

9. Bank Audit

Banks have certain characteristics distinguishing them from most other commercial enterprises.

- **Custody of large volumes of monetary items**, including cash and negotiable instruments, whose physical security has to be ensured.
- **Engagement in transactions** that are **initiated at one location, recorded at a different location and managed at yet another location**.
- **Direct Initiation and completion of transactions** by the customer **without any intervention by the bank's employees**.
- **Regulatory requirements** often **influence accounting and auditing practices** in the banking sector.

Special audit considerations arise in the audit of banks because of:

1. the **particular nature of risks** associated with the transactions undertaken;
2. the **scale of banking operations** and the resultant significant exposures which can arise within short period of time;
3. the **extensive dependence on IT to process transactions**;
4. the **effect of the statutory and regulatory requirements**;
5. the **continuing development of new products and services and banking practices** which may **not be matched** by the concurrent **development of accounting principles and auditing practices**.

Form and content of financial statement

Balance Sheet and Profit and Loss Account: Every banking company must prepare a Balance Sheet and a Profit and Loss Account according to the forms specified in the **Third Schedule** to the **Banking Regulation Act, 1949**.

Form A: Balance sheet.

Form B: Profit and loss account.

Compliance with Accounting Standards:

Banking companies must **adhere** to disclosure requirements outlined in **AS** as per section 133 of the Companies Act, 2013

The implementation of **(Ind AS)** has been deferred for **scheduled commercial banks** by RBI.

Branch Audit: **Private banks** have **centralized accounting processes without mandatory branch audits**, as per RBI guidelines.

Audit of Accounts & Appointment of Auditor

Most banks, especially those in nationalised banks or public sector, **appoint 4 or more firms of chartered accountants to act jointly as statutory central auditors (SCAs)**.

Authority Appointing Auditors:

Auditors are appointed at the **annual general meeting** by shareholders + (RBI Approval).

Nationalised Banks: Board of Directors + (RBI Approval).

State Bank of India: **C&AG** of India, in consultation with the **Central Government**.

Regional Rural Banks: Concerned bank with **approval from the Central Government**.

Conducting Audit / Audit of bank stages

5. Initial Consideration:

Acceptance & Continuance: The assessment of engagement risk should be done prior to the acceptance of an audit/SSS engagement.

Declaration of Indebtedness: The RBI has advised that the banks, before appointing their statutory central//branch auditors, should obtain a declaration of indebtedness i.e., a written confirmation that auditor/firm/partners/family members have not been declared as wilful defaulters by any bank/financial institution.

Internal Assignments in Banks by Statutory Auditors: The RBI decided that the audit firms should not undertake statutory audit assignment while they are associated with internal assignments in the bank during the same year.

Terms of Audit Engagements

Communication with Previous Auditor

Planning

Establish the Engagement Team

6. Understanding

Understanding the Bank and Its Environment including Internal Control

Understand the Bank's Accounting Process

Understanding the Risk Management Process:

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

1) **Monitoring activities:** **Risk management models, methodologies and assumptions used** to measure and manage risk **should be regularly assessed and updated**.

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) **Oversight by TCWG:** **Approve Risk mgt policies** and they **policies should be consistent** with the bank's business objectives and strategies, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

4) **Reliable info. systems:** that provide **adequate financial, operational and compliance information** on a timely and consistent basis.

5) **Control activities:** **Appropriate controls** - SOD, verification and approval of transactions, setting of limits, reporting and approval of exceptions, physical security.

3) Risk Assessment:

Identifying and Assessing the Risks of Material Misstatements

Assess the Risk of Fraud including Money Laundering

Assess Specific Risks

Risk Associated with Outsourcing of Activities

4) Execution:

Engagement Team Discussions

Response to the Assessed Risks.

Establish the Overall Audit Strategy

Audit Planning Memorandum

Determine Audit Materiality

Consider Going Concern

5) Reporting

Special Considerations in IT Environment

Bank should share detailed information with auditors like: -

1. Overall **IT policy**, structure and environment of Bank's IT system
2. **Data integrity and data security**
3. **Accounting manual and critical accounting entries**, their processes and involvement of IT systems
4. **MIS reports** being generated and their periodicity
5. **Major exception reports** and process of generation including embedded logic

Overall review of IT environment and computerized accounting system has to be taken at head office level. The **branch auditors generally do not have access to IT policy** and processes implemented by the bank. Hence, **based upon guidance and information received from Statutory central auditors**, branch auditors need to ensure that **data review and analysis through CBS is carried out**.

The key security control aspects that an auditor needs to address when undertaking audit in a computerised bank include:

- Ensure that **authorised, accurate and complete** data is made available for processing.
- Ensure that **in case of interruption due to power, mechanical or processing failures**, the system restarts without distorting the completion of the entries and records.
- Verify that **segregation of duties** is ensured while granting system access to users.
- Ensure that the **system prevents unauthorised amendments** to the programmes.
- Verify that **changes made** in the parameters or user levels are **authenticated**.

- Verify that the **account master and balance cannot be modified/amended/altere**d except by the authorised personnel.

Risk-based Internal audit

The risk assessment process includes: -

- **Identification of inherent business risks** in various activities undertaken by branches (Business risk)
- **Assessment of effectiveness of control systems** for monitoring inherent risks of business activities of branch (Control risk)
- **Making an assessment of level and direction of various risk areas** and assess level and direction of overall business risk and control risk
- **Drawing up of risk matrix** taking into account factors viz. Risk of branch

Internal Control

General

- 1) **Staff and officers** of a bank should be **shifted from one position to another frequently** and without prior notice.
- 2) **Work of one person** should always be **checked by another person**.
- 3) **Arithmetical accuracy of the books** should be proved independently every day.
- 4) **Signature book and the telegraphic code book** should be kept with **responsible officers** and **access** should be allowed only to **authorised officers**.
- 5) **Take out insurance policies** against loss due to all the risks such as **fire, natural calamities, theft and employees' infidelity**.
- 6) There should be **surprise inspection** of head office and branches at periodic interval by the **internal audit department**.

Cash

1. Cash should be kept in the **joint custody of two responsible officers**.
2. Cashier should have **no access to the customer's ledger accounts** and the Day Book.
3. **Payments** should be made only after the **vouchers have been passed for payment** by the authorised officer.
4. **High value cash receipts and payments** should be **verified by a higher officer/ branch manager**.

Clearings

1. Under the **Cheque Truncation System (CTS)** implemented by RBI, an **electronic image of the cheque is transmitted** to the **paying branch** through the **clearing house**, along with relevant information like data on the MICR band, date of presentation, presenting bank, etc. This effectively **eliminates the associated cost of movement of the physical cheques, reduces the time** required for their collection.
2. As per RBI guidelines, the **branch is required to either call the customer or email him for any cheque received for the amount of ` 5 lakh and above** in respect of inward clearings. **The Auditor may verify the compliance on test check basis**.
3. Auditor to **check whether signature of the drawer of the cheque is being verified** by the staff or not as **else there will be liability of the paying bank** under all circumstances.

Bills for Collection

- 1) **All the documents accompanying the bills should be received and entered in the Register by a responsible officer**. At the time of dispatch, the officer should also see that all the documents are sent along with the bills.
- 2) The **accounts of customers or principals should be credited only after the bills have been collected** or an advice to that effect received from the bank branch or agent.
- 3) It should be ensured that **bills sent by one branch for collection to another branch of the bank, are not taken in the bills for collection twice** in the amalgamated balance sheet of the bank. For this purpose, the receiving branch should reverse the entries regarding such bills at the end of the year for closing purposes.

Bills Purchased

1. Officer should verify that all the **documents of title are properly assigned to the bank**.
2. **Sufficient margin** to cover any decline in the value of the security etc.
3. If the **bank is unable to collect a bill on the due date**, immediate **steps should be taken to recover** the amount
4. All **irregular outstanding account/s** - reported to the **Head Office**.
5. 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.

Loans and Advances

1. Bank should make advances only after satisfying itself as to the **creditworthiness of the borrowers** and after obtaining sanction from the proper authorities of the bank.
2. All the **necessary documents** (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) **should be executed** by the parties **before advances are made**.
3. **Sufficient margin** should be **kept against securities** taken to **cover any decline in the value** thereof and to comply with Reserve Bank directives.
4. All the **securities should be received and returned by responsible officer**. They should be kept in the **Joint custody of two such officers**.
5. **All accounts should be kept within both the drawing power and the sanctioned limit** as per prescribed norms. **Additional temporary limit** may be **sanctioned**, for a maximum of **20% of existing limit and 90 days maximum tenure**.
6. All the accounts **which exceed the sanctioned limit or drawing power** or are against unapproved securities or **are otherwise irregular** should be **brought to the notice of the Management** regularly.
7. The **operation** (in each advance account) should be **reviewed at least once every year**.

Demand Drafts

- The **signatures** on a demand draft should be checked by an officer with the Signature Book.
- All the D.Ds. **sold/ issued by a branch** should be **immediately confirmed by an advice to the paying branch**.

- If the **paying branch does not receive proper confirmation of any D.D.** from the issuing branch or does not receive credit in its account with that branch, it should take immediate steps to **ascertain the reasons**.

Credit Card Operations

1. There should be **effective screening of applications** with reasonably good credit assessments.
2. There should be **strict control over storage and issue of cards**.
3. There should be a **system whereby a merchant confirms the status of unutilised limit** of a credit-card holder from the bank **before accepting the settlement**, in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.
4. **Reimbursement to merchants** should be made **only after verification of the validity of merchant's acceptance of cards**.
5. All the **reimbursement (gross of commission)** should be **immediately charged to the customer's account**.
6. There should be a **system** to ensure that **statements are sent regularly** and promptly to the customer.
7. There should be a **system** to **monitor and follow-up customers' payments**.

Compliance with CRR & SLR requirements

1. **Cash Reserve Ratio (CRR)** is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank.
2. **Statutory Liquidity Ratio (SLR)** -is required to maintain in the form of certain liquid assets such as gold, cash and government approved securities before providing credit to the customers.

The RBI requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a fiscal year not being Fridays.

Audit Approach and Procedure to check Compliance with CRR and SLR Requirements

1. Obtain an **understanding of the relevant circulars/ instructions** of the RBI, particularly regarding composition of items of DTL.
2. Request the **branch auditors to send their weekly trial balance as on Friday** and these are consolidated at the head office. Based on this consolidation, the **DTL position is determined for every reporting Friday**. The **statutory central auditor** should **request the branch auditors to verify the correctness of the trial balances** relevant to the dates selected by him/her. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates.
3. Examine, on a **test** basis, **the consolidations regarding DTL position** prepared by the bank with reference to the **related returns received from branches**.

4. Even though **interest accrues daily**, it is **recorded at periodic intervals**. Thus, examine whether **such interest accrued but not accounted** for in books is **included in the computation of DTL**.
5. While reporting on compliance with SLR requirements, the auditor should **specify the number of unaudited branches** and **state that he/she has relied on the returns received from the unaudited branches in forming opinion**.
6. While examining the **computation of DTL**, specifically examine that items have been **excluded from liabilities** as per RBI guidelines. Some of these items are:-

- 1) **Paid up capital, reserve, any credit balance in profit & loss account of bank, amount of loan taken from RBI and amount of refinance taken from EXIM bank, NHB, SIDBI and NABARD**
- 2) **Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful.**
- 3) **Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.**
- 4) **Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.**
- 5) **Margins held and kept in sundry deposits for funded facilities.**

Specifically examine that the items have been **included in liabilities** as per RBI guidelines. Some of these items are:-

- 1) **Net credit balance in branch adjustment accounts.**
- 2) **Borrowings from abroad by banks in India** needs to be considered as 'liabilities to other' at **gross level unlike 'liabilities towards banking system in India'**, which are **permitted to be netted off against 'assets towards banking system in India'**.
- 3) The **reconciliation of Nostro accounts** (with Nostro Mirror Accounts) needs to be **scrutinized** to analyze and ascertain **if any inwards remittances are received remained unaccounted** and / or **any other debit (inward) entries have remained unaccounted**.

Verification of Assets:

Balance with RBI:

- (a) Verify ledger balances with reference to bank confirmation certificates & reconciliation
- (b) Review reconciliation statements and give special attention to:
 - Cash transactions remaining unresponded;
 - Revenue items requiring adjustments/write-offs; and
 - Other credit and debit entries originated in statement provided by RBI remaining unresponded for more than 15 days.

Money at call and Short Notice:

- (a) Examine whether there is proper system of authorisation for lending of money at call or short notice.
- (b) Call loans should be verified with the certificates of the borrowers and the call loan receipts held by the bank.
- (c) Examine whether the aggregate balances comprising this item as shown in the relevant register tally with the control accounts as per the general ledger.
- (d) Examine subsequent repayments received from borrowing banks to verify the amounts shown under this head as at the year-end. It may be noted that call loans made by a bank cannot be netted-off against call loans received.
- (e) Verify that the interest has been properly accrued and accounted for on year-end outstanding balances of call/ short notice money.

Investments in special-purpose certificates:

1. **Account Separation:** Banks must verify if they maintain **separate accounts for investments in their own Investment Account, PMS clients' account, and on behalf of other constituents, including brokers.**
2. **External Audit Requirement:** In line with RBI guidelines, banks are **REQUIRED to have their investments under Portfolio Management Services (PMS) audited separately by external auditors.**
3. **Half-Yearly Reviews:** Banks are required to conduct half-yearly reviews of their investment portfolio, specifically as of **30th September and 31st March.**

Income Recognition Norms - Investments:

- (i) **Performing Investments:** **On accrual basis provided interest rates on these instruments are pre-defined.**
- (ii) **Income on NPI: on realisation.**
- (iii) **Dividends:** **Accrual basis, if the same has been declared by the Corporate Body in its AGM and the Shareholder's right to receive payment is established.**
- (iv) **Units of MFs: on cash basis.**

Advances - Area of Focus & Suggested Audit Procedures

Evaluation of Internal Controls over Advances

- A) **Examine advances are sanctioned according to delegated authority;**
- B) Review **operations of the accounts** and look for **adverse features** like **unauthorised over drawings beyond limits;**
- C) Examine area of **credit appraisal** and verify whether laid down procedures regarding credit appraisals including loan applications, preparation of proposals, obtaining satisfaction about **credit worthiness of borrowers** are being followed;
- (C)** Examine **compliance** with stipulated **terms of sanction** and end use of funds more particularly in case of term loans;
- D) Review whether **drawing power** is being calculated properly on basis of stock/book debt statements received from borrowers.

- E) Examine **all necessary loan documents have been executed after sanction but before disbursements** are made to borrowers;

Substantive Audit Procedures

- L) Examine all **large advances** while other advances may be examined on a **sample basis.**
- M) Verify correctness of **master data** of loan accounts updated in CBS. Check parameters like instalments, EMI, rate of interest, tenure of loans etc.
- N) Examine accounts identified to be problem accounts but which have **not yet slipped into NPA category**. This can be done by obtaining list of SMA1 and SMA2 borrowers from the bank and same can be considered for selection of problematic accounts.
- O) Carry out **appropriate analytical procedures.**
- P) Examine list of restructured accounts to ensure that **restructure is as per RBI guidelines**. Remember **restructured account portfolio requires additional provisioning.**
- Q) Examine **quick/early mortality accounts**. Any advance slippage to **NPA within 12 months of its sanction is called as quick/early mortality case.**
- R) Examine those accounts which have been adversely commented upon by concurrent auditors/bank's internal inspection/**RBI inspection team.**

Recoverability of Advances

- S) Review **periodic statements** submitted by the borrowers indicating the extent of **compliance with terms and conditions.**
- S) Review **latest FS** of borrowers.
- S) Review **reports on inspection of security.**
- S) Review auditor's reports in case of borrowers having credit facilities from the banking **system beyond a cut-off limit** fixed by board of directors of bank

Verification of asset classification, income recognition and Provision for Non-performing assets:

Interest/ Principal is in arrears and **remains unpaid for more than 90 days: NPA**

Audit Procedures

Classification and Provision

Verify whether bank has a **system of ongoing identification and classification of advances through CBS without manual intervention** and its accuracy in **crystallising date of NPA.**

Examine whether the **classification made by the branch is appropriate**. Particularly, **examine the classification of advances where there are threats to recovery.**

Examine whether the **secured and the unsecured portions of advances** have been **segregated correctly** and **provisions** have been calculated properly.

Review and compare the **date of NPA of loan accounts** mentioned in C.Y. statements with that of P.Y. **Reasons for any change** should be **ascertained.**

Accounts regularized near Balance sheet date

- 1) Account has **been regularised before the balance sheet date** by payment of overdue amount through **genuine sources**, the account **need not be treated as NPA**.
- 2) Auditor should assess whether the repayment was out of **genuine sources** or not.
- 3) Where the account **indicates inherent weakness**, the account should be **deemed as NPA**.
- 4) **Classification** is made **as per the position as on date** and hence **classification of all standard accounts** be reviewed as on balance sheet date.
- 5) NPA should be **recognized only based on concept of Past Due/ Overdue concept**, and **not based on the Balance Sheet date**.

Drawing Power Calculation

- 1) Ensure that the drawing power is calculated as per **guidelines** formulated by the Board of Directors.
- 2) Special consideration should be given to **sundry creditors and stocks covered under LCs/guarantees** for the purposes of calculating drawing power.
- 3) The drawing power needs to be calculated carefully in case of working capital advances **to companies engaged in construction business**.
- 4) The **stock audit** including **audit of book debts** should be **carried out** by the bank for all accounts having **funded exposure of more than stipulated limit**.

Accounts with temporary deficiencies

Banks should **not classify an advance account as NPA** merely **due to the existence of some deficiencies which are temporary in nature** such as

- non-availability of drawing power **based on latest available stock statement**,
- **balance outstanding exceeding the limit temporarily** and
- **non-renewal of limits on the due date**.

However, stock statements relied upon by the banks for determining drawing power should not be older than 3 months.

The outstanding in the account based on drawing power calculated from **stock statements older than 3 months are considered as irregular**.

Limits not reviewed

Accounts where regular/**ad hoc limits are not reviewed within 180 days** from the **due date/date of ad hoc sanction**, should be considered as NPA.

Asset classification to be borrower wise and not facility wise

Ensure that **asset classification is borrower wise and not facility wise**. Further, if debits arising out of devolvement of LC or invoked guarantees are kept in separate account, the outstanding balance should be treated as part of borrower's principal account for purpose of application of prudential norms on asset classification, income recognition and provisioning.

Government Guaranteed Advances

Income recognition

If **government guaranteed advance becomes NPA**, interest on such advance should not be taken to income unless interest is realized.

Asset classification

Credit facility backed by CG, though **overdue**, can be treated as NPA only when the **CG repudiates its guarantee, when invoked**.

This exception is not applicable for **State Government Guaranteed advances**, where advance is to be considered **NPA if it remains overdue for more than 90 days**.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

Agricultural Advances

Ensure that **NPA norms have been applied in accordance with the crop season** determined by the **State Level Bankers' Committee in each State**. Depending upon the **duration of crops** - short term/ long term - raised by an agriculturist, the **NPA norms would also be made applicable to agricultural term loans** availed of by them.

Ensure that **these norms are made applicable to all direct agricultural advances** listed in Master Circular on lending to priority sector.

In respect of agricultural loans, **other than those specified in the circular**, ensure that **identification of NPAs has been done on the same basis as non-agricultural advances**.

Restructured Advances

Restructuring is an act in which a lender, for economic or legal reasons relating to borrower's financial difficulty, **grants concessions to the borrower**.

It may involve **modification of terms of advances** including alteration of amount of instalments/alteration of repayment period/rate of interest/sanction of additional credit facilities etc. to help in curing of default.

RBI has given **revised guidelines for treatment** of restructured accounts by its circular. The auditor should verify **compliance** with the **circular** issued in this regard.

Banks may restructure the accounts classified under standard, substandard or doubtful categories. **Banks cannot restructure accounts with retrospective effect**. Once the bank receives an application for restructuring, it **implies that the account is intrinsically weak**. Accordingly, during the time the **account remains pending for restructuring**, the auditors need to take a view whether **provision needs to be made** in respect of such accounts.

On restructuring, the account will be downgraded from Standard to substandard. NPAs will remain in the same category.

Upgradation of Account

Examine **all the accounts upgraded from NPA to standard category** during the year, to ensure that the **upgrading of each account is strictly in terms of RBI guidelines**.

There can be a possibility of **incorrect upgradation** of account on the **basis of partial recoveries made**. There can also be a possibility of recoveries being made in the account after cut-off date and account being upgraded as on date of balance sheet.

Sale/ Purchase of NPAs

Sale/ Purchase of NPAs (General)

Policy relating to **procedures, valuation and delegation of powers**.

only such **NPA has been sold** which has **remained NPA** in the books of the bank for **at least 2 years**.

the assets have been **sold/ purchased "without recourse"** only.i.e the **entire credit risk associated with the NPA should be transferred** to the purchasing bank.

subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.

the **NPA has been sold at cash basis** only. Under **no circumstances, NPA can be sold to another bank at a contingent price**. The **entire sale consideration has to be received on upfront basis**.

the **bank has not purchased an NPA** which it had **originally sold**.

In case of sale of an NPA, the auditor should also ensure that: (Sale)

Removed from BOA after sale

If the **SP < NBV** (net book value), the **shortfall** should be **debited to the P&L** of that year.

If the **SP > NBV**, the **excess provision shall not be reversed** but **will be utilised to meet the shortfall/ loss on account** of sale of other non-performing financial assets.

Similarly, in case of purchase of NPAs, the auditor should verify that: (Purchase)

Provisioning requirements as per **classification status** in the **books of the purchasing bank**.

any **recovery w.r.t NPA** purchased from other banks is **first adjusted against its acquisition cost** and in **excess has been recognised as profit**.

For Capital adequacy, banks have assigned **100% risk weights** to the NPAs purchased from other banks.

Verification of other assets

Inter-Office Adjustments

- 1) Examine whether **Inter-branch accounts** are normally reconciled at the **central level**.
- 2) The auditor should **report on the year-end status** of **inter-branch accounts** indicating the **dates up to** accounts have been reconciled.
- 3) The auditor should also **indicate the number and amount of outstanding entries** in the inter branch accounts, giving the relevant information separately for debit and credit entries.
- 4) The auditor should ensure that any **discrepancies found** in inter-branch accounts have been **properly dealt** with in the books.
- 5) The auditor can **obtain the relevant information** primarily from **branch audit reports**.

Stationery and Stamps

- 1) Ensure that the item "Stationery and Stamps" includes **only exceptional items of expenditure** on stationery like **bulk purchase of security paper** which is to be written off over a period of time. Such items should be **valued at cost**. **Normal expenditure on stationery** is charged to **profit & loss account**.
- 2) Evaluate the *existence, effectiveness and continuity* of **internal controls** over these items in the normal course of audit.
- 3) **Physically verify the stationery and stamps on hand as at the year-end**, Any **shortage** should be **inquired**.
- 4) Examine whether the **cost of stationery and stamps** consumed during the year has been properly **charged to the profit and loss account** for the year.

Non-Banking Assets Acquired in Satisfaction of Claims

- 1) Ensure that the **heading** includes **those immovable properties/tangible assets** which the bank has **acquired in satisfaction of debts due** or its other claims and **these are being held with intention of being disposed off**.
- 2) Verify **such assets** with **reference** to the **relevant documentary evidence**, e.g., order of the Court or the award of arbitration, etc.
- 3) Check that the **ownership of the property is legally vested with the bank**. If there is any **dispute** examine whether the **recording of the asset is appropriate or not**. In case the **dispute arises subsequently**, examine **whether a provision for liability** or disclosure of a contingent liability is **appropriate** (AS29)
- 4) Ensure **compliance with Section 9** of Banking Regulation Act, on holding period of such assets.
- 5) Ensure that as **at date of acquisition**, the assets should be recorded at **lower of** -
 - net book value of advance or
 - net realisable value of asset acquired.

Capital Adequacy

The term 'capital adequacy' is used to describe the **adequacy of capital resources** of a bank in relation to the **risks associated with its operations**.

Capital Adequacy measures:

- ◆ **Tier I capital** consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses.
- ◆ **Tier II capital** consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital.

Tier II capital \leq Tier I capital

Capital Risk Adequacy Ratio

Eligible Total Capital Funds/ Risk weighted assets and off-balance sheet items X 100

Maintain a minimum **CRAR of 9%**

Stress Testing:

- RBI has required that **all commercial banks (excluding RRBs)** shall put in place a Board approved '**Stress Testing framework**' to suit their individual requirements which would **integrate into their risk management systems**.
- Stress tests are designed to understand **whether a bank has enough capital to survive plausible adverse economic conditions** and to maintain **enough buffer to stay afloat** under extreme scenarios.

BASEL III framework:

- Basel III norms relate to **Capital Adequacy requirement compliance** which Bank has to achieve as contained in the BASEL III accord.
- **Basel capital adequacy norms** are meant **for protection of depositors & shareholders** by **prescriptive rules for measuring capital adequacy**, thereby evolving methods of determining regulatory capital and ensuring efficient use of capital.
- Basel III accord strengthens the regulation, supervision and risk management of the banking sector.

It is **global regulatory standard** on

- **capital adequacy of banks,**
- **stress testing,**
- **market liquidity risk.**

• The Basel III accord, aims at:

- (a) improving the banking sector's **ability to absorb shocks** arising from **financial and economic stress**, irrespective of reasons thereof;
- (b) improving **risk management and governance practices**; and
- (c) strengthening **banks' transparency and disclosure standards**.

Verification of Deposits

Current and saving accounts

- 1) **KYC Norms**.
- 2) Verify **balance** on sample basis
- 3) Check the **calculations of interest** on a test check basis. No interest is paid generally on current accounts by banks.
- 4) **Inoperative accounts** (both current and saving) are a high-risk area of frauds in banks. As per RBI guidelines, a savings/ current account should be treated as inoperative/dormant if there are **no transactions in the account for over a period of two years**. Verify on a sample basis some of inoperative accounts revived/closed during the year.

Term deposits

- 1) Examine whether the **deposit receipts and cash certificates** are **issued serially**.
- 2) Verify in case of **bulk deposits (Rs.2 crore and above for scheduled commercial banks presently)**, **correct rate of interest has been offered**.
- 3) In case of **closure of term deposit**, test check required **foreclosure penalty has been deducted**.
- 4) **Verify correctness of rate of interest on term deposits on sample basis**.

Bills Payable

(i) Evaluate existence, effectiveness and continuity of **ICs** over bills payable. Such controls should usually include the following:

- **Drafts, traveller's cheques**, etc. should be made out in **standard printed forms**.
- **Unused forms** should be kept under the **custody of a responsible officer**.
- Bank should have a **reliable private code** known only to the **responsible officers**
- **Signatures on a DD** should be **checked by an officer** with specimen signature book.
- All **TTs and DDs** issued by a branch should be **immediately confirmed by advices** to the **branches** concerned.

(ii) Examine **samples of o/s items** comprised in bills payable a/cs with relevant registers.

(iii) Reasons for **old o/s debits in respect of DDs or other instruments paid without advice** should be ascertained.

(iv) **Correspondence with other branches after the year-end** should be examined specially for **large value items o/s** on the balance sheet date.

Contingent Liabilities

Audit Approach

The auditor should obtain representation from management that:-

- (i) all off-balance sheet transactions **have been accounted** in the books of accounts as and when such transaction has taken place;
- (ii) all off balance sheet transactions are **supported by the underlying documents**;
- (iii) all year end contingent liabilities **have been disclosed**;
- (iv) the **estimated amounts of financial effect** of the contingent liabilities are **based on the best estimates in terms of AS 29**.

Presentation/Disclosure Requirement

1. **Claims against the bank not acknowledged as debts**
2. **Liability for partly paid investments**
3. **Liability on account of outstanding forward exchange contracts & Derivative Contracts**
4. **Guarantees given on behalf of constituents** (within India; outside India)
5. **Acceptances, endorsements and other obligations**
6. Other items for which the bank is contingently liable

Audit procedures of Contingent Liabilities

1. Ascertain whether the **accounting system** of the bank **provides for maintenance of adequate records** in respect of such obligations.
2. adequate **internal controls** to ensure that **transactions giving rise to contingent liabilities are executed only by persons authorised**.
3. Verify in case of **LCs** for import of goods, the **payment** to the overseas suppliers is **made based on shipping documents** and after ensuring that the said documents are in strict conformity with the terms of LCs.
4. Test the **completeness** of the **recorded obligations**.
5. Review whether **comfort letters** issued by the bank **has been considered** for disclosure of contingent liabilities.

Claims Against the Bank Not Acknowledged as Debts

1. Examine the **relevant evidence**, e.g., **correspondence with lawyers/ others, claimants, workers/officers, and workmen's/officers' unions**.
2. Review the **minutes of meetings** of BOD /committees, **contracts, agreements and arrangements**, to **identify claims against the bank**.
3. Ascertain from the management the **status of claims outstanding at year end**.
4. A **review of subsequent events** would also provide evidence about completeness and valuation of claims.
5. Verify **outstanding derivative contracts** like options, interest rate swaps etc with reports generated.

Guarantees Given on Behalf of Constituents

1. Ascertain **IC over issuance** of Guarantees.
2. **Control over unused guarantee forms**. (kept under custody of responsible Officer)
3. Examine **guarantee register** - whether **prescribed procedure of marking off expired guarantee is being followed or not**.
4. Check **guarantee register** - **All o/s guarantee included are disclosed**.
5. In case of **Claim** arises - **AS 29**, "Provisions, Contingent Liabilities and Contingent Assets".

Acceptances, Endorsements and Other Obligations

1. Evaluate the **adequacy of internal controls over issuance of letters of credit** and over **custody of unused LC forms** in the same manner as in the case of guarantees.
2. **Verify the balance of letters of credit** from the **register maintained** by the bank.
3. Obligation has been cast in respect of **Letter of Comfort**, **ensure the amount to be disclosed under contingent liability**.

Auditor's Report

Auditor's Report on **Nationalised Bank & SBI (Addressed to CG)**

Unaudited Branches:

Disclose details on unaudited branches, including quantification of advances, deposits, interest income, and interest expense.

Long Form Audit Report (LFAR): (30th June)

- **Applicable to all banks (including branches) and prepared by statutory branch auditors and central auditors.**

- LFAR submitted in the form of a **questionnaire** covering cash, balances, investments, advances, deposits, etc., to central auditors.

- **Consolidation** done at the **head office**;

- LFAR submitted to **management** by **central auditors**.

- **ACB reviews LFAR, takes action on irregularities, and submits copy of LFAR and related documents to RBI within 60 days.**

Other Reporting Requirements:

- Circular on Bank Frauds applies to scheduled commercial banks (excluding Regional Rural Banks).

Reports and Certificates / Special purpose certificate relating to invest

Reports and certificates issued by Central Statutory Auditors include:

- **Reconciliation of securities** by the bank.

- Assessment of **ICFR** adequacy and effectiveness.

- Long Form Audit Report (**LFAR**).

- Compliance report on **SLR** requirements.

- Verification of **income recognition, asset classification, and provisioning** adherence to RBI guidelines.

- Authentication of **capital adequacy ratio** and other ratios reported in the notes to accounts.

- Asset liability management (**ALM**).

Concurrent Audit - Audit concurrently as transaction/ activity take place

Scope of Concurrent Audit in Banks

Cash

Deposits

Advance

Investments

Foreign Exchange

House Keeping

Coverage of Business/Branches for concurrent Audit

Scope / coverage - **discretion of head of Internal Audit** with due approval of Audit Committee of Board of Directors (**ACB**)

Areas of focus in Concurrent Audit:

Cash

1. Daily cash transactions with particular reference to any abnormal/high value receipts and payments.
2. Proper accounting of inward and outward cash remittances.
3. Proper accounting of currency chest transactions, its prompt reporting to the RBI.
4. Expenses incurred by cash payment involving sizeable amount.

Investments

1. **Purchase/sale** of securities - Delegated power
2. **Purchase/ sale** - Rates beneficial to bank
3. Securities in books should be **physically held** by it
4. **Compliance with RBI/HO guidelines**

Advances

- 1) Ensure **sanction of advances** in accordance with **delegated authority**.
- 2) **Securities- properly received and registered** in name of bank.
- 3) **Proper post disbursement** supervision & follow-up
- 4) **LC issued within delegated power**
- 5) **BG issue** - properly worded & recorded in register
- 6) Classification as per **RBI** guidelines
- 7) Claims to **ECGC & DICGC** submitted in time.

Foreign Exchange

- 1) Check foreign bills **negotiated under letters of credit**.
- 2) Check whether **inward/outward remittance** have been properly accounted for.
- 3) Examine **extension and cancellation** of forward contracts for purchase and sale of foreign currency.
- 4) Ensure that **balances in Nostro accounts** in different foreign currencies are within prescribed limit.
- 5) Ensure adherence to **guidelines** issued by **RBI/HO** of bank about dealing room operations.
- 6) Ensure **verification/reconciliation** of **Nostro and Vostro** account transactions/balances.

Appointment of concurrent auditor

Own staff or external auditor - discretion of bank

ACB of bank shall **decide max. tenure** of external concurrent auditor.

- Shall **not be more than 5 years** on **continuous basis for a bank**.
- Shall **not be more than 3 years** on **continuous basis for a single branch**.

Reporting Systems in case of concurrent audit

1. There should be **zone-wise reporting of findings** of concurrent audit to **ACB** and **annual appraisal/report** of audit system should be placed **before ACB**.
2. **Before submission of report** auditor should **discuss important issues with branch manager and concerned officers**. This will enable auditor to consider opposite view point and clarify any doubts.
3. **Minor irregularities pointed** out by concurrent auditors are to be **rectified** in timely manner.
4. **Serious irregularities** should be **reported** to controlling offices/ **Head Offices** for immediate action.
5. **Whenever fraudulent transactions are detected**, they should immediately be **reported to Inspection & Audit Department (Head Office) + Chief Vigilance Officer + Branch Managers concerned (unless branch manager is involved)**.
6. **Follow-up action on concurrent audit reports** should be given high **priority** by **controlling office/Inspection and Audit Department** and rectification of features done without any loss of time.

Audit Programme to Verify advances against life insurance Policies

1. Inspect the **policies** and see whether they are **assigned** to the bank and whether **such assignment has been registered** with the insurer.
2. Examine whether **premium has been paid** and **whether policies are in force**.
3. **Certificate regarding surrender value obtained from the insurer** should be examined.
4. Check if **surrender value is subject to payment of certain premium**, the **amount of such premium has been deducted from the surrender value**.