducted or collected at specified rate out of (5)<br>7 Amount of tax deducted or collected out of (6)<br>8 Total amount on which tax was deducted or collected at less than specified rate out of (5)<br>9 Amount of tax deducted or collected on (8)<br>10 Amount of tax deducted or collected not deposited to the credit of the Central Government out of (6) and (8) | Details to be provided |
| | (b) Whether the assessee has furnished the statement of tax deducted or tax collected within the prescribed time. If not, please furnish the details: | Details to be provided |
| | Tax deduction and collection Account Number (TAN) \| Type of Form \| Due date for furnishing \| Date of furnishing, if furnished \| Whether the statement of tax deducted or collected contains information about all transactions which are required to be reported | |
| | (c) Whether the assessee is liable to pay interest under section 201(1A) or section 206C(7). If yes, please furnish: | Details to be provided |
| | Tax deduction and collection Account Number (TAN) \| Amount of interest under section 201(1A)/206C(7) is payable \| Amount paid out of column (2) along with date of payment. | |
| 35 | (a) In the case of a trading concern, give quantitative details of principal items of goods traded:<br>(i) opening Stock;<br>(ii) purchases during the previous year;<br>(iii) sales during the previous year;<br>(iv) closing Stock;<br>(v) shortage/excess, if any. | Not Applicable |

| | | |
|---|---|---|
| | (b) In the case of manufacturing concern, give quantitative details of the principal items of raw materials, finished products and by-products:<br>A Raw materials :<br>(i) opening stock;<br>(ii) Purchases during the previous year;<br>(iii) consumption during the previous year;<br>(iv) sales during the previous year;<br>(v) closing stock;<br>(vi) yield of finished products;<br>(vii) percentage of yield;<br>(viii) shortage/excess, if any. | Not Applicable |
| | B Finished products/By-products :<br>(i) opening stock;<br>(ii) purchases during the previous year;<br>(iii) quantity manufactured during the previous year;<br>(iv) sales during the previous year;<br>(v) closing stock;<br>(vi) shortage/excess, if any. | Not Applicable |
| 36 | In the case of a domestic company, details of tax on distributed profits under section 115-O in the following form: -<br>(a) total amount of distributed profits;<br>(b) amount of reduction as referred to in section 115-O(1A)(i);<br>(c) amount of reduction as referred to in section 115-O(1A)(ii);<br>(d) total tax paid thereon;<br>(e) dates of payment with amounts. | Not Applicable |
| 37 | Whether any cost audit was carried out, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor. | Not Applicable |
| 38 | Whether any audit was conducted under the Central Excise Act, 1944, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor. | Not Applicable |
| 39 | Whether any audit was conducted under section 72A of the Finance Act,1994 in relation to valuation of taxable services, Finance Act,1994 in relation to valuation of taxable services, if yes, give the details, if any, of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the auditor. | No |
| 40 | Details regarding turnover, gross profit, etc., for the previous year and preceding previous year:<br>1. Total turnover of the assessee<br>2. Gross profit/turnover<br>3. Net profit/turnover<br>4. Stock-in-trade/turnover<br>5. Material Consumed/finished goods produced | Not Applicable |
| | (The details required to be furnished for principal items of goods traded or manufactured or services rendered) | |
| 41 | Please furnish the details of demand raised or refund issued during the previous year under any tax laws other than Income Tax Act, 1961 and Wealth tax Act, 1957 alongwith details of relevant proceedings. | At Head Office |

# FRAUDS

Sec **447 of the Companies Act, 2013** defines Fraud in relation to affairs of a company of any-body corporate, to include,

(a) any act
(b) omission,
(c) concealment of any fact
(d) abuse of position committed by any person or any other person with the connivance in any manner
   - with intent to deceive
   - to gain undue advantage from, or
   - to injure the interests of,
     - the company or
     - its shareholders
     - or its creditors or
     - any other person

   Whether or not there is any wrongful gain or wrongful loss;

- *"wrongful gain"* means the gain by unlawful means of property to which the person gaining is not legally entitled
- *"Wrongful loss"* means the loss by unlawful means of property to which the person losing is legally entitled.

Fraud is also defined in **Para 11(a) of SA 240** issued by the Institute of Chartered Accountants of India –"Auditors Responsibilities relating to Fraud in Audit of Financial Statements" as

'An intentional act by one or more individuals among
- Management
- those charged with governance
- employees or
- or third parties,

Involving use of deception to obtain an unjust or an illegal advantage."

Similarly **Standards on Internal Audit** i.e. **SIA 11** issued by the ICAI – "Consideration of Fraud in an Internal Audit define Fraud as

"An intentional act by one or more individuals among management, those charged with governance or third parties involving the use of deception to obtains unjust or illegal advantage. A Fraud could take form of mis-statement of an information (Financial or otherwise) or mis-appropriation of assets of that entity" Another notable definition of Fraud is as per Section 17 of the Indian Contract Act,1872

'Fraud' **means and includes** any of the following acts committed by

- a party to a contract or
- with his connivance,
- or by his agent,

With an intent to
- Deceive another party thereto or
- His agent or
- To induce him to enter into the contract

1. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true
2. The active concealment of a fact by one having knowledge or belief of the fact
3. A promise made without any intention of performing it
4. Any other act fitted to deceive
5. Any such act or omission as the law specially declares to be fraudulent

Reserve Bank of India, based on the findings from certain forensic scrutiny conducted by it and vide Circular No DBS. CO.FrMC.BC.No.10/23.04.001/2010-11 date 31st May, 2011, had identified certain areas wherein frauds had shown occurrence or increasing trend in banks. These areas include:-

- Loans/ advances against hypothecation of stocks
- Housing loans cases
- Submission of forged documents including letters of credit
- Escalation of overall cost of the property to obtain higher loan amount
- Over valuation of mortgaged properties at the time of sanction
- Grant of loans against forged FDRs
- Over-invoicing of export bills resulting in concessional bank finance, exemptions from various duties, etc.
- Frauds stemming from housekeeping deficiencies.

Reserve Bank of India (RBI) has issued a Master Circular - Ref CDBS.CO.CFMC.BC.No.1/23.04.001/2015-16 dated 1st July 2015 on Frauds – Classification & reporting to all Scheduled Commercial banks which states:-

Chairmen/Managing Directors/Chief Executive Officers (CMD/CEOs) of banks must provide focus on "Fraud Prevention and Management Function" to enable, effective investigation of fraud cases and prompt and accurate reporting to appropriate regulatory & law enforcement authorities including RBI.

Fraud risk management, fraud monitoring and fraud investigation function is to be owned by the Bank's CEO, Audit Committee of the Board & Special Committee of the Board.

Banks may, with their respective Boards approval, frame an internal policy for fraud risk management & fraud investigation function, based on governance standards relating to ownership of the function & accountability resting on defined & dedicated organizational set up & operating processes.

Banks are required to send Fraud Monitoring Returns (FMR) and data, based on the Frauds Reporting and Monitoring System (FRMS) - Banks should specifically nominate an official of the rank of General Manager responsible for submitting all the FMR returns.

FMR 1 – Report on actual & suspected frauds to be submitted within 3 weeks of detection or within 1 week of detection if amount involved is over 1 Crore

FMR 2 – Quarterly report on Frauds outstanding to be submitted within 15 days of quarter end

FMR 3 – Quarterly Progress report on Frauds to be submitted within 15 days of quarter end

In order to have uniformity in reporting, Frauds have been classified as under, based mainly on the provisions of the Indian Penal Code:

a. Misappropriation and criminal breach of trust.
b. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
c. Unauthorised credit facilities extended for reward or for illegal gratification.
d. Negligence and cash shortages.
e. Cheating and forgery.
f. Irregularities in foreign exchange transactions.
g. Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred in items (d) and (f) above are to be reported as fraud if the intention to cheat/defraud is suspected/ proved. However, the following cases where fraudulent intention is not suspected/ proved at the time of detection will be treated as fraud and reported accordingly:

(a) Cases of cash shortage more than 10,000/-, (including at ATMs) and
(b) Cases of cash shortage more than 5,000/- if detected by management / auditor/ inspecting officer and not reported on the day of occurrence by the persons handling cash

Banks should ensure that the reporting system is suitably streamlined to avoid delays in reporting of frauds, submission of delayed and incomplete fraud reports. Banks must fix staff accountability in respect of delays in reporting fraud cases to RBI.

Delay in reporting of frauds and the consequent delay in alerting other banks about the modus operandi and issue of caution advices against unscrupulous borrowers could result in similar frauds being perpetrated elsewhere. Banks may, therefore, strictly adhere to the timeframe fixed in this circular for reporting fraud cases to RBI failing which they would be liable for penal action prescribed under Section 47(A) of the Banking Regulation Act, 1949.

Banks should ensure that all frauds of 0.1 million and above are reported to their Boards promptly on their detection. Such reports should, among other things, take note of the failure on the part of the concerned branch officials and controlling authorities, and give details of action initiated against the officials responsible for the fraud.

The main aspects which may be taken into account while making a review on Frauds are -

a. Whether the systems in the bank are adequate to detect frauds, once they have taken place, within the shortest possible time.
b. Whether frauds are examined from staff angle and, wherever necessary, reported to Vigilance Cell for further action in the case of public sector banks.
c. Whether deterrent punishment is meted out, wherever warranted, to persons found responsible.
d. Whether frauds have taken place because of laxity in following the systems and procedures and, if so, whether effective action has been taken to ensure that the systems and procedures are scrupulously followed by the staff concerned.
e. Whether frauds are reported to local Police or CBI, as the case may be, for investigation, as per the guidelines issued in this regard to public sector banks by Government of India.

The annual reviews should also, among other things, include the following details:

a. Total number of frauds detected during the year and amount involved compared to previous 2 years.
b. Analysis of frauds according to different categories & business areas indicated in FMR 2.
c. Modus operandi of major frauds reported during the year along with their present position.
d. Detailed analysis of frauds of 0.1 million and above.
e. Estimated loss to the bank during the year due to frauds, amount recovered & provisions made.
f. Number of cases (with amounts) where staff are involved & the action taken against staff.
g. Region-wise/Zone-wise/State-wise break-up of frauds & amount involved.
h. Time taken to detect frauds (Cases detected within 3/6 months & 1 year of their taking place).
i. Position with regard to frauds reported to CBI/Police.
j. Number of frauds where final action has been taken by the bank & cases disposed of.
k. Preventive/punitive steps taken during the year to reduce/minimise the incidence of frauds.

The major functions of the Special Committee of Board formed to monitor and review all the frauds of 10 million and above are-

- Identify systemic lacunae if any that facilitated perpetration of the fraud & put in place measures to plug the same.
- Identify reasons for delay in detection, if any, reporting to top management of the bank & RBI.
- Monitor progress of CBI/Police investigation & recovery position.
- Ensure staff accountability is examined at all levels in all the cases of frauds & staff side action, if required, is completed quickly without loss of time.
- Review efficacy of the remedial action taken to prevent recurrence of frauds (strengthening of internal controls).

Precautions to be taken in case of cheque related Frauds –

I. Ensuring use of 100% CTS - 2010 compliant cheques.
II. Strengthening the infrastructure at cheque handling Service Branches & bestowing special attention on quality of equipment & personnel posted for CTS based clearing, so that it is not merely a mechanical process.
III. Ensuring that beneficiary is KYC compliant so that the bank has recourse to him/her as long as he/she remains a customer of the bank.
IV. Examination under UV lamp for all cheques beyond a threshold of say, 0.2 million.
V. Checking at multiple levels, of cheques above a threshold of say, 0.5 million.
VI. Close monitoring of credits / debits in newly opened accounts based on risk categorization.
VII. Sending an SMS alert to payer/drawer when cheques are received in clearing.

The threshold limits mentioned above can be reduced or increased with the approval of the Board depending on the volume of cheques handled by the bank or it's risk appetite. Banks may also consider the following preventive measures for dealing with suspicious or large value cheques (in relation to an account's normal level of operations):

a. Alerting the customer by a phone call and getting the confirmation from the payer/drawer.
b. Contacting base branch in case of non-home cheques.

The early detection of Fraud and the necessary corrective action are important to reduce the quantum of loss which the continuance of the Fraud may entail. A Red Flagged Account (RFA) is one where a suspicion of fraudulent activity is thrown up by the presence of one or more Early Warning Signals (EWS). These signals in a loan account should immediately put the bank on alert regarding a weakness or wrong doing which may ultimately turn out to be fraudulent. A bank cannot afford to ignore such EWS but must instead use them as a trigger to launch a detailed investigation into a RFA.

The circular has given an illustrative list of some EWS is given for the guidance of Banks. Banks may choose to adopt or adapt the relevant signals from this list and also include other alerts/signals based on their experience, client profile and business models. The EWS so compiled by a bank would form the basis for classifying an account as a RFA.

During the course of the audit, auditors may come across instances where the transactions in the account or the documents point to the possibility of fraudulent transactions in the account. In such a situation, the auditor may immediately bring it to the notice of the top management and if necessary to the Audit Committee of the Board (ACB) for appropriate action.

In case of accounts classified as 'fraud', banks are required to make provisions to the full extent immediately, irrespective of the value of security. However, in case a bank is unable to make the entire provision in one go, it may now do so over four quarters provided there is no delay in reporting

As in the case of accounts categorised as NPAs, banks must initiate and complete a staff accountability exercise within six months from the date of classification as a Fraud. Wherever felt necessary or warranted, the role of sanctioning official(s) may also be covered under this exercise. The completion of the staff accountability exercise for frauds and the action taken may be placed before the SCBF and intimated to the RBI at quarterly intervals as hitherto.

Banks may bifurcate all fraud cases into vigilance and non-vigilance. Only vigilance cases should be referred to the investigative authorities. Non-vigilance cases may be investigated and dealt with at the bank level within a period of six months.

Borrowers who have defaulted and have also committed a fraud in the account would be debarred from availing bank finance from Scheduled Commercial Banks, Development Financial Institutions, Government owned NBFCs, Investment Institutions, etc., for a period of five years from the date of full payment of the defrauded amount. After this period, it is for individual institutions to take a call on whether to lend to such a borrower. The penal provisions would apply to non-whole time directors (like nominee directors and independent directors) only in rarest of cases based on conclusive proof of their complicity. No restructuring or grant of additional facilities may be made in the case of RFA or fraud accounts.

Third parties such as builders, warehouse/cold storage owners, motor vehicle/tractor dealers, travel agents, etc. and professionals such as architects, valuers, chartered accountants, advocates, etc. are also to be held accountable if they have played a vital role in credit sanction/disbursement or facilitated the perpetration of frauds. Banks are advised to report to Indian Banks Association (IBA) the details of such third parties involved in frauds. Before reporting to IBA, banks have to satisfy themselves of the involvement of third parties concerned and also provide them with an opportunity of being heard. In this regard the banks should follow normal procedures & the processes followed should be suitably recorded. On the basis of such information, IBA would, in turn, prepare caution lists of such third parties for circulation among the banks.

**Some Early Warning signals which should alert the bank officials about some wrongdoings in the loan accounts which may turn out to be fraudulent**

1. Default in payment to the banks/ sundry debtors and other statutory bodies, etc., bouncing of the high value cheques.
2. Raid by Income tax /sales tax/ central excise duty officials.
3. Frequent change in the scope of the project to be undertaken by the borrower.
4. Under insured or over insured inventory.
5. Invoices devoid of TAN and other details.
6. Dispute on title of the collateral securities.
7. Costing of the project which is in wide variance with standard cost of installation of the project.
8. Funds coming from other banks to liquidate the outstanding loan amount.
9. Foreign bills remaining outstanding for a long time and tendency for bills to remain overdue.

10. Onerous clause in issue of BG/LC/standby letters of credit.
11. In merchanting trade, import leg not revealed to the bank.
12. Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
13. Delay observed in payment of outstanding dues.
14. Financing the unit far away from the branch.
15. Claims not acknowledged as debt high.
16. Frequent invocation of BGs and devolvement of LCs.
17. Funding of the interest by sanctioning additional facilities.
18. Same collateral charged to a number of lenders.
19. Concealment of certain vital documents like master agreement, insurance coverage.
20. Floating front / associate companies by investing borrowed money.
21. Reduction in the stake of promoter / director.
22. Resignation of the key personnel and frequent changes in the management.
23. Substantial increase in unbilled revenue year after year.
24. Large number of transactions with inter-connected companies and large outstanding from such companies.
25. Significant movements in inventory, disproportionately higher than the growth in turnover.
26. Significant movements in receivables, disproportionately higher than the growth in turnover and/or increase in ageing of the receivables.
27. Disproportionate increase in other current assets.
28. Significant increase in working capital borrowing as percentage of turnover.
29. Critical issues highlighted in the stock audit report.
30. Increase in Fixed Assets, without corresponding increase in turnover (when project is implemented).
31. Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet.
32. Liabilities appearing in ROC search report, not reported by the borrower in its annual report.
33. Substantial related party transactions.
34. Material discrepancies in the annual report.
35. Significant inconsistencies within the annual report (between various sections).
36. Poor disclosure of materially adverse information and no qualification by the statutory auditors.
37. Frequent change in accounting period and/or accounting policies.
38. Frequent request for general purpose loans.
39. Movement of an account from one bank to another.
40. Frequent ad hoc sanctions.
41. Not routing of sales proceeds through bank.
42. LCs issued for local trade / related party transactions.
43. High value RTGS payment to unrelated parties.
44. Heavy cash withdrawal in loan accounts.
45. Non submission of original bills.

**RBI in the Master Circular dated 1st July, 2015 applicable to Urban Co-operative Banks has further stated that the following acts constitute Fraud -**

Fraudulent removal of pledged stocks / disposal of hypothecated stocks without the knowledge of the bank / inflating the value of stocks in the stock statements & drawing excess bank finance.

Diversion of funds, lack of interest or criminal neglect on the part of the borrowers partners etc in adhering to financial discipline and managerial failure with mala fide intent leading to the unit becoming sick and laxity in effective supervision over the operations in borrowable accounts on the part of bank functionaries rendering the advance difficult for recovery and resulting in financial loss to the bank.

Auditors should take due cognizance of the same and banks could be asked to report the same as Frauds on a case to case basis after due consideration of the borrower's intent & the frequency of such instances, risk of default as a result of such practices, materiality of the amount financed by the bank and outstanding, defaults & overdue, availability of collateral & loan to value ratio or margin of safety.

As per SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objectives are to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. The attitude of professional scepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

ICAI has issued a Guidance note in February 2016 on Reporting on Frauds under Section 143(12) of the Companies Act, 2013. Part B of the Guidance Note paragraph 11 deals with Reporting to RBI in case of Frauds noted during Audit of Banks. Auditors may also refer the Guidance note for further clarity.

RBI in its Master Circular on KYC-AML has stated that "Money mules" can be used to launder the proceeds of fraud schemes (*e.g.,* phishing and identity theft) by criminals who gain illegal access to deposit accounts by recruiting third parties to act as "money mules." In some cases these third parties may be innocent while in others they may be having complicity with the criminals.

In a money mule transaction, an individual with a bank account is recruited to receive cheque deposits or wire transfers &then transfer these funds to accounts held on behalf of another person or to other individuals, minus a certain commission payment. Money mules may be recruited by a variety of methods, including spam e-mails, advertisements on genuine recruitment web sites, social networking sites, instant messaging and advertisements in newspapers. When caught, these money mules often have their bank accounts suspended, causing inconvenience &potential financial loss, apart from facing likely legal action for being part of a fraud. Many a times the address and contact details of such mules are found to be fake or not up to date, making it difficult for enforcement agencies to locate the account holder.

RBI has advised periodical up-dation of customer identification data after the account is opened and also to monitoring of transactions in order to protect themselves and their customers from misuse by such fraudsters.

Auditors should duly consider the money laundering frauds and ensure that the banks report Suspicious Transaction to FIU.

Some of the types of Frauds specific in a Banking Industry are as under –

1) **Cheque frauds –** alteration / impersonation
2) **Accommodation Bills –** These are drawn and accepted without any consideration passed or received. These are done to oblige friends in need of money by readily raising cash without any underlying trading activity. Usually before the due date the drawer provides funds to the acceptor to honor the bill
3) **Evergreening or Window Dressing of NPA accounts –** This is usually done by providing additional funds to some associate / sister concern which are then credited to the overdue / defaulted borrower account. The purpose is to show lesser NPA an consequentially higher profits by reduced mandatory provisioning.
4) **Debt Restructuring frauds–** where an individual or corporate hides or transfers asset before filing for bankruptcy by knowingly concealing or mis-stating the assets, the debtor abuses the process to escape financial liabilities while holding on to the wealth that these liabilities or creditors helped to create.

   Borrowers often ask for restructuring mainly to buy time to prevent their assets from being sold or delay the legal process with no intent to actually restart the business activities afresh.
5) **Auction frauds–** Assets which are pledged as collateral get sold hen the borrower is unable to repay. These are sold at auctions where the bidders are fixed or have formed a price cartel. Low bids are accepted and the difference with the market price is shared to agreed extent.
6) **Unauthorized Operations** in dormant accounts / Pay-orders / Demand drafts –
7) **Use of suspense a/c's / old reconciliation** balances to adjust unauthorized entries.
8) **Documentation frauds -Loans obtained on forged papers –** Common in Housing loans / Loans – Overdrafts granted against property. Forging of Chartered Accountants signature, using his letter heads or stamps to issue an audit report or certify the accounts is also done to lend credibility to unaudited accounts.
9) **Hypothecation frauds / Siphoning of Funds –** Funds borrowed from banks / FI's are utilized for the purpose unrelated to the operations of the borrower to the detriment of the financial health of the entity or the lender.
10) **Wire transfer fraud -**Wire transfer networks such as international SWIFT interbank fund transfer system are tempting as targets as a transfer, once made, is difficult or impossible to reverse. As these networks are used by banks to settle accounts with each other, rapid or overnight wire transfer of large amounts of money are commonplace; while banks have put checks and balances in place, there is the risk that insiders may attempt to use fraudulent or forged documents which claim to request a bank depositor's money be wired to another bank, often an offshore account in some distant foreign country.
11) **Rogue Traders–**engages in unauthorized trading to recoup the loss he incurred in earlier trades. Out of fear and desperation, he manipulates the internal controls to circumvent detection to buy more time.
12) **ATM – Debit / Credit card frauds**

Fraud is much more than numbers. It involves complex human behaviors such as greed & deception, factors that are difficult to identify & quantify. Books, records & computers do not commit frauds. People do. Concealment is the cornerstone of Fraud. Understanding how a fraud is committed and why people commit frauds is the key to prevention & detection of frauds. There are infinite ways in which a person can defraud. However there are still some distinct patterns to a fraud. If these patterns could be known & their frequency of occurrence identified in advance, it would help greatly in understanding & responding effectively to frauds.

Frauds is simply all about cheating, lying & stealing. It is motive, opportunity & rationalization. What is far more important than the definition is how to prevent it. The potential of being caught most often persuades likely perpetrators from committing it. The existence of a robust internal control system is essential to prevent frauds. Fraud prevention is more pro-active than reactive. Accountability & Integrity along with strong compliance & ethics will reduce frauds.

The war between the Fraudsters & the Regulators / Organizations will go on. And as they say the best man can only win. However Truth prevails and Fraud will eventually meet the strong arm of the law.

**Alan Greenspan** (Former chairman Fed Reserve)- Corruption, embezzlement, fraud, these are all characteristics which exist everywhere. It is regrettably the way human nature functions, whether we like it or not. What successful economies do is keep it to a minimum. No one has ever eliminated any of that stuff.

# AUDIT OF FOREIGN EXCHANGE TRANSACTIONS IN STATUTORY BANK BRANCH AUDIT

**PREFACE:**

With the process of liberalization gathering momentum, the Government of India (GoI) and the Reserve Bank of India (RBI) are opening more and more areas for investment in and outside the country. Moreover, with lesser restrictions on the current account transactions, Indian Rupee has been floating freely with the international market forces. As a consequence of this, various interesting developments have started taking place in foreign exchange market. Apart from substantial rise in the volume of business in foreign exchange, almost all the major banks dealing in it are discovering it as a profit centre, making substantial contribution to their bottom line.

The world is now a Global Market where anyone can sell their products with ease. With the growing demand in the Global Market, the Indian Manufacturer / Service Provider are willing to export their products and services all over the world. At the same time foreign firms also find Indian market lucrative. As a multiplier effect of these two factors, Foreign Exchange Transactions are increasing at a rapid speed, both in number and value.

In addition to it, during the last decade there has been large scale growth in banking services, covering more and more geographical area and large number of population. This has necessitated applying modern technology, particularly in the field of data capturing, recording and processing. CBS is outcome of the same.

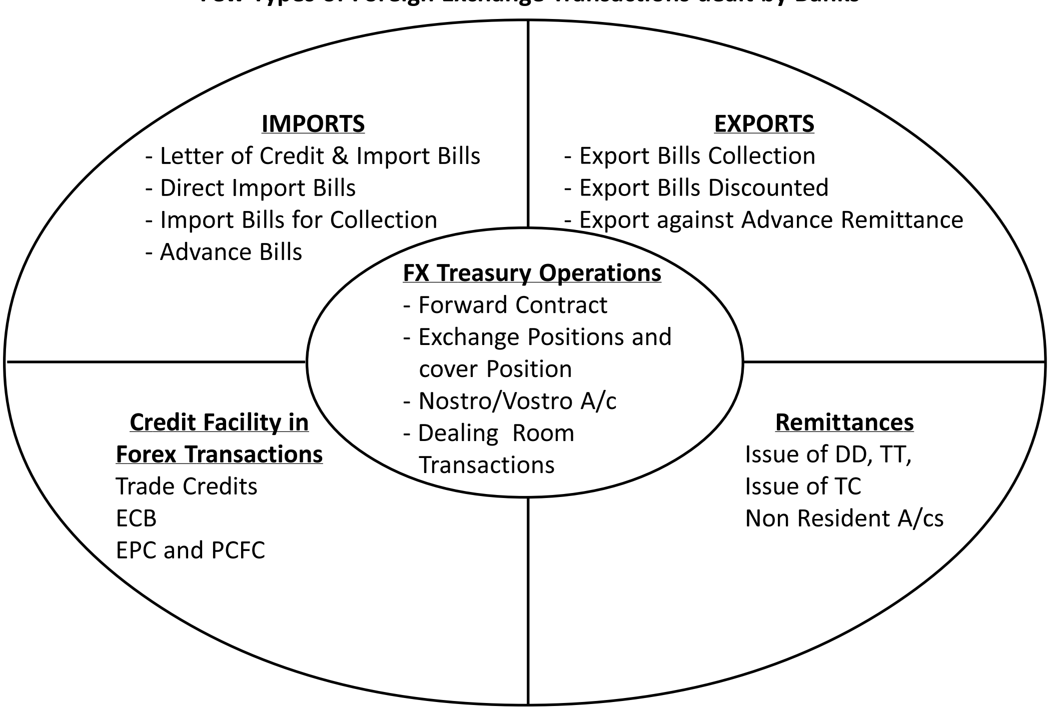
For obvious reasons audit methodology cannot remain static, it has also to change. Therefore, with the spread of CBS in large number of cases, changing audit methodology also became inevitable. If the auditee’s dependence on technology hinges heavily, there is no reason why auditor should not apply the same technology.

This write-up is focused on the Mechanics and the Intricacies of Forex Transactions. It also covers Auditors’ actionable for auditing Foreign Exchange Transactions under both Manual and CBS environment.

Before going through the mechanics and intricacies of Forex Transactions let us understand the type of Bank Branches as per Exchange Control Manual.

- **Category – A:** Offices and branches maintaining independent foreign currency accounts in their own names
- **Category – B:** Offices and branches not maintaining independent foreign currency accounts but having powers of operating on the accounts maintained abroad by their Head/Principal Office or any other link office
- **Category – C:** All other offices and branches handling foreign exchange business through other offices or branches in category A or B (Can maintain Non-Resi. Accounts)

**Few Types of Foreign Exchange Transactions dealt by Banks**



To understand the mechanics of any Forex transaction, it is important to know first the terms that are commonly used in Forex Transactions.

a. **Bill of Entry:**

Section 2(4) of Customs Act, 1962 defines bill of entry as follows. The importer of any goods, other than goods intended for transit or transshipment, shall make entry thereof by presenting to the proper officer a bill of entry for home consumption or warehousing in the prescribed from.

b. **GR/PP/SOFTEX Form:**

Section 2(37) of Customs Act, 1962 defines Shipping Bill as "The exporter of any goods shall make entry thereof by presenting to the proper officer in the case of goods to be exported in a vessel or aircraft, a shipping bill". The following are the types of Declarations to be submitted along with shipping details.

**GR Forms:**

In the case of exports of tangible goods through ports, GR form will be completed by exporter and the same will be certified by the customs department. One copy of GR form will be submitted to Authorised Dealer [AD].

**SDF Forms:**

On account of introduction of electronic data interchange (EDI) system at certain Customs offices where shipping bills are processed electronically, the existing declaration in GR form is replaced by a declaration in form of Statutory Declaration Form (SDF). The SDF Form will be submitted along with shipping bill to concerned customs officer.

**PP Form:**

In the case of export by Postal Forms PP forms will be used. Postal authorities will allow export of goods by post only if the original copy of the form has been countersigned by the Banker.

**Softex Form:**

In the case of export of computer software SOFTEX form is used.

***With a view to simplify the process RBI has introduced EDF (Export Declaration Form) to declare all type of export of goods through Non-EDI ports. (Change w.e.f. 1st Oct., 2013)***

***In addition to above, under the Ease of Doing Business initiative of the Govt. of India certain export procedures have been relaxed. One of such process is discontinuation of SDF (Statutory Declaration Form) for Export Transactions. SDF declarations have now been subsumed under Shipping Bill.***

c. **Bill of Lading / Marine Transport Documents / Air Way Bill**

A Bill of Lading is a document issued by the shipping company or its agent, acknowledging the receipt of goods for carriage which are deliverable to the consignee or his assignee in the same condition as they were received. The Bill of Lading will render the following functions

1. It is an evidence of contract of carriage
2. It is an receipt for the goods received by the carrier and
3. It is a document of title of goods.

d. **LIBOR:**

LIBOR stands for the London Interbank Offered Rate and is the rate of interest at which banks borrow funds from other banks in the London wholesale (or "interbank") money market.

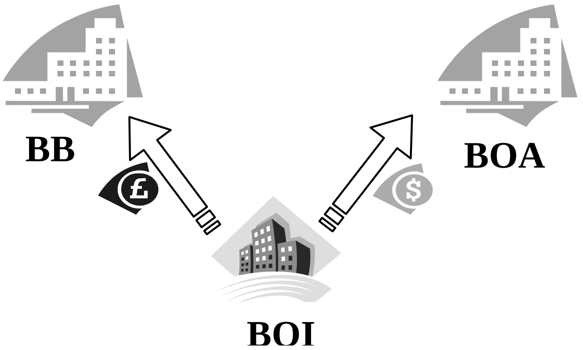
The London Interbank Offered Rate is the rate charged by one bank to another in inter-bank money market.

e. **Nostro Account**

Nostro Account is an account maintained by a bank in India with a Bank Abroad.

For example, Bank of India [BOI] may maintain an account with Bank of America, New York. [BOA] The account will be in US Dollar. Similarly, BOI may have an account with Barclays Bank, London in Sterling Pound.

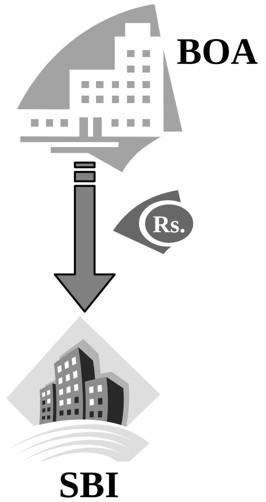
While corresponding to the Foreign Bank, BOI will refer its account with Bank of America or Barclays Bank [BB] as Nostro account, meaning 'our account with you'. In nutshell, it is the foreign currency account of any Indian Bank with the Foreign Bank. Hence, in this case when BOI issue a Demand Draft payable in New York in US Dollar, it will draw on BOA. When the draft is presented in New York, the BOA will debit BoI's Account with it.




f. **Vostro Account**

Vostro Account means an account maintained by a foreign bank in Indian Rupee with an Indian Bank. In reference to Indian Bank means 'your account with us'.

For example, Bank of America [BOA] may open an account with State Bank of India [SBI] and draw drafts on the said account. On presentation of draft, SBI will pay to the debit of BOA's account with it.




**<u>IMPORT TRANSACTIONS</u>**

**1. LETTER OF CREDIT (LC)**

**<u>Basics of Letter of Credits:</u>**

Goods can be bought and sold with payment of price in various forms like in cash, cash against delivery of goods, cash against documents, cash against acceptance of bill of exchange etc.

However, when the International Sale transaction is contemplated there is a risk on the part of Seller for realization of sale proceeds. On the other hand, the Buyer is concerned about the quality and quantity of goods imported. A conflict of interest thus arises and, to overcome this situation, both the parties will resort to Documentary Credit.

**<u>Important parties to LC:</u>**

1. **<u>Applicant [Buyer]:</u>**
   The applicant is normally a buyer of the goods, who has to make payment to the seller i.e. beneficiary. The LC is initiated and issued at his request and on the basis of orders/contracts exchanged between the buyer and the seller.
2. **<u>Beneficiary [Seller]:</u>**
   The beneficiary is normally a seller of the goods, who has to receive the payment for having supplied the goods. A credit issued in his favor enables him, to obtain the payment from the Issuing bank or Advising Bank on surrender of stipulated documents duly comply the terms and conditions of the credit.
3. **<u>Issuing Bank:</u>**
   The issuing bank is the one which issues the LC at the request of the applicant in favor of the beneficiary. The issuing Bank is the one which creates a Letter of Credit and undertakes to make the payment on receipt of the complied documents from the beneficiary or through their banker. It is important to note here that ***<u>the payment to the beneficiary is to be made by issuing bank irrespective of the fact that whether they receive the payment from the applicant or not for the complied documents they receive under their credit</u>*****.**

4. **Advising Bank:**
   The advising bank is one who advises the credit to the beneficiary at the request of the issuing bank thereby assuming the genuineness of the credit. It is normally situated in the county of the beneficiary. For advising the credit issued by another bank, there should be an agency arrangement between two banks.
5. **Other Parties:**
   Depending upon the country of Import, currency of the transaction, country of the supplier of goods etc., there will be more parties connected to the LC other than mentioned above. These are,

   i. **Confirming Bank:**
   The confirming Bank is the *one which steps in the shoes of issuing bank* over the responsibility of honouring the claim under the LC when required documents are presented to them within the validity of the credit established by the issuer.

   ii. **Reimbursing Bank:**
   The reimbursing bank normally is the one who maintains with it the account of the credit opening bank. When the documents under the credit are negotiated by the beneficiary's banker or advising bank, they claim the negotiated amount from the named reimbursing bank in the Letter of Credit who pays the amount on receipt of the claim made within the validity date of the credit by debiting to the account of the opener against the authority held by them from the opener of the LC. *The role of the reimbursing banker is to honour the claim of negotiating / paying banker provided sufficient funds are held in the account*.

   iii. **Negotiating Bank:**
   The negotiating Bank is the bank who negotiates the documents submitted to them by the beneficiary under the credit either advised through them or restricted to them for negotiation. On negotiation of the documents they will claim the reimbursement under the credit and makes the payment to the beneficiary provided the documents submitted are in accordance with the terms and conditions of the LC.

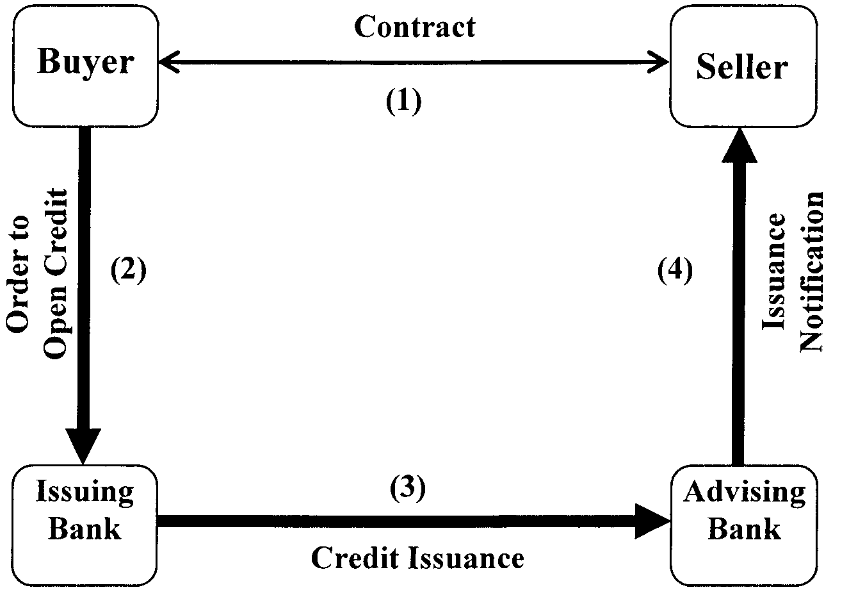
Few types of LC:

1. Confirmed / Unconfirmed Letter of Credit
2. Transferable / Divisible Letter of Credit
3. Deferred Payment Letter of Credit
4. Revolving Letter of Credit
5. Anticipatory Letter of Credit
6. Stand by Letter of Credit

A letter of credit may be either *revocable or irrevocable* one. If nothing is specified the LC will deemed to be irrevocable one. Hence, such type of credit cannot be cancelled before its expiry.

LC Opening Process:

1. A contract will take place between a buyer and a seller
2. Buyer will order to Issuing Bank to open a credit
3. Issuing Bank will issue the credit and will send to the advising bank
4. On receipt message for credit issuance Advising Bank will notify the beneficiary.



**Revenue aspect of LC Transaction**

- Bank charges fees / commission for opening of Letter of Credit.
- The commission amount is collected upfront at the time of opening of LC.
- The commission so collected is for the entire tenure / duration of Letter of Credit.
- Income for unrealized period will be shown under Other Liability.

**Accounting aspect of LC Transaction**

- Letter of credit is a Non-Fund based facility extended by the banks. Hence, there are no accounting entries for Letter of Credits which will have impact on Balance Sheet.
- However, a Contra Transaction will be initiated which will update the Contingent Liability / Assets accounts for Off-Balance Sheet items reporting.
- Moreover, Banks will enter LC Transactions in LC Register / LC Module in CBS.
- Bills under LC will be tracked and status will be updated under specific LC Ref. No.
- Outstanding Liability under particular LC will also be updated (either in Register / LC Module in CBS)
- In case of a devolvement of Bills under LC, the transaction will be recorded as Advance to customer transaction and thus will be brought into the Balance Sheet.

**Compliance Aspect of LC Transaction**

- In the event of devolvement of Bills under LC, the said facility will be converted to Fund Based Facility.
- From the said date, IRAC Guidelines issued by RBI will be applicable in determining Asset Classification.

**Auditing Aspect of LC Transaction**

- Verify the cases of Outstanding LCs as on 31st of March.
- Are there any LCs outstanding as per CBS beyond the Date of Expiry? If so what are the reasons for the same?
- Whether balance of Letter of Credits under Contingent Liability agrees with the outstanding Letter of Credit Liability? (Under BASEL Guidelines computation of Capital Adequacy Ratio [CAR] takes cognizance of Contingent Liabilities. Any excess amount appearing under Contingent Liability will impact Bank's CAR.)
- Whether the activity of collection of charges is system driven or manual? Select appropriate sample based on the review of process.
- Whether Charges so collected are inclusive of Service Tax? If so, verify how the Service Tax Liab. is determined and accounted?

**2. IMPORT BILLS UNDER LC**

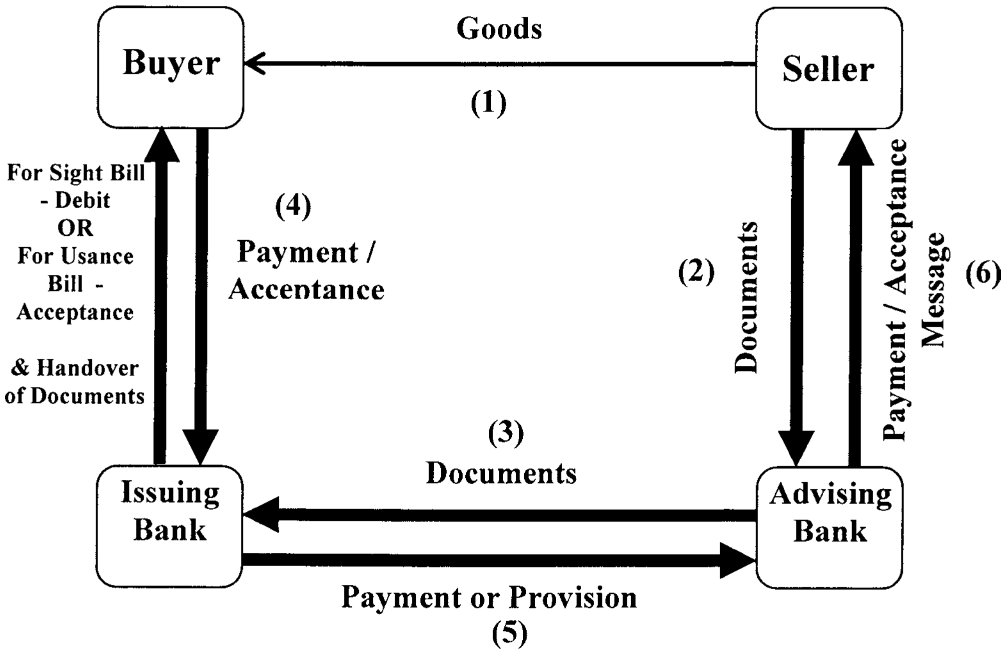
**Basics of Bills under LC:**

After establishment of LC, the foreign seller exports the goods to the named port at Buyer's country. Transport and other documents pertaining to the export will be routed through Advising Bank. Advising Bank in turn will send the documents to the LC issuing Bank. The set of documents will be called as Bill in banking parlance.

When the bills are received by the LC issuing Bank the documents will be scrutinized for its correctness as per the office copy of LC. If the documents are in accordance with the LC, the bill will be registered as non discrepant bills. The Issuing Bank will inform the Customer i.e. Buyer about the receipt of the documents.

Issuing bank as per the LC terms delivers the documents to Buyer either after receiving payment or acceptance of bill.

**Diagram:**




## Revenue aspect of Bills under LC Transaction

- Bank charges fees / commission for handling bills under LC. The activity includes Lodgement, Liquidation / Realization, Devolvement (if any)
- Moreover, there are charges to the account of LC Applicant in case of discrepancies observed by Bank when the documents presented under LC are not in conformity with the terms and conditions of Letter of Credit Issued.

## Accounting aspect of Bills under LC Transaction

- The bills are Lodged in CBS / recorded in Bills register under LC Ref. No.
- In case of CBS operations the payment of Bill made through LC / Bill module in CBS which will update the outstanding Bill Liability and outstanding LC Liability.
- However, in case of Non payment / non availability of sufficient balance on the due date of LC in Borrower's Account, the Bank has to make the payment to the Beneficiary. It is known as devolvement of bill. In such a scenario, the bill amount will be crystallized and will be brought to the books by treating it as funded facility.

## Compliance aspect of Bills under LC Transaction

- With respect to Devolvement of LC, as per IRAC guidelines it is prescribed as follows,

  *If the debits arising out of devolvement of letters of credit or invoked guarantees are parked in a separate account, the balance outstanding in that account also should be treated as a part of the borrower's principal operating account for the purpose of application of prudential norms on income recognition, asset classification and provisioning.*

  (Paragraph 4.2.7.ii of Master Circular on IRAC)

## Auditing aspect of Bills under LC Transaction

- Generate Bill Balancing Report for Bills under LC Transaction. *It is preferable to have the said report generated for 31st March.*
- Carry out physical verification of all outstanding bills appearing under Bill Balancing Reports. Special attention should be given to outstanding bills under "Lodgement" status for availability of Transport Documents. (*Transport documents alongwith other documents are handed over only after payment in case of Sight LC or only after acceptance of Bill of Exchange in case of Usance LC.*)
- Generate list of cases of Devolvement of Bills under LC from CBS. Verify the accounts in which the said amount is debited. (*For instance, the auditor may use the menu command "**BI** – For Inland Bills" and "**FBI** – For foreign Bills" in **Finacle** with Status code as "**K** - Delinked", "**Status date Filter**", "**Reg. Type**" and "**Sub Type**" of Bills under LC to find out the cases of Delinked Bills*)
- Whether the activity of collection of charges is system driven or manual? Select appropriate sample based on the review of process.

- It is observed that charges for discrepancy memo are manual. If so, verify whether the charges have been properly collected or not.
- Whether Charges so collected are inclusive of Service Tax? If so, verify how the Service Tax Liab. is determined and accounted?

## 3. IMPORT BILLS UNDER COLLECTION BASIS

**Basics of Import Bills under Collection:**

Import Bills can be received on collection basis. It means the Foreign Seller will send the import documents to its banker. The banker will in turn send the documents to the Banker of Importer with certain terms and conditions. The Importer's Bank will follow the instruction mentioned in the bill schedule and deliver the documents to the buyer.

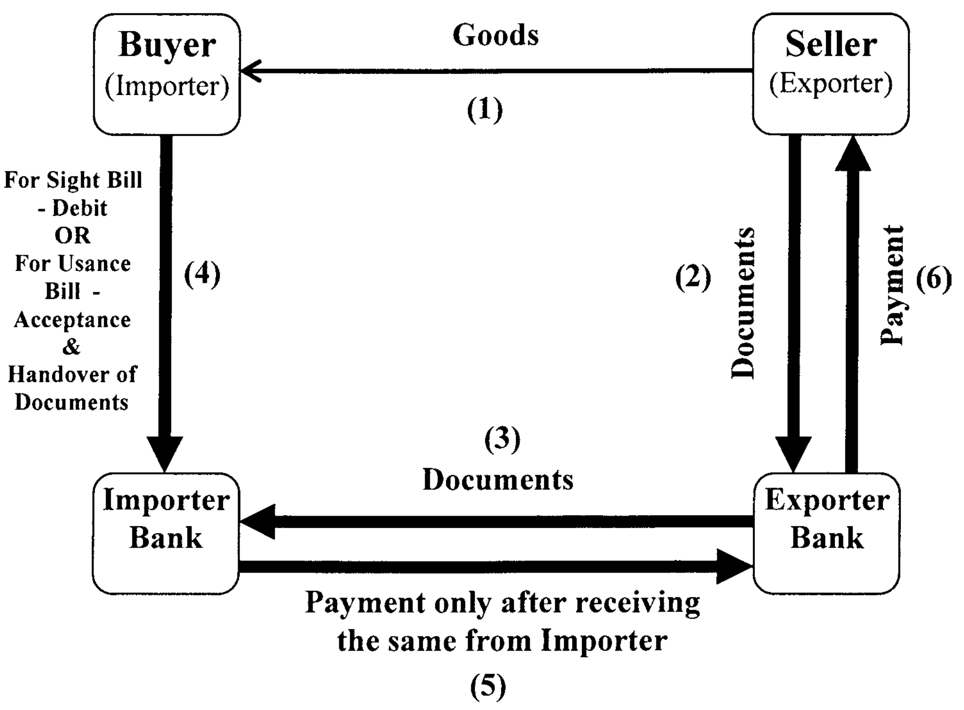
In this type of transaction Importer's Banker is dealing only as mediatory. i.e. in case the Importer does not pay the bill amount the Importer's bank will notify the Exporter's Bank and will act as per Exporter's Bank instruction.

**Difference between Import Bills under LC and on Collection basis**

In the case of bills under LC, if the Importer does not pay the bill amount on due date, the LC issuing bank has to make payment to the advising bank as the LC issuing bank has added their confirmation to the transaction by issuing LC. However, in the case of Import Bill under collection the Importer's banker is not assuming any liability as no confirmation is added to the transaction.

The benefit from the transaction under bills of collection is that it is less costly than the LC transactions. However, an element of risk is involved on the part of exporter for payment. However, the exporter can feel secure as the documents are not delivered to the buyer without payment or acceptance. Hence, the buyer will not be able to take delivery of goods.

**Diagram:**




**Revenue aspect of Import Bills on Collection**

- Bank charges fees / commission for handling bills on Collection.
- Generally it is observed that in case of Forex Transactions handled through CBS, the charges are collected by CBS. However, the auditor should carry out walkthrough process of collection of charges.

**Accounting aspect of Import Bills on Collection**

- The bills are Lodged in CBS / recorded in Import Bills on Collection register
- In case of CBS operations the payment of Bill made through Bill module in CBS. CBS will update the outstanding Bill Liability on realization event.
- Only contra transaction for Contingent Liability is created for Import Bills on Collection.

**Compliance aspect of Import Bills on Collection**

- Import Bills under collection must form part of Contingent Liability.
- Lodgement, Realization and Closure of Bill should be carried out through Bill module under CBS.

**Auditing aspect of Import Bills on Collection**

- Generate Bill Balancing Report for Import Bills on Collection Transaction. *It is preferable to have the said report generated for 31st March.*
- Carry out physical verification of all outstanding bills appearing under Bill Balancing Reports. Special attention should be given to bills under "Lodgement" status for availability of Transport Documents. (*In normal course Transport documents alongwith other documents are handed over only after payment in case of Sight Bill or only after acceptance of Bill of Exchange in case of Usance Bill.*)
- Verify whether total of Outstanding Import Bills on Collection as per Bill Balancing Report agrees with Bills for Collection under Contingent Liability?
- Whether the activity of collection of charges is system driven or manual? Select appropriate sample based on the review of process.
- It is generally observed that activity of collection of charges for discrepancy memo is manual. If so, verify whether the charges have been properly collected or not.
- Whether Charges so collected are inclusive of Service Tax? If so, verify how the Service Tax Liab. is determined and accounted?

**TRADE FINANCE TRANSACTIONS**

**1. Export Financing:**

To boost up the Exports of the country, the RBI has directed banks to grant credit at a concessional rate. It helps Indian Exporter to procure raw material and can produce the goods to be exported. Export Financing can be in Indian Rupees [EPC] and in Foreign Currency [PCFC].

Banks provide finance for purchase, processing, manufacturing or packing of goods prior to shipment / working capital expenses towards rendering of services. It is also known as Pre-Shipment Credit Facility.

In addition to it, Banks provide finance to exporters by way of loan or advance post to Shipment stage by way of Export Bill Discounting, Export Bill Purchase, Advances against Export collection bills.

**A. Pre-Shipment Credit to Exporters**

**Important Points:**

- Export packing credit can be in Indian Rupees and in Foreign Currency.
- Maximum period for Packing credit is 360 days.
- EPC / PCFC is disbursed against specific orders, in one lumpsum tranche or against the requirement as per export orders.
- EPC / PCFC is also disbursed as per Running Account Facility where availability of Letter of Credit / Confirmed orders before disbursement are not insisted.
- Liquidation of EPC / PCFC will be by way of exports proceeds only. Liquidation by any other means than by way of exports will attract higher rate of interest as per Bank's Policy.

**Accounting Aspect:**

- Banks open separate Loan account in CBS for EPC / PCFC. It helps in monitoring the utilization and liquidation.
- Bank at the request of the borrower may convert the amount of Pre-Shipment credit into Post-Shipment credit by discounting / purchasing the export bills.

**Compliance Aspect:**

- **End use of funds**
  Banks should keep a close watch on the end-use of the funds and ensure that credit at lower rates of interest is used for genuine requirements of exports. Banks should also monitor the progress made by the exporters in timely fulfillment of export orders.
- **Order Book Maintenance**
  Banks maintain order book / register to track export orders vis-a-vis Export Credit extended.

- **Liquidation Methodology**
  If the liquidation of Export Credit is by other than the way of Export of Goods / Services within the maximum period of 360 days, the advance will cease to qualify for prescribed rate of interest for export credit ab initio. It means that the bank will have to collect the difference in concessional rate of interest and normal rate of interest. The rate of interest to be applied will be as per Bank's Policy.

**Auditing Aspect:**

- Generate the list of EPC / PCFC accounts opened and maintained by the branch.
- Whether the liquidation of EPC / PCFC is as per RBI guidelines? If not, whether interest rate as per Bank's Policy is charged or not.
- Documents evidencing end use of funds should be verified.
- Whether genuineness of Export LC is confirmed before sanctioning EPC / PCFC?

**B. Post-Shipment Credit to Exporters**

**Export Bills Discounted / Purchased**

- Banks extend credits to Exporters by way of purchasing / discounting export bills. Banks also provide facility of advance against Exports on collection basis.
- Facility of discounting / purchase of bill is available in both Indian Rupee and in Foreign Currency.

**Revenue Aspect**

- Interest on Bill Discounting / Purchase is revenue for the bank.
- Bank also charges fees for export bill lodgement and claims courier and other charges for submission of Export Documents.

**Accounting Aspect:**

In case of Discounting / Purchase in Foreign Currency,

- The rupee equivalent of the discounted value of the export bills will be payable to the exporter and the same should be utilised to liquidate the outstanding export packing credit.
- As the discounting of bills/extension of foreign exchange loans (DP bills) will be in actual foreign exchange, banks may apply appropriate spot rate for the transaction.
- The rupee equivalents of discounted amounts/foreign exchange loan may be held in the bank's books distinct from the existing post-shipment credit accounts.
- In case of overdue bills, banks may charge overdue interest as per the interest rate policy of bank from the due date to the date of crystallisation.

**Compliance Aspect:**

- In case of overdue bills, IRAC Norms for overdue bills will be applicable and the advance will be subject to Asset Classification.
- Export Bills will be subject to maximum period of 365 days.

**Auditing Aspect**

- Generate a report on Export Bills purchased during the audit period.
- Also generate a report on outstanding / realized during the audit period.
- In case of overdue bills check whether the interest has been charged as per Bank's Policy.
- Auditor should verify whether the period of sanction is within the period prescribed by RBI i.e. 360 days.

**2. Import Financing:**

**Trade Credits**

**Basics of Trade Credits:**

Trade Credit is defined by RBI in Master Direction on External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorized Dealers (RBI/FED/2015-16/15 FED Master Direction No.5/2015-16 Dated January 01, 2016) as follows.

***'Trade Credits'*** *(TC) refer to credits extended for imports directly by the overseas supplier, bank and financial institution for maturity of less than five years.*

*Depending on the source of finance, such trade credits include suppliers' credit or buyers' credit.*

*Suppliers' credit relates to credit for imports into India extended by the overseas supplier,*

*while buyers' credit refers to loans for payment of imports into India arranged by the importer from overseas bank or financial institution.*

**Amount and Maturity of TC:**

For the cases other than companies in Infrastructure Sector, *AD banks are permitted to approve trade credits for imports into India up to USD 20 million per import transaction for imports permissible under the current Foreign Trade Policy of the DGFT with a maturity period up to one year (from the date of shipment). For import of capital goods as classified by DGFT, AD banks may approve trade credits up to USD 20 million per import transaction with a maturity period of more than one year and less than five years (from the date of shipment). No roll-over/extension will be permitted beyond the permissible period.*

Certain other restrictions are applicable based on the type of commodity and nature of transaction.

**Interest Rates and cost of TC:**

As per Master Circular issued by RBI, interest rate and other costs viz. arranger fee, upfront fee, management fee, handling/ processing charges, out of pocket and legal expenses for TC cannot exceed the prescribed limits. The said limit is known as All-in-Cost ceiling.

As per current regulations the All-in-cost limit is 6 Months LIBOR (for respective currency) + 350 basis points.

**Issuance of Guarantee / Letter of Comforts (LoC) by Banks:**

For the cases other than companies in Infrastructure Sector, *AD banks are permitted to issue Letters of Credit/ guarantees/Letter of Undertaking (LoU) /Letter of Comfort (LoC) in favour of overseas supplier, bank and financial institution, up to USD 20 million per transaction for a period up to one year for import of all non-capital goods permissible under Foreign Trade Policy (except gold, palladium, platinum, Rhodium, silver etc.) and up to three years for import of capital goods.The period of such Letters of credit / guarantees / LoU / LoC has to be co-terminus with the period of credit, reckoned from the date of shipment. Further, issuance of guarantees will be subject to prudential guidelines issued by the RBI from time to time.*

**Mechanics of Trade Credit**

**1. <u>Buyers' Credit:</u>**

Let us understand the Buyer's Credit Transaction with the help of an example.

**<u>Example:</u>**

M/s ABC Co. Ltd, India wants to import goods worth USD 1 million from M/s XYZ of New York. For import M/s ABC has approached Bank of India (BOI) to open an LC in favour of M/s XYZ of New York. BOI (LC Issuing Bank) has opened an LC in Favour of M/s XYZ having Bank of America (BOA) as Advising Bank. The import transaction was concluded on 15.Apr.13. The due date of payment of Import Bill is 15.Jun13.

In between, M/s ABC Co. Ltd. has approached Bank of Baroda (BOB), Jersey Branch for extending a credit for the amount of Import that M/s ABC has made. BOB has asked M/s ABC to obtain Letter of Comfort for its credit standing. Hence, on 11.May.13, M/s ABC approached State Bank of India, Nariman Point Branch, Mumbai (SBI) to issue a Letter of Comfort for Buyers' Credit Transaction.

On the LC due date i.e. on 15.Jun.13 M/s ABC Co. Ltd. has to retire the Import Bill. The SBI will request BOI (LC issuing Bank) to provide their Nostro Details and the SBI will forward the same to Credit Extending Bank (i.e. BOB, Jersey) so that the payment of Import Bills can be made on due date.

This will complete the transaction of Import. However, a new transaction will come into picture that is Trade Credit extended by Foreign Lender in favour of Indian Importer.

Figure 1 : LC Opening Transaction – Buyer's Credit

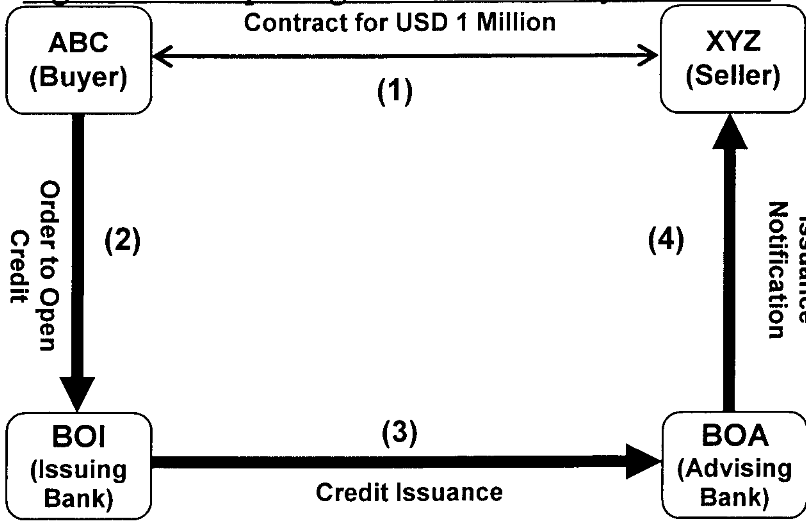



Figure 2 : Import Transaction under LC – Buyer's Credit

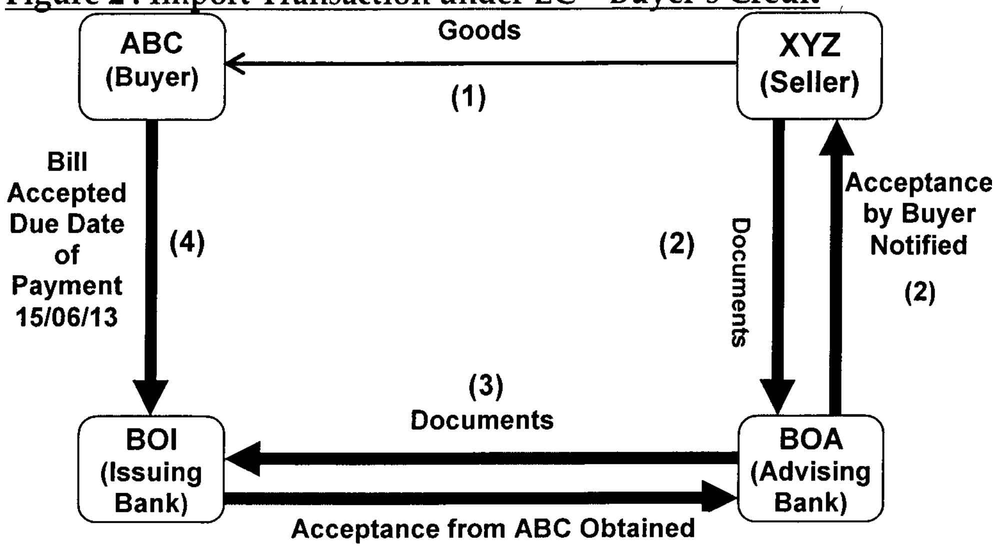
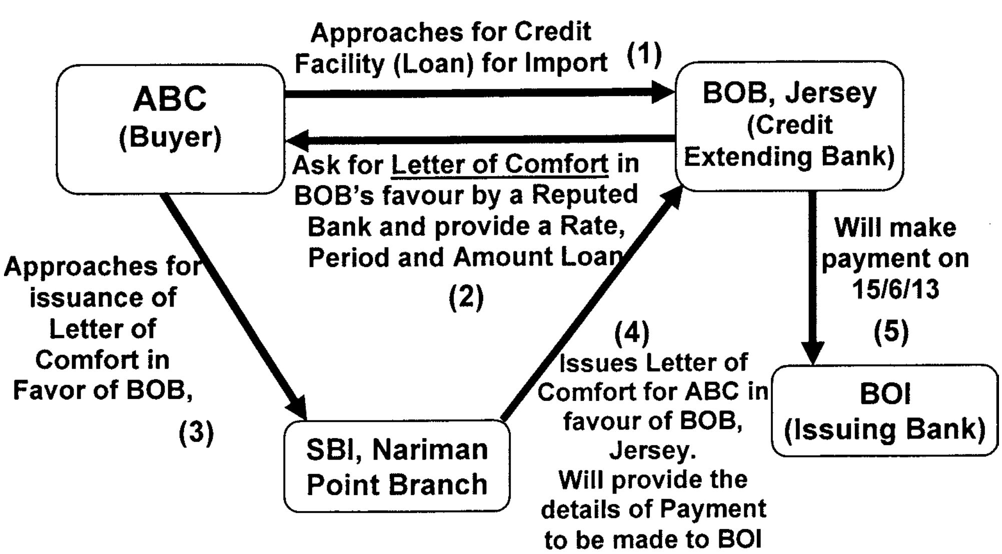



Figure 3: Credit Facility Extended by payment of Import Bill to Issuing Bank



Buyer's Credit transaction referred above is with respect to LC transactions and LoC by bank other than LC Issuing Bank. However, such kind of transactions can be arranged for the cases of Import Bills for collection and Direct Import Bills transactions. In nutshell, the process as mentioned above in Figure 2 and Figure 3 will remain more or less same.

**2. Suppliers' Credit:**

Credit call in the case of Buyer's Credit transactions is taken on the Importer (Buyer). Hence, the creditability of buyer is taken into consideration while extending the Buyer Credit Transaction. The buyer can avail the credit for the payment of Import Liability by taking credit call on the supplier. That is to say the buyer can avail the supplier's credit for the Import Liability. Let us understand first, how the Supplier Credit Transaction actually works?

**Example:**

M/s ABC Co. Ltd, India wants to import goods worth USD 1 million from M/s XYZ of New York. For import M/s ABC has approached Bank of India (BOI) to open an LC in favour of M/s XYZ of New York. The LC issuing bank is BOI while the Advising Bank is BOA.

M/s XYZ (Exporter) is not willing to give any credit to M/s ABC and hence, it asks for SIGHT LC. However, on the other hand M/s ABC on the date of presentation of bills will not be able to discharge the Import Liability.

Hence, M/s ABC Co. Ltd. approaches BOA through its Banker i.e. BOI for extending a credit facility. BOA will provide a quote for extending credit facility. The quote provided will be subject to a ceiling limit of LIBOR + 50 basis points and for a maximum period of 180 days. (Let us assume that the quote provided by the BOA is LIBOR+ 40 basis points for 45 days)

M/s XYZ (Exporter) will send goods to M/s ABC (Importer) and documents to BOI (LC Issuing Bank) through its banker BOA. Being, a sight LC, the due date of the Bill will be at sight.

With predetermined arrangement with the BOA, the Importer will discharge its dues after 45 days. However, the BOA will pay the export bill amount to M/s XYZ (Exporter) by discounting the Export Bill. Due to this arrangement M/s XYZ will get the export proceeds as like Sight Bill and M/s ABC can enjoy credit of 45 days.

The charges and rate of interest of discounting of export bill will be charged to M/s ABC (Importer) by the BOA.

**Figure 1: Arrangement of Credit and Opening of LC**

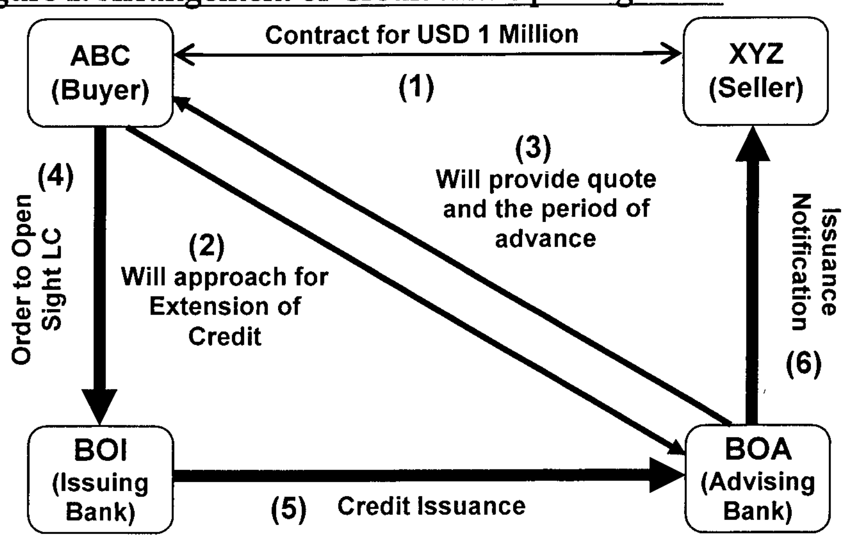
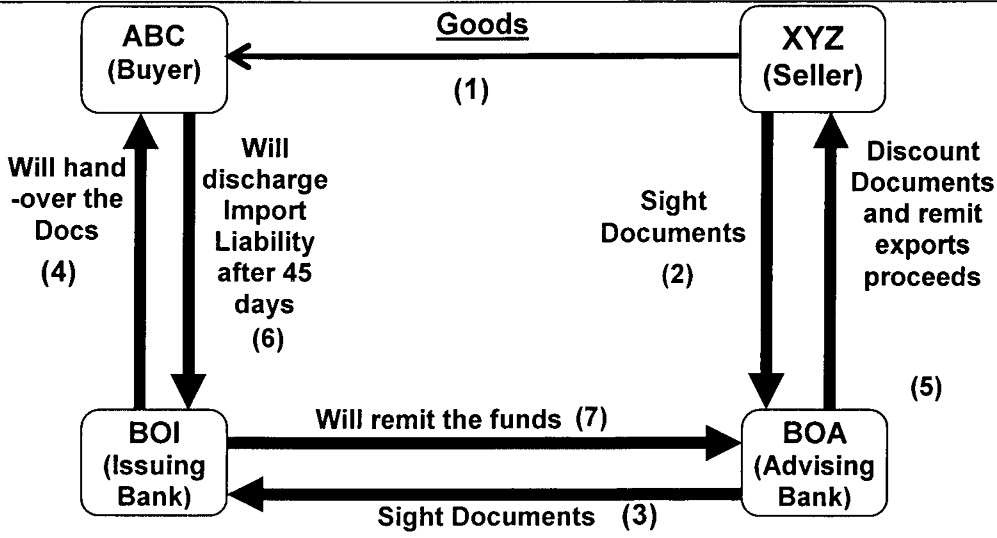


**Figure 2: Process of Movement of Goods and Documents and Remittance of Funds**




**Revenue aspect of Trade Credit:**

- Bank issuing LoU / LoC / BG for Buyers' credit Transaction earns commission / charges as that of Letter of Credit.

**Accounting aspect of Trade Credit:**

- Issuance of LoU / LoC / BG for Trade Credit is generally considered as Non Funded facility by banks.
- From CBS perspective various banks adopts different mechanism to lodge LoU / LoC / BG transaction for TC.
  - As LC in CBS:

    Few banks treat it as Letter of Credit transaction and will lodge it under LC module of CBS with transaction information as Trade Credit.
  - As BG in CBS:

    It has also been observed that few banks treat it as Bank Guarantee and lodges the Trade Credit transaction under BG module of CBS. In such cases separate type of BG is used for reporting purpose.

**Compliance aspect of Trade Credit:**

- TC transaction should be within the prescribed tenure.
- Interest Rate and other costs for TC transaction must be within the prescribed All-in-Cost ceiling.
- There are certain restrictions on availing TC for select commodities. Prescribed tenure in Master Circular issued by RBI for the said TC transaction must be adhered to.
- Trade credit is not permissible for Merchanting Trade Transactions.

**Auditing aspect of Trade Credit:**

- Underlying transaction for Trade Credit is Import Transactions. Hence, it is important for the auditors to verify the Evidence of Import. Exchange Control Copy of Bill of Entry is the document which can be said to be Evidence of Import.
- Auditor should check Offer Letter issued by overseas lender and conformity of TC transaction with FEMA guidelines.
- Are there any cases of devolvement by borrower in remitting Trade Credit amount? In such cases Bank who has issued LoU / LoC / BG has to remit the funds on due date to Foreign Lender. Check are there any cases of such nature during Audit Period?
- Whether Fees / Charges for LoU / LoC / BG issuance is collected upfront?
- Whether liability for Fees / Charges collected for unexpired period is reversed and shown as Liability?

## 3. ADVANCES IN FOREIGN CURRENCY AND AGAINST ACCOUNTS HELD BY NON RESIDENT AND HOLDING OF OTHER DEPOSIT ACCOUNTS:

**Features of various Deposit Schemes available for Non-Resident Indians (NRIs)[1]**

| Particulars (1) | Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account] (2) | Non-Resident (External) Rupee Account Scheme [NRE Account] (3) | Non-Resident Ordinary Rupee Account Scheme [NRO Account] (4) |
|---|---|---|---|
| Who can open an account | NRIs (individuals / entities of Bangladesh / Pakistan nationality / ownership require prior approval of RBI) | NRIs (individuals / entities of Bangladesh / Pakistan nationality/ownership require prior approval of RBI) | Any person resident outside India (other than a person resident in Nepal and Bhutan). Individuals / entities of Pakistan nationality / ownership, entities of Bangladesh[2] ownership and erstwhile Overseas Corporate Bodies[5] require prior approval of the Reserve Bank. |
| Joint account | In the names of two or more non-resident individuals provided all the account holders are persons of Indian nationality or origin; Resident close relative (relative as defined in Section 6 of the Companies Act, 1956) on 'former or survivor' basis. The resident close relative shall be eligible to operate the account as a Power of Attorney holder in accordance with extant instructions during the life time of the NRI/ PIO account holder. | In the names of two or more non-resident individuals provided all the account holders are persons of Indian nationality or origin; Resident close relative (relative as defined in Section 6 of the Companies Act, 1956) on 'former or survivor' basis. The resident close relative shall be eligible to operate the account as a Power of Attorney holder in accordance with extant instructions during the life time of the NRI/ PIO account holder. | May be held jointly with residents |
| Nomination | Permitted | Permitted | Permitted |
| Currency in which account is denominated | Any permitted currency i.e. a foreign currency which is freely convertible | Indian Rupees | Indian Rupees |
| Repatriablity | Repatriable | Repatriable | Not repatriable except for the following: i) all current income and ii) up to USD 1 (one) million per financial year (April-March), by A NRI/ PIO. |
| Type of Account | Term Deposit only | Savings, Current, Recurring, Fixed Deposit | Savings, Current, Recurring, Fixed Deposit |
| Period for fixed deposits | For terms not less than 1 year and not more than 5 years. | From one to three years, However, banks are allowed to accept NRE deposits above three years from their Asset-Liability point of view | As applicable to resident accounts. |

| Particulars<br><br>(1) | Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account]<br>(2) | Non-Resident (External) Rupee Account Scheme [NRE Account]<br>(3) | Non-Resident Ordinary Rupee Account Scheme [NRO Account]<br>(4) |
|---|---|---|---|
| Rate of Interest | With effect from March 1, 2014 (i)deposits of 1 year to less than 3 year maturity, interest shall be paid within the ceiling rate of LIBOR/ SWAP rates plus 200 basis points; (ii) deposits of 3-5 years maturity, interest shall be paid within the ceiling rate of LIBOR/ SWAP rates plus 300 basis points.<br>On floating rate deposits, interest shall be paid within the ceiling of SWAP rates for the respective currency / maturity plus 200 bps/ 300 bps as the case may be. For floating rate deposits, the interest reset period shall be six months. | With effect from March 1, 2014, interest rates offered by banks on NRE deposits cannot be higher than those offered by them on comparable domestic rupee deposits. | Banks are free to determine their interest rates on savings deposits under Ordinary Non-Resident (NRO) Accounts. However, interest rates offered by banks on NRO deposits cannot be higher than those offered by them on comparable domestic rupee deposits. |
| Operations by Power of Attorney in favour of a resident by the non-resident account holder | Operations in the account in terms of Power of Attorney is restricted to withdrawals for permissible local payments or remittance to the account holder himself through normal banking channels. | Operations in the account in terms of Power of Attorney is restricted to withdrawals for permissible local payments or remittance to the account holder himself through normal banking channels. | Operations in the account in terms of Power of Attorney is restricted to withdrawals for permissible local payments in rupees, remittance of current income to the account holder outside India or remittance to the account holder himself through normal banking channels.<br>Remittance to the NRI/ PIO account holder is subject to the ceiling of USD 1 (one) million per financial year. |
| Loans | | | |
| a. In India | | | |
| i) to the Account holder | Permitted without any ceiling subject to usual margin requirements. | Permitted without any ceiling subject to usual margin requirements | Permitted subject to the extant rules[3] |
| ii) to Third Parties | Permitted without any ceiling subject to usual margin requirements. | Permitted without any ceiling subject to usual margin requirements. | Permitted, subject to conditions[4] |
| b. Abroad | | | |
| i) to the Account holder | Permitted without any ceiling subject to usual margin requirement | Permitted without any ceiling subject to usual margin requirement | Not Permitted |
| ii) to Third Parties | Permitted without any ceiling subject to usual margin requirements. | Permitted without any ceiling subject to usual margin requirements. | Not Permitted |

| Particulars (1) | Foreign Currency (Non-Resident) Account (Banks) Scheme [FCNR (B) Account] (2) | Non-Resident (External) Rupee Account Scheme [NRE Account] (3) | Non-Resident Ordinary Rupee Account Scheme [NRO Account] (4) |
|---|---|---|---|
| c. Foreign Currency Loans in India | | | |
| i) to the Account holder | Permitted without any ceiling subject to usual margin requirement | Permitted without any ceiling subject to usual margin requirement | Not Permitted |
| ii) to Third Parties | Permitted without any ceiling subject to usual margin requirements. | Permitted without any ceiling subject to usual margin requirements. | Not Permitted |
| Purpose of Loan | | | |
| a. In India | | | |
| i) to the Account holder | i) Personal purposes or for carrying on business activities*<br>ii) Direct investment in India on non-repatriation basis by way of contribution to the capital of Indian firms / companies<br>iii) Acquisition of flat / house in India for his own residential use. (Please refer to para 9 of Schedule 2 to FEMA 5). | i) Personal purposes or for carrying on business activities.*<br>ii) Direct investment in India on non-repatriation basis by way of contribution to the capital of Indian firms / companies.<br>iii) Acquisition of flat / house in India for his own residential use. (Please refer to para 6(a) of Schedule1 to FEMA 5). | Personal requirement and / or business purpose.* |
| ii) to Third Parties | Fund based and / or non-fund based facilities for personal purposes or for carrying on business activities *. (Please refer to para 9 of Schedule 2 to FEMA 5). | Fund based and / or non-fund based facilities for personal purposes or for carrying on business activities *. (Please refer to para 6(b) of Sch. 1 to FEMA 5) | Personal requirement and / or business purpose * |
| b. Abroad To the account holder and Third Parties | Fund based and / or non-fund based facilities for bonafide purposes. | Fund based and / or non-fund based facilities for bonafide purposes. | Not permitted. |
| * The loans cannot be utilised for the purpose of on-lending or for carrying on agriculture or plantation activities or for investment in real estate business. | | | |

**Note :**

a. When a person resident in India leaves India for Nepal and Bhutan for taking up employment or for carrying on business or vocation or for any other purpose indicating his intention to stay in Nepal and Bhutan for an uncertain period, his existing account will continue as a resident account. Such account should not be designated as Non-resident (Ordinary) Rupee Account.

b. Authorised Dealers (ADs) may open and maintain NRE / FCNR (B) Accounts of persons resident in Nepal and Bhutan who are citizens of India or of Indian origin, provided the funds for opening these accounts are remitted in free foreign exchange. Interest earned in NRE / FCNR (B) accounts can be remitted only in Indian rupees to NRIs and PIO resident in Nepal and Bhutan.

c. In terms of Regulation 4(4) of the Notification No.FEMA.5/2000-RB dated May 3, 2000, ADs may open and maintain Rupee accounts for a person resident in Nepal and Bhutan.

d. The regulations relating to the various deposit schemes available to Non-Resident Indians have been notified vide Notification No.FEMA.5 dated 3rd May 2000, as amended from time to time. The relevant Notifications and A.P. (DIR Series) Circulars are available on our website [www.rbi.org.in? Sitemap ? FEMA ? Notifications / A.P.(DIR Series) Circulars]. The Master Circular on Non-Resident Ordinary Rupee (NRO) Account [www.rbi.org.in? Sitemap ? Master Circulars] may also be referred to. The details of rate of interest on the various accounts, are available in the "Master Circular on Interest Rates on Rupee Deposits held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts" and "Master Circular of instructions relating to deposits held in FCNR (B) Accounts"issued by our Department of Banking Operations and Development, available on our website [www.rbi.org.in? Sitemap ? Master Circulars].

e. AD Category – I banks and authorized banks may credit the proceeds of account payee cheques/ demand drafts / bankers' cheques, issued against encashment of foreign currency to the NRE account of the NRI account holder where the instruments issued to the NRE account holder are supported by encashment certificate issued by AD Category-I / Category-II.

f. AD Category – I banks and authorised banks may permit remittance of the maturity proceeds of FCNR (B) deposits to third parties outside India, provided the transaction is specifically authorised by the account holder and the Authorised Dealer is satisfied about the bonafides of the transaction.

---

[1] NRI means a person resident outside India who is a citizen of India or is a person of Indian origin [Regulation 2 (vi) of Notification FEMA 5/2000-RB dated May 3, 2000 viz. Foreign Exchange Management (Deposit) Regulations, 2000].

[2].In terms of A.P.(DIR Series) Circular No. 82 dated February 11, 2013 Authorised banks are permitted to open NRO account of individual/s of Bangladesh nationality without the approval of the Reserve Bank subject to conditions.

[3] Subject to usual norms as are applicable to resident accounts, for personal purposes or for carrying on business activities except for the purpose of relending or carrying on agricultural / plantation activity or for investment in real estate business.

[4] Subject to conditions such as (i) the loans shall be utilised only for meeting borrower's personal requirements and/ or business purpose and not for carrying on agricultural/ plantation activities or real estate business, or for relending, (ii) Regulations relating to margin and rate of interest as stipulated by the Reserve Bank from time to time shall be complied with and (iii) The usual norms and considerations as applicable in the case of advances to trade/industry shall be applicable for such loans/ facilities.

[5] Overseas Corporate Body (OCB) means a company, partnership firm, society and other corporate body owned directly or indirectly to the extent of at least sixty per cent by Non-Resident Indians and includes overseas trust in which not less than sixty percent beneficial interest is held by Non-resident Indians directly or indirectly but irrevocably, which was in existence as on September 16, 2003 and was eligible to undertake transactions pursuant to the general permission granted under Foreign Exchange Management Regulations

[Source: FAQs by RBI on Features of various Deposit Schemes available to Non-Resident Indians (NRIs) as updated upto February 02, 2015]

## 4. GENERAL REMITTANCES AND APPROVAL ACTIVITIES

Apart from the transactions discussed above, Banks undertake following types of transactions as well. Since, the said transactions are of the procedural nature, detailed discussion is not included herein above. However, auditor must acquaint himself with Master Circulars issued by RBI on the following transactions for compliance and other important guidelines.

1. Outward Remittances
2. Inward Remittances
3. Approval Activity with respect to
   - External Commercial Borrowing Transaction
   - Foreign Currency Convertible Bonds
   - Investment in Joint Ventures(JV), Wholly Owned Subsidiaries (WoS) abroad
   - Investment in India
   - Branch Office Remittances

## 5. FOREIGN EXCHANGE TREASURY TRANSACTIONS

Generally such transactions are carried out at Category-A Branches / Specialized branches. Audit in respect of the same is being carried out by Statutory Central Auditors. Hence, the same are not discussed herein above.

********

**Important Master Circulars issued by RBI**

- Master Circular on Foreign Investment in India

**Important Master Directions issued by RBI**

- Master Direction - External Commercial Borrowings, Trade Credit, Borrowing and Lending in Foreign Currency by Authorised Dealers and Persons other than Authorised Dealers
- Master Direction - Miscellaneous
- Master Direction – Reporting under Foreign Exchange Management Act, 1999
- Master Direction – Import of Goods and Services
- Master Direction – Export of Goods and Services
- Master Direction – Direct Investment by Residents in Joint Venture (JV) / Wholly Owned Subsidiary (WOS) Abroad
- Master Direction - Deposits and Accounts
- Master Direction - Remittance of Assets
- Master Direction – Acquisition and Transfer of Immovable Property under Foreign Exchange Management Act, 1999
- Master Direction - Establishment of Liaison/ Branch/ Project Offices in India by Foreign Entities
- Master Direction - Other Remittance Facilities
- Master Direction - Liberalised Remittance Scheme (LRS)
- Master Direction – Borrowing and Lending transactions in Indian Rupee between Persons Resident in India and Non-Resident Indians/ Persons of Indian Origin
- Master Direction- Compounding of Contraventions under FEMA, 1999

# THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

Russell Street Office: ICAI Bhawan 7, Anandilal Poddar Sarani (Russell Street), Kolkata- 700071
Kasba Office : ICAI Bhawan, 382/A, Prantik Pally, Kasba, Kolkata – 700 107

| | Responsibility | Kasba Office | Russell Street Office | EMAIL |
|---|---|---|---|---|
| **Dr. Alok Ray**, Jt. Secretary (9330001192) | Decentralised Office - Head | 30840277 | 30211102 | alokray@icai.in |
| **Mr. Abhijit Basu**, Dy. Secretary (98306 64225) | In charge of Members & Articles | 30840271 | | abhijit.basu@icai.in |
| **Mr. Pallab Sarkar**, Dy. Secretary (9230062227) | Decentralised Office | 30840272 | | pallab@icai.in; |
| | **MEMBERS SECTION** | | | |
| **Mr. Pradip Sarkar**, Consultant | Disputes, Query Redressal Fees Enquiry | 30840296 | | eromem@icai.in |
| **Mr. Arun Kumar Santra**, Asst. Secretary | Fellow COP, Cancellation & Restoration of COP, Script Certificate and Fees enquiry, CA. Main Exam | 30840287 | | erofellow@icai.in; eroexam@icai.in |
| **Ms. Nandini Guha**, Executive Officer | Enrollment of Associate Membership, Identity Card, Script Certificate and fees enquiry | 30840299 | | eroenroll@icai.in |
| **Mr. Somnath De**, Executive Officer | Merger, Networking, Reconstitution of Firms | 30840288 | | erofirm@icai.in, |
| **Mr. Soumen Mondal**, DEO | Restoration of Name, Registration of Firms | 30840289 | | erorestore@icai.in |
| | **ARTICLES SECTION** | | | |
| **Mr. Utpal Basu**, Consultant | Article Registration, Completion | 30840257 | | Utpal.basu@icai.in |
| **Ms. Anindita Kundu**, Sr. Executive Officer | Article Re-registration, termination, Other Courses, Exam eligibility | 30840265 | | eroart@icai.in; anindita.kundu@icai.in |
| **CA Shreya Lohia**, Executive Officer | Registration alongwith other courses, Supplementary Registration | 30840256 | | shreya@icai.in |
| **Ms. Sutapa Das**, Executive Officer | Article Completion & Secondment | 30840263 | | erocompl@icai.in |
| **Mr. Pallab Ghosh**, DEO | Registration, Industrial Training, ATC | 30840259 | | eroreg@icai.in |
| **Ms. Moushumi Bhadra Chatterjee**, DEO | Article Re-registration, termination & Other Course | 30840266 | | eroterm@icai.in |
| | **BOARD OF STUDIES** | | | |
| **Mr. Srijib Bardhan**, Dy. Director (93325 61250) | Head - BOS & Accounts | 30840251 | | sbardhan@icai.in, |
| **Mr. Bivas Kanti Dasgupta**, Consultant | Final & ITT Certificate, Campus Placement | 30840242 | | erocct@icai.in |
| **Ms. Susmita Sen**, Student Counsellor (Gr. A. S.) | To know about CA Course, Student Programmes, Campus Placement | 30840239 | | erobos@icai.in |
| **Ms. Sarmistha Biswas**, Section Officer | Orientation Course, Mock Test | 30840237 | | eircorient@icai.in |
| **Ms. Piyali Chatterjee**, DEO | CPT, IPCC | 30840238 | | erocpt@icai.in |
| **Mr. Kaushik Bhattacharjee**, DEO | IPCC, CPT, Revalidation | 30840241 | | eroipcc@icai.in |
| **Mr. Swarup Karmakar**, LDC | Distribution of Study Materials | 30840243 | | eroitt@icai.in |
| | **Post Qualification Courses (PQC) CELL** | | | |
| **CA Debasish Sen**, Asst. Secretary | Co-ordinator and Nodal Officer of all Post Qualification & Certificate Courses, Computer Centres & Publication | | 30211117 | ero@icai.in |
| | **CALCUTTA COMPUTER CENTRE** | | | |
| **Ms. Malini Sinha Chowdhury**, Sr. Faculty | In Charge of Computer Centers. | | 30211142 | malini.sinha@icai.in |
| | **REGIONAL COUNCIL** | | | |
| **Mr. Kabir Ghosh**, Consultant | Seminar Information | | 30211134 | eircpubn@icai.in |
| **Mr. Pradyut Chakraborty**, Consultant | Seminar information | | 30211104 | pradyut.chakraborty@icai.in |
| **Mr. Saibal Krishna Chakraborty**, Asst. Secretary | Seminar Information | | 30211104 | schakraborty@icai.in |
| **Mr. Amit Paul**, Assistant Secretary | Seminar information | | 30211133 | eirc@icai.in, amit.paul@icai.in, |
| **CA Manish Agarwal**, Executive Officer | GMCS | | 30211260 | eircgmcs@icai.in, manish.agarwal@icai.in |
| **CA Jyoti Luharuka**, Executive Officer | Website(eirc-icai.org), Seminar information | | 30211108 | jyoti.luharuka@icai.in |
| **Mr. Santanu Bose**, DEO | Seminar Information, CPE Hrs. | | 30211108 | eircevents@icai.in; eirccpe@icai.in |
| | **LIBRARY** | | | |
| **Ms. Swati Banerjee**, Librarian (Gr. A. S.) | In Charge of Library Section | | 30211103 | eirc.library@icai.in, swati.banerjee@icai.in |
| | **SALES COUNTER / PUBLICATIONS** | | | |
| **Mr. Avijit Roy**, LDC | Sale of Books | | 30211101/47 | psc_ero@icai.in |


# helpLine

This is an initiative by Team EIRC of ICAI to extend assistance to our Professional fraternity. Please feel free to call the helpline numbers in case you, have any query or face any problem while conducting bank audit assignment

**HELPLINE AVAILABLE FROM 1ST APRIL TO 15TH APRIL 2016**

**TIME 10.00 AM to 5.00 PM**

88201 54348

98302 85088

Disclaimer: Team EIRC of ICAI do not have any role in the allocation of Bank Branch Audit. We are not in a position to respond to any such related query