

8. AUDIT OF BANKS

CHAPTER OVERVIEW

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SECTION 1: THEORY FOR CLASSROOM DISCUSSION

INTRODUCTION: A Bank is a Financial Institution that accepts deposits from the public and lends loans. Banking sector is the backbone of any economy as it is essential for sustainable economic growth and financial stability in the economy.

It deals with large amounts of public monies and is highly sensitive to reputational risk.

Two of its main functions are accepting deposits and granting advances.

PECULIAR FEATURES OF BANKS:

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

Q.No.1. Explain the Regulatory Framework in case of Banks.

(B) (NEW SM)

REGULATORY FRAMEWORK: Some of the examples of laws and regulations applicable to the banking industry are as follows:

- 1) Banking Regulation Act, 1949.
- 2) RBI Act, 1934.
- 3) Companies Act, 2013.
- 4) State bank of India act, 1955.
- 5) Banking companies (Acquisition and Transfer of Undertakings) Act, 1970 & 1980.
- 6) Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. (SARFAESI)
- 7) Regional Rural Banks Act, 1976
- 8) Information Technology Act, 2000.
- 9) Prevention of Money laundering Act, 2002.
- 10) Credit Information Companies Regulation Act, 2005.
- 11) Payment and Settlement Systems Act, 2007.

Q.No.2. The Functioning of banking industry in India is regulated by the Reserve Bank of India which is the Central Bank of our country. Explain. (A) (NEW SM)

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. RBI is responsible for development and supervision of the constituents of the Indian financial system (banks and NBFC's).

- 1) **POWER TO DETERMINE CRR AND SLR:** Each commercial bank is required to maintain certain portion of their Net Demand and Time Deposits in the form of cash with the Reserve Bank, called Cash Reserve Ratio (CRR) and in the form of investment in approved securities, called Statutory Liquidity Ratio (SLR).
- 2) **BANKER'S BANK:** RBI is the bank of all banks in India as it provides the loan to banks/bankers, accept the deposit of banks, and rediscount the bills of banks.
- 3) **POWER TO INSPECT ANY BANK:** As per Section 35 of Banking Regulation Act, 1949, RBI has the power to inspect any bank.
- 4) **PRUDENTIAL NORMS:**
 - a) RBI issues "Prudential Norms" to be followed by the commercial banks to strengthen the balance sheets of banks.
 - b) Few of them are related to income recognition, asset classification and provisioning etc.
- 5) **MONEY SUPPLY AND CONTROLLER OF CREDIT:** To control demand and supply of money in Economy, it is also responsible for formulating and implementing the monetary policies such as Open Market Operations, varying the Repo rates, reserve ratios etc.
- 6) **THE ISSUER OF BANKING LICENSE:**
 - a) As per Sec 22 of Banking Regulation Act, every bank should obtain a Banking license from RBI to conduct banking business in India.
 - b) No bank can commence the business of banking or open new branches without obtaining licence from RBI.
 - c) Banking operations are only conducted at the branches, while other offices acts as controlling authorities or administrative offices.
- 7) **CORPORATE GOVERNANCE IN BANKS:**
 - a) RBI is to ensure high-quality corporate governance in banks.
 - b) RBI has issued guidelines for 'fit and proper' criteria for director of banks.
 - c) RBI can also appoint additional directors to the board of a banking company.

SIMILAR QUESTIONS:

1. Explain how RBI is regulating the banking industry in India?
 - A. Refer above answer.
2. The Functioning of banking industry in India is regulated by the Reserve Bank of India which is the Central Bank of our country. Explain (NEW SM – TYK)
 - A. Refer above answer
3. RBI is responsible for development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions) as well as for determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour. Explain SM
 - A. Refer above answer

Q.No.3. Explain the NPA norms for the following advances:

- 1) Accounts regularized near about the balance sheet date
- 2) Advances under consortium
- 3) Accounts where there is erosion in the value of security
- 4) Advances against term deposits, NSCs, KVPs

5) Agricultural advances affected by natural calamities**6) Advances to staff****7) Agricultural advances****(A) (NEW SM)****1) ACCOUNTS REGULARIZED NEAR ABOUT THE BALANCE SHEET DATE:**

- a) These are the accounts with few credits received just before the date of balance sheet.
- b) The asset classification of such accounts should be handled with care. If the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA.
- c) However, if such accounts are Central Govt. Guaranteed Advances, then they would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
In other words provisioning norms do not apply and interest is recognised only if it is realised i.e., cash basis.

2) ADVANCES UNDER CONSORTIUM:

- a) Consortium advances should be based on the record of recovery of the respective individual member banks.
- b) Where the remittances by the borrower under consortium lending arrangements are received by the lead bank and the lead bank is not transferring the share of other member banks, the account should be deemed to be NPA as per respective provisions.

3) ACCOUNTS WHERE THERE IS EROSION IN THE VALUE OF SECURITY: They should be straight-away classified as doubtful or loss asset as appropriate.

- a) **As Doubtful asset:** If the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection,
Such assets may be straight-away classified under doubtful category and provisioning should be made as applicable to doubtful assets.
- b) **As Loss asset:** If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrower accounts,
Then the existence of security should be ignored and the asset should be straight-away classified as loss asset. It shall be fully written off.

4) ADVANCES AGAINST TERM DEPOSITS, NSCS, and KVPS: Advances against Term Deposits, NSCs, and KVP/IVP need not be treated as NPAs, provided adequate margin is available in the accounts.**5) AGRICULTURAL ADVANCES AFFECTED BY NATURAL CALAMITIES:**

- a) Banks may decide about of NPA treatment on their own.
- b) E.g., They may convert a short term production loan into a term loan or re-schedule of the repayment period and the sanctioning of fresh short term loan.
- c) In such cases, the NPA classification would be governed by such rescheduled terms.

6) ADVANCES TO STAFF:

- a) Interest on staff advances should be included as part of advances portfolio of the bank.
- b) In the case advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards.
Such loans/advances should be classified as NPA only when there is a default in repayment of instalment on the respective due dates for beyond 90 days.

NOTE: However, the staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets. (Salary advance)

7) AGRICULTURAL ADVANCES: Agricultural Advances are of two types,

- a) Agricultural Advances for "long duration" crops (LDC) and
- b) Agricultural Advances for "short duration" crops (SDC)

The following NPA norms would apply to agricultural advances:

- a) **SDC:** A loan will be treated as NPA, if the instalment remains overdue for two crop seasons.

b) **LDC:** A loan will be treated as NPA, if the instalment remains overdue for one crop season.

NOTE: The “long duration” crops would be crops with crop season longer than one year and crops, which are not “long duration” crops would be treated as “short duration” crops.

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

SIMILAR QUESTIONS:

1. "Ramjilal & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2018. In the audit planning, the partner of Ramjilal & Co., observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose." Now he needs your assistance on the following points so as to incorporate them in the audit plan:

i) For determination of NPA norms for agricultural advances.

ii) For accounts where there is erosion in the value of security/frauds committed by the borrowers.

N18 (N) - 5M

A. Write Point 7 and 3

2. State bank of India is having a branch which is located in the rural areas which comprises of majority of agricultural advances. The manager of the branch wants to treat advances as NPA which are overdue for more than 90 days. Comment.

A. Refer 7

Q.No.4. Write about audit of drawing power for advances?

(A) (NEW SM)

- 1) The stock statements, quarterly returns and other statements including Audited Annual report submitted by the borrower to the bank should be scrutinised in detail.
- 2) The stock audit should be carried out by the bank for all accounts having funded exposure of more than Rs.5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same.
- 3) In case of consortium of advances – Lead bank will execute the stock audit and shall forward the report to other member banks.
- 4) It needs to be ensured that the drawing power is calculated as per the guidelines formulated by the Board of Directors of the respective bank. Further in case of consortium advances the lead bank decides the drawing power guidelines.
- 5) All accounts should be kept within both the drawing power and the sanctioned limit at all times.
The accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the Management/Head Office regularly.
- 6) Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.

Q.No.5. Explain the nature of securities accepted by a bank while advancing any loans and what are various modes of creation of such securities?

(B) (NEW SM)

1) **NATURE OF SECURITY:**

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

b) **Collateral security** is an additional security.

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

- i) Goods/Stocks/Debtors /Trade Receivables
- ii) Gold Ornaments and Bullion
- iii) Immovable Property
- iv) Plantations (For Agricultural Advances)
- v) Life Insurance Policies
- vi) Stock Exchange Securities and Other Instruments

2) MODE OF CREATION OF SECURITY:

- a) **Mortgage:** Mortgages are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.
- i) **A Registered Mortgage** can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.
 - ii) **Equitable Mortgage**, on the other hand, is affected by a mere delivery of title deeds or other documents of title with intent to create security thereof.
- b) **Pledge:**
- i) A pledge involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a security for the advance.
 - ii) The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods.
- c) **Hypothecation:**
- i) Neither ownership nor possession is transferred to the bank and the borrower holds the physical possession of the goods as an agent/trustee of the bank.
 - ii) The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is determined.
- d) **Assignment:** Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a secured debt) such as book debts and life insurance policies are accepted by banks as security by way of assignment.
- e) **Set – Off:**
- i) The set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and in the same right (i.e., the capacity of the account holder in both the accounts should be the same).
 - ii) For the purpose of set-off, all the branches of a bank are treated as one single entity.
 - iii) The right of set-off can be exercised in respect of time-barred debts also.
- f) **Lien:** Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien

SIMILAR QUESTIONS:

1. Mr. A approaches a Bank for financial assistance for his upcoming project. The Bank Branch Manager after verifying the proposal is agreeable to financing Mr. A, but asks for the security to be offered to the bank. Discuss the nature of securities required to be offered to the Bank. M18(N) - 5M
- A. Refer Point A Above
2. Distinguish between Primary Security and Collateral Security with reference to audit of Banks. Also give examples of most common types of securities accepted by the Banks. N20 RTP
- A. Refer A
3. Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien. Explain with specific reference to Audit of Banks. N20(RTP)
- A. Refer B

Q.No.6. Explain the provisions relating to appointment of Auditor for Banks.

(B) (NEW SM)

1) ELIGIBILITY, QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITOR:

Same as auditor of company as prescribed under section 141 of the Companies Act, 2013.

2) AUTHORITY TO APPOINTMENT:

- a) **Auditor of a BANKING COMPANY:** Appointed by shareholders of the bank at the AGM.
- b) **Auditor of a NATIONALISED BANK:** By BOD subject to certain approvals from RBI.

- c) **Auditors of the SBI:** Appointed by the CAG of India in consultation with CG
- d) **Auditors of subsidiaries of SBI:** Appointed by SBI
- e) **Auditors of REGIONAL RURAL BANKS:** By BOD with approval of CG.
- 3) **REMUNERATION OF AUDITOR:**
- a) **Auditor of a banking company:** Fixed in accordance with the provisions of section 142 of the Companies Act, 2013 (i.e., by the company in general meeting).
- b) **Auditors of nationalised banks, SBI and RRBs:** Fixed by the Reserve Bank of India in consultation with the Central Government.
- 4) **POWERS OF AUDITOR:** Same powers as those of a company auditor prescribed in companies act, 2013 like access to the books, accounts, documents and vouchers etc.

Q.No.7. While conducting bank audit, the engagement team shall discuss and document about understanding of audit of bank. Explain. (A) (NEW SM)

ENGAGEMENT TEAM DISCUSSIONS: The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control.

They should assess the potential for material misstatements of the financial statements.

These discussions are ordinarily done at the planning stage of an audit. All these discussions should be appropriately documented for future reference.

- 1) **MATTERS TO BE DISCUSSED IN GENERAL:** The engagement team discussion ordinarily includes a discussion of the following matters:
- a) Errors that may be more likely to occur;
- b) Errors which have been identified in prior years;
- c) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures.
- d) Need to maintain professional skepticism throughout the audit engagement;
- 2) **ADVANTAGES OF DISCUSSIONS:**
- a) Provides an opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment including its business risks.
- b) Provides an understanding amongst the engagement team members about effect of the results of the risk assessment procedures including decisions about the nature, timing, and extent of further audit procedures.

SIMILAR QUESTIONS:

1. "The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference". Explain. NEW SM - TYK
- A. Refer above answer
4. The engagement team of FRN & Co.- Auditors of Bank of Baroda held discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. The discussion between the members of the engagement team and the audit engagement partner are being done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit. Analyse and advise the matters to be discussed in the engagement team discussion. MTP M19 (N), MTP M18 (N)
- A. Refer above answer
5. List out matters which you would discuss at planning state of an audit to gain a better understanding of the bank and its environment? QP-M19(N)-4M
- A. Intro and Point – A.

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Q.No.8. Write a short note on: Conducting a Bank audit.

(B) (NEW SM)

1) INITIAL CONSIDERATION BY THE STATUTORY AUDITOR:

- a) **Communication with Previous Auditor:** As per Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him in writing.
- b) **Acceptance & Continuance:** Performing procedures required by SA 220, "Quality Control for Audit Work" regarding the acceptance of the client relationship and the specific audit engagement (Assessing Engagement risk); and
- c) **Declaration of Indebtedness:** The RBI has advised that the banks, before appointing their statutory central/branch auditors, should obtain a declaration of indebtedness.
- d) **Terms of Audit Engagements:** SA 210 requires that for each period to be audited, the auditor should agree on the terms of the audit engagement and they should be documented, in order to prevent any confusion.
- e) **Internal Assignments:** The audit firms should not undertake statutory audit assignment, if they are associated with internal assignments in the bank during the same year.
- f) **Establish the Engagement Team:** The assignment of qualified and experienced professionals of engagement team should be done on the basis of size, nature, and complexity of the bank's operations.

2) UNDERSTANDING THE BANK AND ITS ENVIRONMENT INCLUDING ACCOUNTING PROCESS:

SA 315 lay downs that the auditor should obtain an understanding of the entity and its environment, including its internal control and accounting process,

- a) To identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and
- b) To design and perform further audit procedures.

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

4) DEVELOP THE AUDIT PLAN: SA 300 deals with the auditor's responsibility to plan an audit of financial statements in an effective manner. It requires the involvement of all the key members of the engagement team while planning an audit.

5) DETERMINE AUDIT MATERIALITY: The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit. The determination of audit materiality is a matter of professional judgment.

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

7) MAINTAINING PROFESSIONAL SCEPTICISM: As per SA 240, the attitude of professional scepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

8) STRESS TESTING: RBI has required that all commercial banks shall put in place a Broad approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems.

9) BASEL III FRAMEWORK: In the document titled '**Basel III**', A global regulatory framework for more resilient in banks and banking systems, released by the BCBS in December 2010, it has proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital.

BCBS: Basel Committee on Banking Supervision.

10) RELIANCE ON / REVIEW OF OTHER REPORTS: The auditor should take into account the adverse comments, if any, on advances appearing in the following-

- i) Previous audit reports.
- ii) Latest internal inspection reports of bank officials.

- iii) Reserve Bank's latest inspection report.
- iv) Concurrent / Internal audit report.
- v) Report on verification of security
- vi) Any other internal reports specially related to particular accounts.

Q.No.9. Write about Audit of advances of a banking company?

(A) (NEW SM)

Advances generally constitute the major part of the assets of the bank. The auditor should examine all large advances while other advances may be examined on a sampling basis.

GENERAL RULE: An advance may be considered to be a large advance if the year-end balance is in excess of Rs. 2 crore or 5% of the aggregate year end advances of the branch, whichever is less.

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

- 1) **PRELIMINARY EXAMINATION:** Before making an advance, the bank should
 - a) Satisfy itself as to the credit worthiness of the borrower
 - b) Obtain sanction from the appropriate authorities of the bank.
 - c) Ensure that all necessary documents (e.g., agreements, letters of hypothecation, etc.) have been executed by the parties.
- 2) **ASPECTS TO BE VERIFIED W.R.T SECURITY ACCEPTED:**
 - a) Verify whether securities are registered in the name of the bank.
 - b) If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank.
 - c) Sufficient margin as specified in the sanction letter should be kept against securities taken. The availability of sufficient margin needs to be ensured at regular intervals.
 - d) In the case of goods in the possession of the bank contents of the packages should be test checked. The go downs should be frequently inspected by responsible officers of the branch concerned.
- 3) **ASPECTS TO BE VERIFIED W.R.T DRAWING POWER:**
 - a) Drawing Power Register should be updated every month to record the value of securities hypothecated.
 - b) The accounts should be kept within both the drawing power and the sanctioned limit.
 - c) All the accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the controlling authority regularly.

SIMILAR QUESTIONS:

1. Your firm of Chartered Accountants has been appointed as the Auditor of two branches of OBC which are located in the Industrial area. Considering that the location of the branches of bank in industrial area, these would be "advances oriented branches and audit of advances would require the major attention of the auditors. Advise how you would proceed to obtain evidence in respect of audit of advances. RTP M18 (N) RTP-N19(N) MTP-N19(N)
- A. Refer above answer
2. The auditor should examine the efficacy of various internal controls over advances in case of Banks to determine the nature, timing and extent of his substantive procedures. Explain what is included in the internal controls over advances. MTP M19(N) RTP-N19(N)
- A. Refer above answer
3. "The Auditor should examine the efficacy of various internal controls over advances, to determine the nature, timing and extent of his substantive procedures." Discuss briefly. N18 (N) - 5M
- A. Refer above answer

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Q.No.10. Write a short note on: Audit of Incomes.

(B) (NEW SM)

1) **AUDIT PROCEDURES:** In carrying out an audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, and ensure that there is no unrecorded income.

BASIC INCOME RECOGNITION POLICY: RBI has advised that in respect of any income which exceeds 1% of the total income of the bank or 1% of the net profit before taxes, should be considered on accrual as per AS-9.

- a) If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify the statements in that situation.
- b) It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection.

THE FOLLOWING ARE THE SPECIFIC INCOME RECOGNITION POLICIES TO BE FOLLOWED:

1) **POLICY W.R.T NPA:**

a) **Policy for Income Recognition:**

The policy of income recognition shall be based on the record of recovery.

i.e., Income from NPA's is not recognised on accrual basis but is booked as income only when it is actually received.

b) **Exception:** Interest on advances against the following may be taken to income account on the due date, provided adequate margin is available in the accounts.

- i) Term Deposits,
- ii) National Savings Certificates (NSCs),
- iii) Indira Vikas Patras (IVPs),
- iv) Kisan Vikas Patras (KVPs) etc.

c) **Reversal of Income:** If any advance becomes NPA, the entire interest accrued and credited to income account in the past periods, should be reversed if the same is not realised.

d) **Memorandum Account:** If an accounts turns as NPA, banks should reverse the interest already charged and not collected, by debiting Profit and Loss account, and stop further application of interest.

However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes.

e) **Partial Recoveries in NPA'S:**

- i) If there is no clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to exercise of appropriation of recoveries in a uniform and consistent manner.
- ii) The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed or not recognised in the past should be accounted.
- iii) Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

2) **POLICY W.R.T BILLS PURCHASED:** In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years. [The Unexpired discount / rebate on bills discounted should be recorded as "Other Liabilities"].

3) **POLICY W.R.T BILLS FOR COLLECTION:** In the case of bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee. The commission of the branch becomes due only when the bill has been collected.

- 4) **POLICY W.R.T RESCHEDULING OF LOANS:** Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

Q.No.11. Write a short note on: Audit of Expenses items in case of Audit of Banks. (B) (NEW SM)

1) **AUDIT OF INTEREST EXPENDED:**

a) **Assessing Reasonableness of Interest Paid:**

- i) **Comparison With in the Same Year:** The auditor may work out a weighted average interest rate and then compare this rate with the actual average rate of interest paid on each deposit and enquire into the difference, if material.
- ii) **Comparison with the previous year:** The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

b) **Checking the Calculation of Interest:** The auditor should, on a test check basis, verify the calculation of interest and satisfy himself that:

a) **Period of Interest:** Interest has been provided on all deposits up to the date of the balance sheet.

b) **Rate of Interest:**

- i) **Basic rule:** Interest rates are in accordance with the bank's internal regulations, of the RBI directives, and agreements with the respective depositors;
- ii) **In case of Fixed Deposits:** it should be examined whether the Interest Rate in the accounting system are in accordance with the Interest Rate mentioned in the Fixed Deposit Receipt/Certificate.
- iii) **In case of inter-branch balances:** Interest has been provided at the rates prescribed by the head office.

NOTE: The auditor should obtain the interest rate card for various types of term deposits and analyse the interest cost for the period.

2) **AUDIT OF OPERATING EXPENSES:**

- a) **Internal control:** The auditor should study and evaluate the system of internal control relating to expenses, including authorisation procedures.
- b) **Invoice/ Receipts:** The auditor should verify the expenses with reference to documents evidencing the payment for expenses.
- c) **Analytical procedures:** The auditor should perform an overall analytical review for the payments to assess the reasonableness of expenditure.

3) **AUDIT OF PROVISIONS AND CONTINGENCIES:**

a) **Provisions made in respect of the NPA:**

The auditor should ascertain compliance with the various regulatory requirements:

- i) For the classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets and
- ii) For provisioning of those assets.

b) **Provision for Tax:** The auditor should obtain the tax provision computation from the bank's management. The auditor should re-compute the provision for tax by applying the applicable tax rate after considering the allowances and disallowances as per Income Tax Act, 1961.

c) **Other Provisions:** The other provisions for expenditure should be examined in relation to the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

SIMILAR QUESTION:

1. In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense. Analyse and explain stating the audit approach and procedure in regard to interest expense RTP M20(N)
- A. Refer A

Q.No.12. Write a short note on: Reporting by auditor of a Bank.**(A)**

- 1) **REPORTING TO CG:** In the case of a nationalised bank and State Bank of India, the auditor is required to make a report to the Central Government in which he must state the following:
 - a) Whether the balance sheet and profit and loss containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs and Profit or loss of the bank.
 - b) Whether he has been given any explanation or information requested, and whether it is satisfactory;
 - c) Whether the transactions of the bank, which have come to his notice, have been within the powers of that bank.
 - d) whether the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;
- 2) **FORMAT OF REPORT:**
 - a) **Compliance with SA'S:** The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of relevant Standards on Auditing.
 - b) **Additional disclosure by Central Auditor:** The auditor should ensure that not only information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report. (SA 600 requirement)
 - c) **Matters to be stated as per Sec. 143:** It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report in respect of matters covered by Section 143 of the Companies Act, 2013.
 - d) **CARO applicability:** The reporting requirements relating to the Companies (Auditor's Report) Order, 2016 is not applicable to a banking company.
- 3) **LONG FORM AUDIT REPORT:**
 - a) **Applicable for:** All banks.
 - b) **On what matters:** As specified by the Reserve Bank of India.
 - c) **Time limit for submission:** The LFAR is to be submitted before 30th June every year.
- 4) **REPORTING TO RBI (or) REPORTING OF FRAUD:**
 - a) **As per RBI Circular:** The RBI issued a Circular relating to Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks).
The said circular provided as under: "If an accounting professional, whether in the course of internal or external audit, finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".
 - b) **As per SA 240:** Also, if the auditor while performing his normal duties comes across any fraud, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.
 - c) **As per SA 250:** Auditor should also consider the provisions of SA 250, "**Consideration of Laws and Regulations in an Audit of Financial Statements**". The said Standard explains that the duty of confidentiality is over-ridden by statute, law or courts.
- 5) **DUTY TO REPORT ON FRAUDS UNDER SECTION 143(12) OF THE COMPANIES ACT, 2013:** Same as company auditors appointed under section 139 of the companies act, 2013. This is in addition to reporting to RBI.

SIMILAR QUESTIONS:

1. "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smells any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action". Analyse and explain the above RBI Circular regarding liability of accounting and auditing profession. MTP N18 (N)
- A. Refer Point D and E above
2. In the case of a nationalized bank, the auditor is required to make a report to the Central Government. The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalized bank. Explain what the auditor would state in his report.
- A. Refer Point A above

Q.No.13. What are the types of reports that are required to be furnished by Statutory central auditor of a bank? (SM)

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

- 1) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies
- 2) Long Form Audit Report.
- 3) Report on compliance with SLR requirements.
- 4) Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- 5) Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- 6) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
- 7) Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection credit system.
- 8) Report on instances of adverse credit-deposit ratio in the rural areas.

SECTION 2: QUESTIONS FOR ACADEMIC INTEREST – FOR STUDENTS SELF STUDY

Q.No.1. Form and Content of Financial Statements of Banking Company. (C)

- 1) Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Banking Regulation Act, 1949.
 - a) Form A contains the form of Balance Sheet and
 - b) Form B contains the form of Profit and Loss Account.
- 2) Every banking company needs to comply with the disclosure requirements under the various Accounting Standards, as specified under section 133 of the Companies Act, 2013.

Q.No.2. What are the common questions /steps, which have to be kept in mind while undertaking/ performing control activities in case of audit of banks? (C)

Nature of Questions	Questions to be considered / answered
Who	<ul style="list-style-type: none"> • Who performs the control? • Does the above person have requisite knowledge and authority to perform the control?
What	<ul style="list-style-type: none"> • What evidence is generated to demonstrate /prove that the control is performed?

When	• When and with what frequency is the control performed?
	• Is the frequency enough to prevent, detect and correct Risk of Material Misstatements?
Where	• Where is the evidence of performance of the control retained?
	• For how long is the evidence retained? • Is the evidence accessible for / available for audit?
Why	• Why is the control being performed?
	• What type of errors are prevented or detected through the performance of the control?
How	• How is the control performed?
	• Can these activities be bypassed?
	• Can the bypass, if any, be detected?
	• How are exceptions / deviations resolved on identification?
	• What is the time frame for resolving the exceptions / deviations?

Q.No.3. Write a short note on “Classification of Advances” made by the banks?

(C)

1) COMPOSITION OF ADVANCES:

Advances comprises of amounts granted by way of:

- a) Term loans.
- b) Cash credits, Overdrafts, Demand Loans.
- c) Bills Discounted and Purchased
- d) Adverse balances in Deposit Accounts
- e) Interest bearing Staff Loan.

2) LEGAL REQUIREMENTS OF DISCLOSURE IN THE BALANCE SHEET:

a) Disclosures Based on Type:

- i) Bills purchased and discounted
- ii) Cash credits, overdrafts and loans repayable on demand
- iii) Term loans

b) Disclosures Based on Security:

- i) Secured by tangible assets
- ii) Covered by Bank/ Government guarantees
- iii) Unsecured

c) Disclosures Based on Place and Sectors:

i) Advances in India:

- Priority sectors
- Public sectors
- Banks
- Others

ii) Advances outside India:

- Due from banks
- Due from others

3) CLASSIFICATION OF ADVANCES:

a) Based on Sector wise:

- i) Priority
- ii) Non - priority

b) Based on Security wise:

- i) Secured
- ii) Unsecured

c) Based on RBI prudential norms wise:

- i) Standard
- ii) NPA's

Q.No.4. Explain RBI Prudential norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. (C)

1) **CLASSIFICATION OF ADVANCES:**

- a) Classification as NPA should be based on the record of recovery.
- b) It is irrelevant about the net worth of borrower/guarantor for purpose of treating an advance as NPA.
- c) The classification of advances based on recoverability is as follows:
 - i) **Standard Asset:** It is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset should not be an NPA.
 - ii) **Non-Performing Assets (NPA):** A NPA is a loan or an advance where -
 - **For Term Loans:** Instalment (principal or interest or both) remain overdue for more than 90 days. Overdue refers to No payment is yet received on due date of instalment.
 - **For CC / OD:** The account remains 'out of order' for 90 days or more.

Meaning of Out of Order:

 - An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power for a period of 90 days.
 - In cases where the outstanding balance in the account is less than the sanctioned limit/drawing power, but
 - There are no credits continuously for 90 days or more.
 - Credits are not enough to cover the interest debited during the same period.
 - **For Bills Discounted:** The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
 - iii) **Types of NPA'S:**
 - **Sub-standard asset:** An asset would be classified as substandard up to a period of twelve months from the date of becoming NPA.
 - **Doubtful asset:** An asset would be classified as doubtful if it has remained as substandard more than 12 months. (More than 12 months from the date of NPA)
 - **Loss asset:** It would be the one where the loss is identified by the bank or auditors or RBI but the amount has not been written off.

2) **PROVISIONING OF ADVANCES:**

- a) **Standard Asset:** 0.40% on all standard advances whether secured or unsecured.
- b) **Non-performing assets:**
 - i) **Sub-standard asset:** 15%
 - ii) **Doubtful assets:**
 - **Up to 1 year:** 25% for secured advances plus 100% for unsecured advances.
 - **1 – 3 years:** 40% for secured advances plus 100% for unsecured advances.
 - **More than 3 years:** 100% for both secured and unsecured advances.
 - iii) **Loss assets:** 100% for both secured and unsecured advances.

3) **INCOME RECOGNITION POLICY:**

- a) **Policy for income recognition:** The policy of income recognition has to be objective and based on the record of recovery.
I.e. Income from NPA's is not recognised on accrual basis but is booked as income only when it is actually received. This will apply to Government guaranteed accounts also.
- b) **Exception:** Interest on advances against the following may be taken to income account on the due date, provided adequate margin is available in the accounts.
 - i) Term Deposits,

- ii) National Savings Certificates (NSCs),
 - iii) Indira Vikas Patras (IVPs),
 - iv) Kisan Vikas Patras (KVPs) etc.
- c) **Reversal of income:** If any advance becomes NPA, the entire interest accrued and credited to income account in the past periods, should be reversed if the same is not realised. This will apply to Government guaranteed accounts also.
- d) **Memorandum Account:** On an account turning NPA, banks should reverse the interest already charged and not collected, by debiting Profit and Loss account, and stop further application of interest.
- However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes.
- e) **Partial Recoveries in NPAs:**
- a) If there is no clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to exercise the right of appropriation of recoveries in a uniform and consistent manner.
 - b) The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed or not recognised in the past should be accounted.
 - c) Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/ additional credit facilities sanctioned to the borrowers concerned

SIMILAR QUESTION:

1. Write a short note on: Income recognition policy w.r.t Advances as per RBI Prudential norms.
- A. Refer point no. C above.

Q.No.5. Explain about understanding of risk management process while conducting audit of a bank. (C) (NEW SM)

Management develops controls and uses performance indicators to aid in managing key business and financial risks.

An effective risk management system in a bank generally requires the following:

- 1) **INVOLVEMENT IN THE CONTROL PROCESS BY THOSE CHARGED WITH GOVERNANCE:** Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, regulatory requirements etc.
- 2) **IDENTIFICATION, MEASUREMENT AND MONITORING OF RISKS:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
- 3) **CONTROL ACTIVITIES:** A bank should have appropriate controls to manage its risks, including effective segregation of duties, verification and approval of transactions, physical security and contingency planning etc.
- 4) **MONITORING ACTIVITIES:** Risk management models, methodologies used to measure and manage risk should be regularly assessed and updated.
- 5) **RELIABLE INFORMATION SYSTEMS:** Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis.

SIMILAR QUESTION:

1. Mr. Piyush, the bank manager develops controls to aid in managing key business and financial risks. Discuss the various requirements for effective risk management system in a bank. QP-M19-4M
- A. Refer above.

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Q.No.6. Write a short note on reversal of income under bank audit.

(C) (NEW SM)

REVERSAL OF INCOME:

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

SIMILAR QUESTION

1. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realized. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyze and Explain RTP M20 (N)

SECTION 3: TEST YOUR KNOWLEDGE

- 1) Pledge Vs. Hypothecation
- 2) List out any 5 laws applicable to Banks.
- 3) Who can appoint auditors of banks?
- 4) What is meant by Reversal of Incomes in audit of banks?
- 5) What are RBI Prudential norms w.r.to advances?
- 6) Explain the NPA classification in the following types of advances:
 - a) Agricultural advances
 - b) Consortium advances
 - c) Assets where there is Erosion in the value of Security
- 7) Write a short note on: Engagement team discussions in audit of banks.

THE END

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